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Ministry of the Attorney General
Ministère du Procureur général

ATTORNEY GENERAL RECEIVES REPORT BY WORKING GROUP ON TRUST COMPLIANCE

March 27, 1995

TORONTO -- Attorney General Marion Boyd today received the results of a report from the Working Group on Residential Construction Trust Compliance.

"The entire housing market will benefit from this report," Mrs. Boyd said. "We see this as a progressive step. Those who make up the industry have come together and agreed on methods to ensure that all sides are satisfied when they enter into a housing contract."

The working group, which included representatives from all segments of the housing industry, was formed by Mrs. Boyd in November 1993, in response to concerns raised by industry-wide problems of trust fund mismanagement. The importance of this issue, which involves home buyers, investors, builders, trades, and suppliers, centred on regulations regarding funds in the *Construction Lien Act* that were, in many cases, either ignored or misunderstood. Such lack of compliance often meant that funds were no longer available to pay costs, resulting in legal actions and delays for the home buyer.

Of key concern to the Attorney General was the apparent serious lack of knowledge about the trust rights and obligations of all parties in the residential construction sector. The trust provisions of the *Construction Lien Act* were designed to prevent such problems. The act requires builders to hold funds in trust to guarantee payment of trades, suppliers and labourers. Until they are paid, the funds may not be used for other purposes.

"The recommendations in the report will hopefully stimulate the housing sector by creating a positive and dependable financial relationship between builders, trades and suppliers. Also, the development of accepted industry-wide trust compliance techniques will provide a sense of comfort to financial lenders and go a long way to alleviate their concerns regarding third party liability for breeches of trust," Mrs. Boyd said.

The report reflects a unanimous consensus of the working group that there is a serious lack of knowledge of the trust obligations under the act and of proper and proven credit management practices. Addressing these and other issues, the report makes 10 recommendations to deal with this problem, including an aggressive education program, the development of standard contract terms, compliance enforcement strategies and exploring approaches to trust monitoring and bonding.

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Background information and copies of the report are available on request.

Ce document est également disponible en français.

RCTC THE ATTORNEY GENERAL'S WORKING GROUP ON RESIDENTIAL CONSTRUCTION TRUST COMPLIANCE UNDER THE *CONSTRUCTION LIEN ACT*

Suite 700, 720 Bay Street, Toronto M5G 2K1

LETTER OF TRANSMITTAL

February 8, 1995

The Honourable Marion Boyd
Attorney General for Ontario

On behalf of the members of your Working Group on Residential Construction Trust Compliance under the *Construction Lien Act*, R.S.O. 1990, c. C.30, as amended, we now have the honour to submit our Report. The Group was formed at your request on November 22, 1993 to explore suitable ways to achieve trust compliance consistent with the provisions of the *Construction Lien Act* to ensure the future health of the residential sector in the construction industry.

This Report represents areas where consensus was achieved and is endorsed by all the members of the Working Group. It represents a pragmatic approach that avoids government intervention and is intended to modify behaviour by addressing and correcting industry practices in a minimally intrusive manner. The Group thinks this is a progressive step as the industry itself is determining the appropriate measures.

The Residential Construction Trade and Supply Association of Ontario was instrumental in having the Working Group formed. The focus of this Association's concern was the apparent non-compliance with the trust provisions of the *Construction Lien Act* by the entire residential construction industry. Initially, there were widely divergent views as to the nature and extent of the problem. This was anticipated by your predecessor, the Honourable Howard Hampton, when he wrote:

> "The construction industry has many dimensions and what would be beneficial to one interest might be seriously detrimental to another."

Based on anecdotal evidence, it was clear that breach of trust was endemic to the industry because of lack of knowledge, poor credit management and, in isolated instances, wilful breach. Representations were made to the Group on behalf of the Institute of Chartered

Accountants of Ontario, the Canadian Banking Association, unions, the Ontario New Home Warranty Program ("ONHWP"), bonding and surety associations, the Credit Institute of Canada, trade and builders' associations and lawyers and their associations (see attached list of Working Group Members).

Various presentations were made by the different interest groups, followed by the striking of subcommittees to examine specific issues and potential remedies. A summary of the findings of each subcommittee along with recommendations is attached. Of the nine issues/options examined, three are recommended for immediate action: training and education, credit management, and standard contract terms.

All members of the Working Group thank you for your wisdom in establishing this Working Group. We also thank the Institute of Chartered Accountants of Ontario for hosting the eight dinner meetings.

Yours sincerely,

Derek R. Freeman

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EXECUTIVE SUMMARY

The Working Group was established to find ways to achieve compliance with the provisions of the *Construction Lien Act* in the residential construction industry. The Working Group was presented with specific examples of the kinds of incidents of abuse and breaches of trust that occur in the industry, particularly in the Toronto area. However, it was hampered by the lack of sound empirical data that could be used to fully evaluate the issue. There was unanimous agreement concerning poor business practices throughout the industry and lack of knowledge concerning the *Act*.

The many issues, options and potential solutions were reduced to nine and the Working Group then divided the nine issues/options amongst sub-committees struck to examine them based on an agreed upon methodology (reproduced below at page 9). In considering ways to improve compliance with the trust provisions, the Working Group tried to be sensitive to the full range of consequences that specific proposals might have.

This report summarizes the conclusions and sets out the Working Group's specific recommendations.

SUMMARY OF CONCEPTS AND RECOMMENDATIONS

The Working Group variously makes the following observations and recommendations.

1. Education

There is a serious lack of knowledge of the "trust" rights and obligations of parties in the residential construction sector. This lack of knowledge is a major cause of failure to comply. There should be education of the residential industry and its advisors to eliminate the lack of knowledge of the trust obligations (and to facilitate the right to information) under the *Act,* directed to builders, trades, lawyers accountants and bankers. The education about the "trusts" could be achieved by an industry-wide program utilizing seminars, workshops, trade and professional publications (including, if possible, pamphlets available through all Bank branches) combined with public service dissemination of information.

2. Credit Management

There is a serious lack of knowledge of proper and proven credit management practices by parties in the residential sector. The under-utilization of proven credit management practice contributes significantly to losses by parties in the residential sector. To correct this, there

should be an active industry-wide program utilizing seminars, workshops, trade and professional publications (including, if possible, pamphlets available through all Bank branches), combined with public service dissemination of information to develop proper and proven credit management practices in the industry to address poor credit management practices.

3. Standard Contract Terms

To establish reasonable standards for credit in the residential industry, to greatly reduce the temptation of parties to misuse trust moneys by delaying payment, to reduce disputes caused by unclear contract terms, and to ensure quick expert determination of disputes, the builders' and trade organizations should establish a committee to develop standard contract terms. Features that would be incorporated into these standard contract terms include: (i) reasonable terms of credit; and, (ii) an arbitration process.

4. Compliance Enforcement through Litigation

Prosecution of trust offenders would deter others. Historically, there has been little use of either the civil or criminal process against trust offenders. Most recently, where groups of trades and suppliers have acted in concert in dealing with specific projects they have been successful. Trades and suppliers could consider acting together in problem situations.

5. Trust Monitoring

Representatives of the home builders' associations, the trades and supply associations, the Canadian Bankers' Association and the Surety Association of Canada should work together to explore the development and marketing of a cost effective standardized trust monitor approach for adoption on a voluntary basis by medium and large builders and trades.

6. Bonding

The Surety Association of Canada should work with representatives of the home builders' associations, the trades and supply associations, the Canadian Bankers' Association and the Ontario New Home Warranty program, to explore the development of a bonding package for medium and large builders and for trades in the residential industry.

7. Software Accounting

The technology exists to create an accounting software package that would assist in trust compliance. However, in the absence of a financial sponsor or demonstrable market demand, it does not appear that there will be a suitable software package available in the near future.

8. Legislative Change

There should be no legislative change to the trust provisions of the *Act* at this time. There should be a test period to determine if the implementation of the recommendations in this report results in increased trust compliance. In January 1996, the Ministry of the Attorney General should convene a meeting of representatives of the organizations represented on this Working Group for the purpose of determining whether further action is needed.

9. Screening by the Ontario New Home Warranty Program

The Ontario New Home Warranty Program should continue with its recent initiative to determine (and monitor on an ongoing basis) the risk factors related to failures by builders to meet their obligations to consumers so that insurance risks can be minimized. The Ontario New Home Warranty Program should also continue its newly established dialogue with the trades and with all segments of the residential industry to promote honesty and integrity.

10. Oversight Committee

The Greater Toronto Home Builders' Association and the Residential Trades and Supply Association of Ontario, jointly, should establish an oversight committee. It will monitor the implementation of the above recommendations and ensure the active flow of communications between the various stakeholders, with a view to providing an assessment to the Ministry in January, 1996. The committee would be open to all the present members/constituencies of the Working Group, as well as other parties as their interests dictate.

REPORT IN DETAIL

GENERAL INTRODUCTION AND BACKGROUND

The residential construction industry is one of Ontario's largest economic sectors — a multi-billion dollar industry employing hundreds of thousands of workers in many thousands of companies and sole proprietorships. The total dollar volume and numbers of people and organizations within the industry speaks of its importance, both economically and socially, to the Province and the interest in ensuring the industry's health and smooth functioning. Any policy-making directed toward this industry must be mindful of the diversity, complexity and competitiveness of the industry.

When the housing boom of the 1980's came to an abrupt end in 1989, a chain of events began that spelled disaster for a great many businesses. Builders carrying an inventory of serviced lots saw the lots' value plunge by as much as 50 percent, and sometimes more. At the same time, purchasers were walking away from deposits and refusing to close on completed houses. And finally, stung by huge failures in the industrial and commercial side of their real estate portfolio, banks became increasingly wary about extending credit.

As one moves from diagnosis to cure, the complicating factor of diversity in the industry becomes even more apparent. Home building companies range from publicly traded corporations to family businesses where accounts are literally kept in shoe boxes and contracts are agreed to verbally and sealed with handshake. A similar range applies to trades, subtrades and suppliers as well as renovation contractors. Beyond these differences in sophistication and volume, companies also sort themselves out by less tangible (but no less real) qualities that can best be summarized as business ethics. Like most other industries, companies and businesses involved in residential construction range from those that scrupulously respect their contractual obligations to those that are deliberately bent on preying upon the unsuspecting or desperate. We believe the wisest and most cost effective course of action is to find ways to positively influence the behaviour of companies that fall in the grey area between these extremes to improve their trust compliance and thus to make the unscrupulous predators more conspicuous.

The Working Group was presented with specific examples of the kinds of incidents of abuse and breaches of trust that occur from time to time. The Working Group was also presented with anecdotal (but uncontested) evidence of poor business practices throughout the industry. This focused largely on a lack of knowledge of legal obligations, rights and remedies as well as inattention to basic principles of credit management. Although empirical data about the nature and extent of the problem was not available for analysis, it was generally agreed that the problem exists and warrants immediate attention. Finally, in terms of understanding the problem, the Working Group was aware of the catastrophic effect of the recession and its aftermath.

In considering ways to improve compliance with the trust provisions, the Working Group tried to be sensitive to the full range of consequences that specific proposals may have. The Group did not feel that it could support solutions that would impose onerous costs on smaller companies or on any one group. Nor did if feel justified in recommending universal approaches that would add to the costs of companies already honouring their commitments.

The Working Group reached the general conclusion that the current trust provisions in the *Construction Lien Act* can be of greater practical value provided:

1. there is increased industry-wide understanding of the obligations, rights and remedies provided in the *Act*;
2. effective credit management is widely practised;
3. the associations of home-builders and the trades and supply associations work together and with the other partners in the residential sector to develop standard credit and arbitration terms; and
4. the opportunities for non-compliance are limited.

The recommendations that follow outline approaches that can help achieve a desired level of awareness of the law and credit management. The report also discusses steps, such as standard contracts and alternative dispute resolution, that support effective use of legal rights and remedies. In addition, it describes a few more intrusive interventions, such as bonding. Such interventions may be explored further by interested parties and tried on a voluntary basis to test their effectiveness and feasibility (for example, bonding has worked well in a few situations at the top tier). The report also recommends a number of specific activities for joint action by home builders' associations and trades and supply associations. The report discusses how non-compliance can be meaningfully deterred.

TRUST PROVISIONS

Before proceeding with a discussion of the Working Group's detailed observations and recommendations, we briefly review the relevant trust provisions in the *Construction Lien Act* in the context of the residential construction industry.

Although the structure of residential building projects is usually less complex than industrial, commercial and institutional construction projects, work done on the improvement of land may be a complex and multi-layered undertaking. The relationship between the owner of land and the various contracting parties to the improvement is usually described as the construction pyramid. At the apex is the owner of the land (or the builder, or builder-developer, who acts as a general contractor). Below the builder are layers of subcontractors, suppliers and workers. Funds for the improvement enter the pyramid at the top (coming from owner's

equity, land mortgages, construction financing and sale proceeds) and flow down through the pyramid as the work progresses.

Given the structure of the construction pyramid and the direction of the flow of funds, ordinary contractual remedies often are ineffective when problems between non-contracting parties arise. If a party higher up the pyramid refuses or is unable to pay for work that has been done, this obviously disrupts the flow of funds. The problem for those at the bottom of the pyramid who are not being paid by their contractor is that they may have no contractual claim against those higher up who are responsible for the non-payment.

The lien legislation, therefore, is intended to provide remedies that go beyond contractual rights. It does this by creating two types of statutory rights. The lien is a right over the owner's premises in favour of persons who supply services and materials to improve the owner's premises. The trust rights give protection to contractors, subcontractors, trades and workers in cases where the owner, contractors, subcontractors or trades higher in the pyramid improperly divert the flow of funds.

Part II of the *Act* sets out the trust provisions. The following is a layperson's guide to the relevant sections. Readers are referred to the *Act* for the exact wording of the sections and, of course, to the numerous articles and court decisions for a detailed interpretation of the full import of the legislation.

Owner's Trust

Subsection 7(1) provides that monies received by the owner with a view to improving the land constitute a trust for the benefit of all parties supplying services or materials for that improvement. The subsection allows, however, that the owner may use the money to purchase and clear title on the land. It is the balance of monies, after the land has been purchased, that constitutes a trust.

Certificate Trust

Subsection 7(2) deals with situations in which the owner is financing the improvement out of his/her own funds. Essentially it provides that an amount, whenever it is received by the owner, that is equal to the amount payable under the contract constitutes a trust.

Substantial Performance Trust

Subsection 7(3) establishes that any amount, whenever it is received by the owner, equal to the unpaid price of a substantially performed contract constitutes a trust.

Generally

Subsection 7(4) states that the owner cannot put the monies constituting a trust to any use that is inconsistent with the trust until all amounts owing to the contractor have been paid.

Draws Trust

Subsection 8(1) establishes the trust through the rest of the construction pyramid. It provides that all amounts owing (whether or not due or payable) and all amounts received by a contractor or subcontractor constitute a trust for those who are lower in the pyramid.

Generally

Subsection 8(2) sets out obligations for the contractors and subcontractors who have received funds. These obligations are equivalent to those set out for the owner in Subsection 7(4).

Vendor's Trust

Subsection 9(1) deals with situations in which the owner sells his or her interest in the land. It provides that the value of the sale, less reasonable expenses and any amount required to discharge the mortgage, constitutes a trust.

Generally

Subsection 9(2) establishes that the former owner is the trustee of the trust and has equivalent obligations as set out in 7(4).

Payment Discharging Trust

Section 10 establishes that any payment for services or materials that is made by a trustee discharges the trustee's obligations to the extent of the payment, subject to the part of the *Act* that requires a 10% holdback be maintained.

Where Trust Funds may be Reduced

Subsection 11(1) provides that a trustee using monies that are not subject to a trust to make payments for services or materials may retain trust funds equal to the amount of the payment.

Subsection 11(2) establishes that if a loan is used to make the payment in 11(1), the trust funds may be used to discharge the loan.

Set-Off by Trustee

Section 12 provides that trust funds can be retained by the trustee as a set-off against debts, claims or damages between the trustee and the party the trustee is liable to pay. The debts, claims or damages need not be related to the improvement.

Liability for Breach of Trust

Section 13 deals with liability for breach of trust and captures the officers and directors and anyone in effective control of a corporate trustee which is in breach.

Although the trust provisions are designed, as noted above, to provide reasonable protection, they are not failsafe. As the then Attorney General, the Honourable Roy McMurtry stated in his forward to the 1980 discussion paper on the Draft Construction Lien Act, "Most of the problems of the construction industry cannot be solved by legislation."

COMMITTEE PROCESS AND MEETINGS

The Working Group met eight times: February 9, April 6, April 27, June 1, July 6, October 5, November 2, 1994 and February 8, 1995.

To facilitate the examination and evaluation of the issues, options and solutions for achieving trust compliance, the Working Group divided itself into several subcommittees: Bonding, Software in Accounting, Trust Fund Monitor, The Oxbow Fund/Enforcement Approach, and Mush (Alternative Dispute Resolution and Education).

Each subcommittee undertook to examine one or more of the options to increase trust compliance and to report back to the Working Group as a whole. The Working Group established a methodology for considering and evaluating each set of options which were to apply across the industry. They were:

1. Define the terms of each of the options considered.

2. Consider and describe the effect of implementation of each option on:

   - the honest business-people who make up the majority in the construction industry;

   - those who are opportunists in the industry, that is, those who will take advantage of others when that is common in the industry but who will behave properly when proper behaviour is the rule; and,

   - those who are dishonest or defaulters.

3. What should the Working Group do to implement each recommended option?

4. What will it cost? Who will pay? Is legislation required?

* * *

Reports of each Subcommittee are available from the Ministry of the Attorney General.

RECOMMENDATIONS AND EXPLANATION

The Working Group presents the body of its report by setting out its recommendations followed by an explanation.

1. EDUCATION

To eliminate lack of knowledge of the trust obligations as a factor in failure to comply, it is recommended that there be education of the residential industry and its advisers, in particular:

- The Ontario Home Builders' Association and the Greater Toronto Home Builders' Association continue their recent initiatives of holding workshops on trust obligations for builders and trades and bring to the attention of their members the recommendations of the Working Group.

- The Ontario New Home Warranty Program continue with its recent initiative of inquiring at interviews with new builders whether there is awareness of trust obligations. ONHWP will also include trust information in future workshops on appropriate business subjects developed for builders.

- The Institute of Chartered Accountants of Ontario, the Society of Management Accountants of Ontario, the Certified General Accountants Association of Ontario, the Canadian Bar Association - Ontario, and the Law Society of Upper Canada - Continuing Legal Education section at least annually remind their members of the trust obligations of their builder and trade clients.

- The Banking industry (in co-operation with the builders, trades and Ministry) allow helpful pamphlets to be distributed at their branches.

- The Ministry of the Attorney General help ensure that those in the residential construction industry know the trust rights and obligations of builders and trades and the personal liability of directors, officers of a corporation and those who have effective control of a corporation that breaches its trust obligations :

    - request the Toronto Construction Association to set out the trust rights and obligations in its popular booklet, "A Layman's Guide to Construction Liens in Ontario", when that booklet is revised;

    - request that the Daily Commercial News publish an article on the Report's conclusions;

- make available to local newspapers and to the non-English press a short synopsis on trust compliance;

- The Ontario Home Builders' Association publish an 800-1200 word piece on trust compliance in its magazine on a regular basis.

EXPLANATION:

It was agreed by the Working Group that the problem is in large part that most builders, trades, suppliers, accountants, bankers and lawyers do not know, in detail or at all, about the trust requirements of sections 7, 8 and 9 of the *Act* and the effect of section 13. As a result of the work of this Committee awareness has increased.

Section 7 requires that money received to finance a project by an owner (builder/vendor) is a trust fund for the benefit of the contractor (in residential construction the trades). Section 8 constitutes all receivables by a contractor or subcontractor trust fund for trades or suppliers with whom the contractor or subcontractor has contracted. Section 9 constitutes the money received by the owner (builder/vendor) on the sale of a building a trust fund for the benefit of the contractor (trades). Those holding trust funds may not appropriate them to their own use until they have paid their trades or suppliers. Section 13 provides that in addition to the persons who are otherwise liable in an action for breach of trust, every director or officer of a corporation and any person who has effective control of a corporation or its relevant activities, who is involved in conduct that he or she knows or reasonably ought to know amounts to a breach of trust by the corporation, is liable for the breach of trust.

Given this lack of knowledge, failure to comply is not surprising. The Working Group has recognized the need for education and its members have begun the process of informing the industry.

The industry will need periodic reminders. In order to be effective, information about trust obligations must be repeated. Repetition will allow the message to reach a broader audience. Industry organizations can play an important role in repeating the trust compliance message. While compliance is required by law, the Working Group believes that it is possible to turn compliance into an economic advantage.

How will education affect the honest business people, the opportunists and those who default in their obligations? Honest business people promptly meet their obligations and may be better off if their competitors have to pay theirs.

It is felt that the opportunists are now beginning to be more aware of their obligations and potential liabilities and the growing chance that they will get caught breaching their trust obligations.

The dishonest defaulters will probably continue to try to get away with mishandling funds. Education programs may alter the market so that it is easier to detect these defaulters and may limit their opportunity for non-compliance.

2. CREDIT MANAGEMENT

It is recommended that organizations of residential trades assist their members to increase their knowledge and utilization of proven credit management techniques. It is also recommended that the organizations work with credit reporting organizations to increase trade participation in supplying information to credit reporting organizations and in using credit reports.

EXPLANATION:

Credit management techniques enable the trades to better assess a builder's financial situation and business practices i.e. the total dollar amount of a builder's payables, the aging of those accounts and whether amounts owing are being paid, if at all.

There are many proven credit management techniques available through commercial credit reporting organizations and the information provided is not difficult to understand. The problem is that many tradespeople are unaware of these services and the information provided.

In addition, credit reports are not as reliable as they could be if the residential construction industry provided them with sufficient information. In an effort to improve their information supply, many credit reporting organizations are trying to form alliances with trade and builder associations. Where builders fail to supply credit information, the trades may be a useful source of information about who owes them money and when it is due.

The Working Group also considered the possibility of credit management through the use of statutory declarations. Statutory declarations are statements by trades and suppliers that they have been paid. They were required under the *Mechanics Lien Act* prior to 1984 as protection from trust claims. They have continued as matters of practice in the trade although they are unnecessary and provide no protection to anyone. The Working Group rejected the use of statutory declarations because they are administratively cumbersome, and more importantly, if you require someone to fill out a paper saying they have been paid as a condition of being paid, people will lie.

What will be the effect of the trades' use of improved credit management techniques on the honest business people, the opportunists and the defaulters?

Improved credit management techniques will simply confirm that the honest business people are meeting their trust obligations in a timely manner. They may further benefit where credit reporting information indicates which of their competitors are not doing the same.

Opportunists will recognize that whatever course of action they follow will be reflected in the credit reports which are widely circulated throughout the industry.

Use of improved credit management techniques will enable trades/suppliers to more readily identify who the defaulters are. Defaulters' poor business practices will either be reflected in the credit reports or conspicuous by the absence of any credit information.

3. STANDARD CONTRACT TERMS

To establish reasonable standards for credit in the residential industry, to greatly reduce the temptation of parties to misuse trust moneys by delaying payment, to reduce disputes caused by unclear contract terms, and to ensure quick expert determination of disputes, it is recommended that the builders' and trade organizations establish a committee to develop standard contract terms. These terms would establish the industry standard and would be recommended by home builder and trade associations to their members, but would not be compulsory.

- Features that should be incorporated into this standard contract terms include

    - reasonable terms of credit; and,
    - an arbitration/quick resolution process.

- The industry committee be composed of representatives of the home builders' associations and the trades' associations. The Canadian Bankers Association, the Canadian Bar Association - Ontario, Construction Associations and an expert in non-court dispute resolution systems (such as ADR) also be invited to participate.

EXPLANATION:

For a variety of socio-economic reasons, years ago in Ontario, builders, trades and suppliers had a more clear understanding about terms of credit, quality of work and payment. Complying with these understandings was a matter of honour. Some builders and trades still

operate on these understandings. Unfortunately, given the rapid growth and diversification of the economy, many no longer operate this way.

Recently, contracts with extended payment terms have become more common. They compromise the payment process and can result in breaches of trust. Extended payment terms have enabled and encouraged those holding trust money to reinvest the proceeds of sale. Any decline in the investment jeopardizes the payment of monies owed to trades/suppliers.

To reduce disputes caused by unclear contract terms and to ensure quick, expert determination of disputes, it is recommended that a committee be established to develop a standard form contract or contracts providing for short terms of credit and arbitration (or other speedy means of resolution).

With standardized short credit terms, longer credit terms would become a clear signal to trades that contracting with that builder or supplying material to a trade could be trouble. With short credit terms as the industry norm, the opportunity for creditors to reinvest proceeds of sale would be reduced. Breach of trust would be reduced.

Litigation is not considered an effective debt collection mechanism for trades/suppliers or for builders to get trades to comply with contract and building code standards. The court process is costly and slow.

If disputes arise, the arbitration process can be a more expeditious and timely procedure for resolving disputes. What would take years in court may be resolved in months with arbitration. Parties would be able to choose from a list of trained arbitrators with experience in the residential construction industry. The speed of a hearing and the expertise of the arbitrators would discourage unmeritorious claims and counterclaims. Those claims that are meritorious would often be settled early.

Industry associations could provide an additional service to meet the specific needs of their membership. The non-mandatory nature of standard contracts/terms fits well with the complex nature of the industry. In addition, standard contract/terms would provide a measure of industry expectations even where no written contract exists.

How will these standard contract terms affect the honest business people, the opportunists and those who default in their obligations?

The honest business people already pay their trades and suppliers promptly. They may, however, benefit if the market forces their competitors do the same. Further, they are less likely to have to waste their time and money responding to unnecessary litigation. For legitimate disputes that do arise, arbitration provides for their efficient resolution.

Industry opportunists will follow the leaders in using standardized contract terms.

If defaulters adopt these standardized terms, the opportunity to reinvest proceeds of sales will be greatly reduced as will the potential for breach of trust. Those who choose not to adopt standardized short credit and arbitrations terms will be sending a clear signal to others that may do business with them. Prudent business people will heed the warning. The industry has little sympathy for fools.

4. COMPLIANCE ENFORCEMENT THROUGH LITIGATION

Because fear of consequences is one element in gaining compliance with the trust provisions, it was considered that there be civil actions and criminal prosecutions when these are appropriate. More particularly, where groups of trades and suppliers have acted in concert in dealing with specific projects they have been successful. Trades and suppliers could consider acting together in problem situations.

EXPLANATION:

Trades and suppliers on a specific project have an economic incentive to pursue breach of trust litigation. By acting in concert, litigation becomes more economically viable as the costs can be spread over a number of companies. Already, the industry has seen a number of cases where this type of joint action has proved successful.

A few well-publicized civil actions and criminal prosecutions could serve as a deterrent against future instances of non-compliance by other companies (there are a few already before the courts). As well, these cases may result in valuable precedents which would reduce some of the uncertainty currently surrounding breach of trust litigation.

What would be the effect of these recommendations on the honest business people, the opportunists and the defaulters?

The deterrent effect of these recommendation would impose no additional burdens on the honest business people who are already in compliance with the *Act*. Prosecutions of those who have been guilty of criminal conduct will have a deterrent effect.

The deterrent effect of litigation would encourage trust compliance in the industry. Accordingly, the opportunists would modify their behaviour to comply with industry norms.

The very real risk that defaulters may be the subject of litigation may result in a change in their behaviour or their departure from the industry.

5. TRUST MONITORING

The Working Group finds that a trust monitor system may be suitable for some builders and trades.

The Working Group recommends that representatives of the Home Builders' Associations, the Trades, the Canadian Bankers' Association, the Surety Association of Canada work together to explore the development of a cost effective standardized trust monitor approach for adoption on a voluntary basis by builders and trades.

In a trust monitor approach, an independent individual (e.g. a quantum surveyor, engineer, lawyer or accountant) or organization (e.g. a trust company) holds mortgage rights on behalf of the trades and suppliers on a project, makes payments on behalf of the builder in accordance with the contracts with the trades and monitors the flow of funds with respect to a project.

EXPLANATION:

The idea of a trust monitor is simple. The intent is to establish an administrative process designed to ensure compliance with the trust provisions. The builder or trade hires someone trustworthy to receive proceeds of house sales and pay it out to the trades and suppliers in accordance with their contracts.

One model is as follows:

1. Before a project can begin, a meeting would be held among all the trades, suppliers, the builder's lawyer, the builder's bank, any mortgage holders, and the lawyer, accountant or trust company that has agreed to be the monitor.

   At this meeting, the following are established:

   (a) the amount the bank and mortgage holders require to be discharged per lot;

   (b) the blanket mortgage in favour of all trades/suppliers which shall be place on the land by the monitor, behind the bank and all other mortgages, which shall be discharged on a per lot basis; and,

   (c) the accepted payment, and notification procedures to be used by the monitor to all trades and suppliers.

2. All mortgage discharges are to be provided to the vendor's lawyer subject to an undertaking to transfer the money on closing to the monitor.

3. Prior to the closing, the monitor would receive a payment schedule from the builder and trade.

4. The monitor would then circulate the schedule to all parties prior to closing, on the understanding that the payments are to be made according to the schedule unless a trade/supplier notifies the monitor of a discrepancy prior to closing.

5. Any amount under dispute e.g. hold-backs, etc. would be taken to court or arbitrated.

6. Upon closing, the vendor's lawyer would pay the bank and mortgage holders for mortgage outstanding, and the government for GST owing. The remaining funds would be given to the "Monitor".

7. The Monitor would then pay all trades according to the payment schedule.

8. The amount remaining after payment of trades/suppliers would be given to the builder and prime contractors.

9. In the event that there were insufficient funds to a pay all trades, the payments would be made on a proportionate basis.

   Most trades would get paid only after closing. Those trades who performed their work at the earliest stages of construction (e.g. excavation, forming) might require earlier payment than closing, in which case, the funds paid would be deducted from the schedule of payments.

The Working Group is of the view that the voluntary use by a builder or trade of a "trust monitor", would improve compliance with trust obligations and in many medium or large projects could be economically viable. The economic costs and benefits of monitoring have yet to be measured.

The benefits of trust monitoring to a builder would be the assurance of trust compliance and possible cost benefits from reduced prices from trades because of secured payment and easier financing.

Although trust monitoring would result in the participants precisely following the trust provisions, it could prove very costly to the industry and to consumers if imposed by government. The development by the industry, on its own, of a voluntary trust monitoring model, may result in a model that is cost effective and minimally intrusive.

6. BONDING

The Working Group finds that while bonding is not practical and economical for the majority of builders and trades, it may have a role in some projects.

The Working Group recommends that the Surety Association of Canada work with representatives of the Ontario Home Builders' Associations, the trades, the Canadian Bankers' Association and the Ontario New Home Warranty Program, to explore for the residential industry a bonding package in which a surety would guarantee quality trade performance and would guarantee payment by the builder.

A bonding package of this kind would effectively ensure that there would not be breach of trust and might be financially viable in certain medium to large size projects depending on the availability and cost of bonds. In practice the surety would be a monitor of the funds coming into the project and funds being used to pay trades. The guarantee feature might be attractive to financial institutions lending money to trades.

EXPLANATION:

A bond is a three party agreement between a builder, a contractor and a bonding company (surety). A balanced bonding package could be developed in which a surety would guarantee both quality trade performance and payment by the builder. On one side, a payment bond would guarantee the payment by the builder to the trades. On the other side, a performance bond would back up a promise from each trade that the builder would be indemnified for any loss stemming from the failure of the trade to perform the work according to contract.

Effectively, the surety would be a monitor of funds coming into the project and funds being used to pay the trades.

Although the primary function of a bond is to ensure the completion of a contract, payment bonds by their very nature would encourage trust compliance. In this regard, bonding and monitoring has been successfully applied in the residential construction industry on government sponsored non-profit projects. These projects have been large and have government guarantees so bonding costs have been much lower than what could reasonably be expected in the private sector.

In addition, bonding would encourage a builder/contractor to maintain a satisfactory accounting system to insure bond obligations are met. Further, the guarantee feature of the bonding package might be attractive to financial institutions lending money to trades. However, if bonding became mandatory, companies unable to get bonding would either go out of business or operate illegally which would have very serious consequences for competitiveness and pricing.

The Working Group rejected the possibility of requiring mandatory bonding for all builders and trades as the cost and complexities of this proposal appeared to outweigh any potential gains in trust compliance. First, to change the current process, massive education would be required. Most players in the industry are not any more familiar with bonding than they are with the *Construction Lien Act*. Second, if bonding/monitoring were to be made mandatory it would require major legislative change and a registry office would have to be established to enforce bonding and monitoring. This is because the cost of a bond would become a competitive item and there would be an incentive for builders and trades not to bond. Third, the bonding/monitoring solution would be too expensive for small projects (adding a minimum 5 to 8 per cent to the sale price). The cost-benefit effect on larger projects has yet to be measured.

However, as a business proposition, the Working Group believes, that bonding of some projects might make sense and therefore should be considered further by the industry.

7. SOFTWARE ACCOUNTING

At this time there does not appear to be sufficient cause or demand to warrant the development of a software accounting system specifically to improve trust compliance.

EXPLANATION:

A number of large and mid-sized builders are already using a U.S. software accounting system. Among other things, the system assists them in meeting their trust obligations. However, this software would be prohibitively expensive for small builders and trades. The cost of the system was approximately $150,000 including the cost to convert the system to deal with GST and other Canadian requirements.

A Canadian software company has indicated that it would not be difficult to design a software system for the small builder or trade. The Working Group was of the view that a software accounting system would improve trust compliance. It is also of the view that if a significant proportion of the industry wished to use such a system, it could be developed at a reasonable cost.

While the technology exists to create an accounting software package that would assist in trust compliance, in the absence of a financial sponsor or demonstrable market demand, it does not appear that there will be a suitable software package available in the near future.

8. LEGISLATIVE CHANGE

The Working Group unanimously recommends that there should be no legislative change to the trust provisions of the *Act* at this time. There should be a test period to determine if the implementation of the recommendations in this report results in increased trust compliance. In January 1996, the Ministry of the Attorney General should convene a meeting of representatives of the organizations represented on this Working Group for the purpose of determining whether there has been substantial improvement in trust compliance, and to determine if there is a need for government action.

EXPLANATION:

The main problem with the trust compliance provisions in the *Construction Lien Act* lies not with the legislation itself, but with the difficulties associated with proving a trust claim.

While there is still room for improvement, the existing provisions of the *Construction Lien Act* provide substantial protection to members of the construction industry:

- Certain funds in the hands of owners (including certain payables) constitute trust funds for the benefit of contractors.

- Receivables of a contractor or subcontractor on a construction project constitute trust funds for the benefit of companies owed money under a contract or subcontract with that person on the project.

- Officers, directors and management of companies in the construction pyramid who caused their companies to breach these trust obligations can become personally liable for breach of trust.

- The effect of these provisions is to set the proceeds of a construction project apart from the assets of members of the construction pyramid in the event of bankruptcy or competing claims, and to provide a means of tracing the movement of such funds out of the company so as to allow for their recovery.

- In addition, trust claimants who have also proved a lien have a super priority as against their payers in the contractual claim.

- The *Construction Lien Act* also provides for the appointment of a trustee to act as a receiver and manager of a construction project. The use of such receiver would, no doubt, improve the chances of trust claimants being paid in a proper case.

Furthermore, the trust provisions of the *Construction Lien Act* have an impact on other legislation:

- Construction trust funds are not seizable by judgment creditors pursuant to execution or garnishment.

- Trust claimants may be able to defeat claims by banks and other lenders pursuant to PPSA secured interests.

- By virtue of section 336 of the *Criminal Code*, breach of the *Construction Lien Act* trust can be an indictable offence punishable by up to 14 years in jail.

- The trust provisions of the *Construction Lien Act* may have an effect on the distribution of the proceeds of the estate of a bankrupt, and the fact of the existence of a breach of trust may be used to oppose discharge.

- Furthermore, breach of trust may allow a construction creditor to sue a bankrupt (including a bankrupt officer or director) notwithstanding the fact of the bankruptcy.

The difficulty, however, lies in proving a breach of trust claim. Unlike a simple contract claim where the claimant knows the value of the goods and materials it supplied, a trust claimant must prove, in addition, that there was in fact a breach of trust, which is not always the case even where an account remains unpaid. Legal and accounting fees can mount up quickly in a breach of trust action, as can exposure to pay the legal fees of the successful defendant in a breach of trust claim. In addition, its hard to motivate people to prosecute, when prosecution does not mean payment.

While legislative changes may be necessary in the future, the recommendations in this report contemplate achievement of trust compliance through changes in industry practice. Members of residential construction industry are in a better position to identify and take responsibility for the problems with trust compliance in their industry. Such non-mandated recommendations fit better with the complex nature of the industry and are more likely to be readily received.

By meeting in 1996 with those organizations represented in the Working Group, the Government will be able to determine whether improvement in trust compliance has been

achieved in the industry. It can determine to what extent the recommendations in this report have been implemented, whether they have been successful and where additional measures are needed.

What will be the effect of this recommendation on the honest business people, the opportunists and the defaulters?

The honest business people who already promptly meet their trust obligations will not have to change their behaviour or deal with any additional red tape. They may, however, benefit from a more level playing field as their practices become the industry norm.

The opportunists will recognize that trust compliance is the industry norm and modify their behaviour accordingly.

The defaulters will be under pressure to comply with industry norms as changes in industry practice will make their behaviour more readily identifiable.

9. SCREENING BY THE ONTARIO NEW HOME WARRANTY PROGRAM

The Working Group recommends that the Ontario New Home Warranty Program continue with its recent initiative to determine (and monitor on an ongoing basis) the risk factors related to failures by builders to meet their obligations to consumers so that insurance risks can be minimized. The Ontario New Home Warranty Program also continue its newly established dialogue with the trades and with all segments of the residential industry to promote honesty and integrity.

EXPLANATION:

The Ontario New Home Warranty Program ("ONHWP") originated as an industry-driven quality control mechanism. The focus of the ONHWP is consumer protection. It provides for the mandatory registration of home builders so as to enforce warranty protection for homeowners purchasing a new home.

ONHWP is a private, self-insuring, non-profit corporation. The corporation and its guarantee funds are financed solely from annual builder registration fees and home enrolment fees (usually passed directly on to the home buyer). To further mitigate risk ONHWP may hold security, limit production (enrolments), invoke inspection requirements, and require training as terms and conditions of registration.

Although registration is mandatory, the Act puts the onus on the Registrar to register an applicant unless there are financial, integrity or technical reasons to refuse. Market forces and home buyer/homeowner awareness also tend to drive the need to be registered. Despite the mandatory nature of the legislation, ONHWP estimates 10 to 15% of builders remain unregistered (the "rogue factor").

The Working Group considered the possibility of using the ONHWP as a model for creating an agency to enforce the trust provisions of the *Construction Lien Act*. However, this proposal was ultimately rejected as being too costly and ineffective. As the home building industry is one of the largest industries in the province, a monitoring/enforcement agency to track the trust compliance of all players would be staggering in potential size and cost. Legislation would be required, an agency designated and a bureaucracy established to license and monitor the entire industry. The costs to the legitimate business person (and ultimately the home buyer) would be high, while not tapping a significant portion of the rogue factor.

Although the creation of a separate monitoring/enforcement agency for trust compliance is not feasible, the ONHWP has undertaken a recent initiative to determine the risk factors related to failures by some builders to meet their obligations to consumers so that these risks can be minimized. Some of the risk factors considered are related to or may be indicative of trust compliance. In addition, trust compliance, itself, may be a relevant factor when assessing a builder's financial and technical ability to honour the claims of the buyers of the builder's homes. In any event, the ONHWP's ability to identify and assess risk factors will be greatly enhanced through its continued dialogue with the trades and with all segments of the residential construction industry.

How will this recommendation affect the honest business people, the opportunists and those who default in their obligations?

The honest business people have already been complying with the mandatory registration requirements of the ONHWP. However, as the ONHWP expands the number of risk factors it considers, registration will better reflect their obligations, at little additional cost.

With the expansion of the number of risk factors considered by the ONHWP, the opportunists will have to consider cleaning up their act, or risk failing to qualify for registration.

Defaulters will either choose not to register with the ONHWP or, given the expansion of risk factors considered, will be unable to qualify. Without an ONHWP registration number, the defaulters will send a clear message to the trades, suppliers and consumers about the type of business they operate.

10. OVERSIGHT COMMITTEE

The Working Group recommends that the Greater Toronto Home Builders' Association and the Residential Trades and Supply Association of Ontario, jointly, should establish an oversight committee. It will monitor the implementation of the above recommendations and ensure the active flow of communications between the various stakeholders, with a view to providing an assessment to the Ministry in January, 1996. The committee would be open to all the present members/constituencies of the Working Group, as well as other parties as their interests dictate.

EXPLANATION:

The best hope for a healthy, effective, and productive residential sector is that the scrupulous builders, trades and suppliers will work together to establish better market practices, such as those recommended in this report. The leadership of the home builders' associations and the leadership of the trades and supply associations represent the most scrupulous in their respective sectors. The Working Group believes that to ensure that there is greater trust compliance, these leaders establish an Oversight Committee to monitor the implementations of the recommendations in this report, to ensure that the various components of the residential sector of the industry are communicating with one another, and to prepare a progress report to the Ministry in January 1996.

THE WORKING GROUP ON RESIDENTIAL CONSTRUCTION TRUST COMPLIANCE

MEMBERS

Members	Nominated By/Representing:
Derek R. Freeman (CHAIR)	Joint Committee on Court Reform
Stephen V. Fram, Q.C., (COORDINATOR)	Ministry of the Attorney General
Mauro Angeloni	Residential Construction Trade & Supply Association of Ontario
Carole Bennett	Ontario New Home Warranty Program
John Bassel	Metropolitan Toronto Apartment Builders' Association
Keith B. Cooper	Labourers' International Union of North America
Alan Driver	Ontario Insolvency Practitioners Association
Stephen Dupuis	Greater Toronto Home Builders' Association
Myer Godfrey	Greater Toronto Home Builders' Association
Lawrence Gold	Residential Construction Trade & Supply Association of Ontario
Peter Goldthorpe	Ontario Home Builders' Association
Jerry Gotkin	Ontario Home Builders' Association
Brice Hatt	Canadian Bankers' Association
Richard Lyall	Metropolitan Toronto Apartment Builders' Association
Patti MacNicol	Institute of Chartered Accountants of Ontario
Uwe Manski	Institute of Chartered Accountants of Ontario
Meier Miller	Society of Management Accountants of Ontario
Steven Ness	Surety Association of Canada
Robert Pattison	Canadian Bar Association - Ontario, Construction Law Section

Dave Pratt	Greater Toronto Home Builders' Association
Gordon Redgrave	Certified General Accountants' Association of Ontario
Virginia Turner	Ministry of the Attorney General
Charles M. Zizzo	Credit Institute of Canada

Consultants, Substitutes and Guests

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Mel Zwaig

Secretaries to the Working Group
Margaret Parsons (February 1994 - August 1994)
Maria Lavelle (September 1994 - February 1995)