An Argument Against the Owner's Right to Setoff Under the New Brunswick *Mechanics' Lien Act*[1]

The contractual framework of any construction project typically takes the form of a pyramid with the project owner hiring a general contractor who in turn hires sub-contractors who likewise hire other sub-contractors. The New Brunswick *Mechanics' Lien Act* ("Act") is similar to other provincial mechanics' lien legislation in that it provides for a statutorily created chain of secured creditors throughout this pyramid. Generally speaking, lien legislation offers three remedies to lienholders. First, the legislation gives to those parties who contribute work or materials a lien against the real property which was improved. To enforce this lien, the *Act* contains an ultimate power of sale wherein the proceeds may be applied against the balance owed to the various lien claimants.[2] Second, the legislation develops or imposes trust relationships throughout the construction pyramid. Usually the money received by a party is impressed with the trust for the benefit of creditors lower in the pyramid.[3] Finally, the legislation requires the owner, or certain other parties in the pyramid, to withhold from payments made to contractually linked parties a certain percentage of the value of the work done.[4] This remedy is commonly called the holdback and is designed to create a reserve of funds from which parties can pay lien claimants. The focus of this note is the holdback fund, specifically on how the giving of notice to the owner of a lien claim pursuant to these holdback sections, affects the rights and liabilities of both owner and lien claimant. Before such an investigation can be made, a preliminary discussion on the statutory holdback mechanism is necessary.

The Statutory Holdback

The *Act* contains general provisions which limit the owner's liability to lien claims provided he complies with its terms:

> 4(2) Save as herein provided, a lien does not attach so as to make the owner liable for a greater sum than that payable by the owner to the contractor.
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> 4(3) Save as herein provided, where a lien is claimed by a person other than a contractor, it does not attach so as to make the owner liable for a greater sum than the amount owing to the contractor for whom, or for whose sub-contractor, the work has been done, or the materials have been furnished.

The saving provisions in these sections refer to section 15 of the *Act*, which creates the duty on the owner to hold back. Subsections (1) and (3) of section 15 operate to require the holdback to equal 15 *per cent* when the value of the work exceeds $15,000 and 20 *per cent* in all other instances.

The *Act* creates a "unitary" holdback scheme in that the statutory owner is the only party compelled to withhold a percentage of the value of the work

[1] R.S.N.B. 1973, c. M-6.

[2] *Ibid.*, s. 44.

[3] *Ibid.*, s. 3.

[4] *Ibid.*, ss. 15(1), 15(3).

and material used.[5] This unitary system is also found in Alberta[6] and Prince Edward Island.[7] Legislation in the remaining provinces creates a multiple holdback scheme whereby each person primarily liable on a contract in the construction pyramid is required to withhold a similar percentage.[8]

The nature of the owner's obligation to this statutory holdback fund was canvassed in *S.I. Guttman Ltd.* v. *James D. Mokry Ltd.*[9] where Schroeder J.A., speaking for the Ontario Court of Appeal, indicated:

> The saving terms of the Act which make other provision and establish a *restricted artificial privity* between the owner and subcontractor are to be found in s. 11(1) and (2) which impose upon the person primarily liable upon any contract, which would necessarily include the owner, the obligation of retaining a fund calculated as therein prescribed for the protection of subcontractors entitled to a lien....[10] (emphasis added)

The strength of the obligation imposed on the owner due to this restricted artificial privity is somewhat unclear. The obligation is arguably strong enough to follow the owner even after he ceases to have an estate or interest in the land. Should, for example, an owner become dissatisfied with the construction project financed by a mortgagee, he may decide to sell his interest in the land without having retained the required holdback funds. The owner's equity would be realized in the proceeds of disposition and would be subject to any lien claims. Should the project be heavily financed and the resultant equity minimal, the lien claimants would have to bear the loss of any resulting deficiencies, unless the restricted artificial privity survives to place a personal liability on the owner.

The Ontario Court of Appeal in *Noren Construction (Toronto) Ltd.* v. *Rosslyn Plaza Ltd.*[11] cast doubt on the extension of personal liability arising out of the restricted artificial privity relationship. The Court held that if the sale of the owner's interest does not realize sufficient monies to discharge his holdback obligations to lien claimants, then a personal judgment will issue against only those persons primarily liable for such a claim. Macklem & Bristow in *Construction and Mechanics' Liens in Canada*[12] support the proposition that the owner's liability to the statutory holdback fund is somewhat restricted:

> While there do not appear to be any reported Canadian decisions directly on point, it is submitted that where a sale is taken of the interest of an owner who cannot be

[5] Although section 15(1) clearly indicates the owner is the only party *statutorily* required to hold back, the New Brunswick Court of Appeal decision in *R.A. Corbett & Co.* v. *Phillips* (1973), 5 N.B.R. (2d) 499 creates a *practical* requirement that each party in the construction pyramid hold back.

[6] *Builder's Lien Act*, R.S.A. 1980, c. B-12, s. 15.

[7] *Mechanics' Lien Act*, R.S.P.E.I. 1974, c. M-7, s. 15.

[8] See, *e.g.*, *Mechanics' Lien Act*, R.S.O. 1980, c. 261, s. 12.

[9] [1969] 1 O.R. 7.

[10] *Ibid.*, at 9.

[11] [1970] 2 O.R. 292.

[12] D.N. Macklem and D.I. Bristow, *Construction and Mechanics' Liens in Canada*, 5th ed. (Agincourt: Carswell, 1985).

> fixed with a contractual liability to a claimant, and the sale does not realize sufficient proceeds to satisfy the owner's holdback liability, no personal judgment for the deficiency may issue against the owner.[13]

It must be noted that if this reasoning is correct, the holdback fund is merely being used to refer to the amount of the lien. If this reasoning is taken to its logical conclusion, lien legislation in Canada provides two remedies only (the trust fund and the lien) as opposed to the more commonly accepted number of three. It is also worthy to note that section 23 of Ontario's new *Construction Lien Act*[14] specifically speaks of an owner's *personal* liability to the holdback fund. It is submitted that in this light the *Noren* decision is incorrect and ought not to be followed in New Brunswick.

It is important to note that the holdback provisions of all lien legislation impose a mandatory duty on the owner to comply. To secure the priority of the lien claimants to this amount, the *Act* impresses the holdback fund with a charge to the benefit of all lienholders:

> 15(6) Every lien is a charge upon the amount directed by this section to be retained in favor of the lienholders who have done work or furnished material for
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> (a) the contractor to whom the money so required to be retained is payable, or
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> (b) his sub-contractor.

The use of the mandatory directive "shall' in section 15(1) in combination with the charge status, and the fact that the amount is "directed to be retained" clearly indicate the obligatory nature of the holdback fund.

As section 15(6) refers to an amount payable to the contractor it was felt necessary to secure the holdback fund further by section 15(9):

> Where a contractor or sub-contractor makes a default in completing his contract, the amount required to be retained under this section shall not, as against a lienholder, be applied by the owner, contractor or sub-contractor to the completion of the contract or for any other purpose than the satisfaction of liens.

This latter protection is triggered when the owner tries to reduce the holdback fund as a result of the contractor having abandoned the contract. The damages sustained as a result of the abandonment are apparently to be met out of the holdback fund. A long judicial history opposed this type of action: "An 'owner' may not reduce the amount of the holdback by deducting damages for which he might have a claim against the contractor, and no such damages may be taken into consideration when arriving at the value of the work done."[15]

As noted above, the amount of the holdback fund available to satisfy lien claims is a percentage of the value of the project. It becomes obvious that in certain circumstances a lienholder will have a claim of such a magnitude as to exhaust completely the holdback fund and still have a balance owing. Indeed, due to the financial interdependance of the parties in the construction pyramid, when one party experiences financial difficulty to the extent that he

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[13] *Ibid.*, at 537.

[14] S.O. 1983, c. 6.

[15] *Supra*, footnote 12 at 155.

liens the project, he knows that other lienholders will follow and that the holdback fund, distributed on a *pro rata* basis, will more often than not be unable to totally satisfy his claim. To offset this situation, further security is statutorily provided to lienholders when they give the owner notice of their claim.

Notice Claims

Most lien legislation in Canada contains a section similar to New Brunswick's section 15(7):

> All payments up to eighty *per cent* as fixed by subsection (1) or up to eighty-five *per cent* as fixed by subsection (3) and payments permitted as a result of the operation of subsections (4) and (5) made in good faith by an owner to a contractor, or by a contractor to a sub-contractor, or by one sub-contractor to another sub-contractor, before notice in writing of the lien given by the person claiming the lien to the owner, contractor or sub-contractor, as the case may be, operate as a discharge *pro tanto* of the lien.

It is this section which affords the owner an opportunity to reduce further his lien liability. In most jurisdictions lienholders serve notice of their claims pursuant to this section; virtually all the major decisions dealing with the owner's right to setoff refer to section 15(7)-type notices. The purposes of the notice was judicially recognized as early as 1900:

> The object of the notice is to warn the owner that he cannot safely make payments on account of the contract price, even within the 80 *per cent* margin, because of the existence of liens of which he was not otherwise bound to inform himself or look for. The notice does not compel him to pay the lien. It does not prove the existence of the lien. Its sole purpose is to stay the hand of the paymaster until he shall be satisfied — either by the direction of the debtor or of the Court, in case proceedings to realize the lien are taken — that there is a lien, and that some amount is really due and owing to the lien-holder.[16]

It is apparent that this section sets up a fund, separate from the holdback fund, in which the owner is required to retain the amount contained in the notice for the benefit of the party giving the notice. While it is clear that there is no statutory duty to retain the notice amount, it appears to be conclusive that should payment be made in the face of the notice, the owner runs a risk that subsequent payments will not find their way down the construction pyramid to satisfy the claimant giving notice. Should this situation occur, the owner may be faced with paying for at least a portion of his building twice.[17] This double liability effect is not contrary to the general limitation on the owner's liability as provided for in subsections 4(2) and (3) of the *Act*, as these provisions were interpreted in *Freedman* v. *Guaranty Trust Co. of Canada*[18] to be subject to the notice provisions.

The key issue arises when these notices have been given to the owner prior to the contractor abandoning the project. Such abandonment invariably causes the costs of completion to overrun the original contract price. The

[16] *Craig* v. *Cromwell* (1900), 27 O.A.R. 585 at 587-88.

[17] *Vaillancourt Lumber Co.* v. *Trustees of Separate School Section No. 2, Township of Balfour et al.* [1964] 1 O.R. 418 (C.A.).

[18] (1927), 60 O.L.R. 200 as quoted by Schroeder J.A., *supra*, footnote 10 at 11.

owner acknowledges the statutory holdback as due and owing to the lien claimants, but attempts to set off the extra costs of completion against the amounts claimed in the notices. Assume, for example, that the project price was $1,000,000. If the contractor abandons the contract having been paid $350,000 when the value of his work is $500,000, the amount payable to him would be $150,000. However, if the abandonment causes the costs of completion to be, *e.g.*, $600,000, the owner would be forced to incur $100,000 in damage. The statutory holdback required to be retained pursuant to section 15(3) is 15 *per cent* of $500,000 or $75,000, leaving a further $75,000 payable to the contractor. If notices have been served just prior to abandonment, can the owner set off his $100,000 cost overrun against the lienholders' notice claims on the final $75,000 payable to the contractor? The law with respect to the owner's right to set off successfully appears well settled.

The Owner's Right to Setoff

A major judicial interpretation of the setoff issue was provided by the Ontario Court of Appeal in the *Guttman* decision. There the contractor had abandoned the project, resulting in additional costs of completion exceeding the contract price. Notice claims had been filed. The sole issue was whether the owners could set off the costs of completion against the excess amount in their hands (after paying the statutory holdback), or whether this excess was subject to the notice claims. The plaintiffs relied on section 12(2) of the Ontario *Mechanics' Lien Act*[19] for protection against the owners setoff assertions:

> 12(2) Every subcontractor is entitled to enforce his lien notwithstanding the non-completion or abandonment of the contract by any contractor or subcontractor under whom he claims.

In rejecting the interpretation advanced by the plaintiff, Schroeder J.A. stated:

> It was made plain in the judgment of Masten, J.A., in *Freedman* v. *Guaranty Trust Co. of Canada* that the purpose of the amendment was to abrogate the legal obstacle created by the principal enunciated in *Appleby* v. *Myers* (1867), L.R. 2 C.P. 651, where it was held that where a contractor engaged to do work or supply materials for a specific sum to be paid on completion of the whole, he was not entitled to recover anything until the whole work was completed unless he was prevented from doing so by the default of the owner.[20]

It is apparent that the majority was of the view that the section was enacted to protect against the situation where abandonment would result in assertions that nothing were owing by the owner to the contractor. A strong dissent was delivered by Laskin J.A., who was of the opinion that section 12(2) begged a further question — whether abandonment by the contractor should be taken into consideration in evaluating a sub-contractor's right to lien. In distinguishing the majority's reasoning he observed that Masten J.A., when delivering the *Freedman* decision was really dealing with two different situations:

[19]R.S.O. 1960, c. 233.

[20]*Supra*, footnote 9 at 11.

> It is manifest that Masten, J.A. was dealing with two classes of contracts; one the entire contract, and, second, a contract calling for intermediate payments at various stages of the work or upon progress certificates; and as to the latter the "all or nothing" rule did not apply, before the enactment of s. 12(2), to frustrate a subcontractor's lien claim merely because the main contractor had later abandoned the work."[21]

The policy behind Laskin's reluctance to grant the owner the right to setoff is clear and somewhat difficult to assail. Later in his judgment he indicates:

> The owner is, of course, also innocent in the circumstances of an abandonment of the work by the contractor, but his choice of a contractor should not be a risk assumed by a subcontractor whose right to a lien is original under the Act and not derivative.[22]

It is also clear that unlike the majority Laskin was of the opinion that the protections afforded by section 12(2) did not conflict with the general provisions of the Act which limited the owner's liability:

> I summarize my views as follows. Sections 5, 9 and 10 of the *Mechanics' Lien Act*, limiting an owner's liability in respect of a lien to "the sum justly owing by the owner", and to "the sum payable by the owner to the contractor", and to "the sum owing to the contractor", are all qualified by "save as otherwise provided clauses. The statutory holdback provisions are, of course, within the exception but so are s. 12(2) and s. 11(6).[23]

Despite this strong dissent the issue of setoff against the excess amounts in the hands of the owner appears to have been settled by the Supreme Court of Canada in *Canadian Comstock Co.* v. *The Toronto Transit Commission et al.*[24] In rejecting the lienholders' claims that section 12(2) provided protection against setoff, the five member court (which did not include Laskin) simply adopted the majority's view in *Guttman*. In effect they interpreted section 12(2) to give protection to the sub-contractors only to the extent of the statutory holdback.

The New Brunswick Court of Queen's Bench indicated its view on the owner's right to setoff in *Curran & Briggs Ltd. et al.* v. *Ryder et al.*[25] From facts similar to the *Guttman* and *Canadian Comstock* cases, Stratton J. indicated:

> The owners assert a right of set-off against the holdback moneys for the costs of completing the contract. But the retention of the statutory holdback by the owners, or on their behalf, is mandatory and it cannot be reduced by the costs of completion: see section 15(9) of the Act and *S.I. Guttman Ltd.* v. *James D. Mokry, et al.*, [1969] 1 O.R. 7 (C.A.). However, if the sum retained by the owners, or on their behalf, exceeds the statutory holdback, then this additional sum is subject to set-off by the owners for the costs of completion: see *Canadian Comstock Company Limited* v. *The Toronto Transit Commission, et al.*, [1970] S.C.R. 205. And, in my opinion, if any sum remains after payment of the costs of completion, that sum too is subject to

[21] *Ibid.*, at 16.

[22] *Ibid.*, at 21.

[23] *Id.*

[24] [1970] S.C.R. 205.

[25] (1977), 19 N.B.R. (2d) 331.

> the lien claims: see *Piggott* v. *Drake*, [1933] O.W.N. 197 (C.A.), and *Western Tractor and Equipment Co.* v. *Milestone School Unit No. 12* (1960), 33 W.W.R. 249 (C.A.).[26]

It will be noted that the notice given in this case was deficient in form; therefore the comments of Stratton J. are *obiter*. Yet the case is revealing to the extent that the Court of Queen's Bench felt bound by the *Canadian Comstock* decision.

The Argument Against the Owner's Right to Setoff in New Brunswick

Based on this case law the owner's right to setoff appears to be cemented in Canadian jurisprudence. It becomes immediately apparent that any argument made against such a right in New Brunswick will require clear and dramatic distinctions from the *Guttman, Canadian Comstock,* and *Curran and Briggs* decisions. The first major distinction lies in the observation that, unlike the *Guttman* and *Canadian Comstock* decisions — where notices were given pursuant to the equivalent of sect. n 15(7) of the *Act* — notices in New Brunswick can be given pursuant to an entirely different section:[27]

> 16(1) Where a lienholder gives the owner notice in writing of his lien, stating under oath the amount claimed, the owner shall retain from the amount payable to the contractor under whom the lien is derived the amount stated in the notice, in addition to the amount retained under section 15.
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> 16(2) The amounts retained pursuant to subsection (1) constitute a fund, separate from that constituted by the amount retained pursuant to section 15, for the benefit of lienholders who give notice under this section.
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> 16(3) The lien of each lienholder who gives notice under this section is a charge in his favour upon the amount directed by this section to be retained; and each of such lienholders ranks *pari passu* on the amount retained under this section for the amount for which his lien may be enforced, and the amount so retained shall be distributed among such lienholders *pro rata* as hereinafter provided.
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> 16(4) A payment made to a lienholder under this section does not disentitle him to claim for any balance remaining payable to him and to be paid therefor from money retained under section 15.

Prince Edward Island enacted the equivalent of our section 16 in 1950;[28] New Brunswick's current section 16 was enacted a year later[29]. Since the legislators of both provinces saw fit to maintain their section 15(7) provisions subsequent to the section 16 enactments, it is reasonable to assume that the legislatures intended some additional measure of protection.

On examination of section 16 it is apparent that it is markedly different from notices served previously under sections analogous to section 15(7). In the first place, it provides that notice of a lien claim be served on only the owner, as opposed to the reference in section 15(7) to the owner, contractor or

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[26] *Ibid.*, at 335.

[27] Communications with Kenneth McCullogh, of the firm of McKelvey, Macauley, Machum, Saint John, indicate that some members of the practicing bar are of the view that notices in New Brunswick are given pursuant to section 16 and that the notice mentioned in section 15(7) merely refers to the section 16 notice.

[28] *Mechanics' Lien Act*, S.P.E.I. 1950, c. 19.

[29] *Mechanics' Lien Act*, S.N.B. 1951, c. 184, s. 15.

sub-contractor. More importantly, the section requires the amount claimed in the notice be stated under oath. It should be noted that failure to comply with this formal requirement is fatal to the notice claim.[30] While section 16 notices exact a strict formal requirement, the form and in fact the objective of a section 15(7)-type notice was that it would be easily understood. In *Craig* v. *Cromwell* Osler J.A. indicated:

> The notice under section 11, sub-section 2, is purely informal, and was manifestly intended to be so, no form or special particulars of detail being prescribed, in regard that it might have to be given promptly, or by illiterate persons, who might, as it were, read and understand the sections as they ran.[31]

That the New Brunswick Legislature saw fit to enhance the formalistic technicality of giving notice should not, perhaps, be seen as a vote of confidence in the literacy of the local construction industry. Rather, it would seem more plausible that the Legislature intended some additional measure of protection to be afforded to the various parties in the construction pyramid.

Perhaps most importantly, it will be noted that once the owner receives such a notice he is *compelled* to separate and retain the notice sum from the amount payable to the contractor. Section 16(3) clearly witnesses this mandatory duty with wording which directly coincides with the duty imposed by section 15(6) (*i.e.*, charge status on amount directed by this section to be retained). It is critical to note that the wording of this latter section was used by the Ontario Court of Appeal in both *Vaillancourt Lumber* and *Guttman* to conclude that the statutory holdback fund was immune from setoff.

The wording would also appear sufficiently similar to establish the restricted artificial privity relationship referred to by Schroeder J.A. in *Guttman*. If this is so, it would make little sense to allow a setoff against a party based on the misconduct of a third party to the privity relationship (*i.e.*, the contractor). This equation to the statutory holdback fund is noted by leading authors in the mechanics' lien field:

> Under section 18 of both the New Brunswick and Prince Edward Island Acts, the owner cannot make any payments under the contract which will reduce the amount he is required to retain upon receiving notice, and under section 17 of either Act he may safely pay over such amount upon expiration of the time limited by the Act applicable to the holdback fund. Essentially, therefore, although separate from the holdback, the fund created by these sections has the same qualities and characteristics, and the consequence of a breach of these special provisions respecting the retention of the amount claimed in the notice of lien are also similar to those of the holdback fund.[32]

The dissent of Laskin J.A. in *Guttman* is important in the New Brunswick context for another reason. As indicated above Laskin was of the opinion that the protections afforded by Ontario's section 12(2) were within the general provisions limiting the owner's liability to sums payable to the contractor. In New Brunswick, however, section 19 is the analagous section to section 12(2) and is *expressly* made subject to these general provisions limiting the owner's

[30] *Downey Building Supplies Ltd.* v. *Kavanaugh and Kavanaugh* (1980), 27 N.B.R. (2d) 672.

[31] *Supra*, footnote 16 at 588.

[32] *Supra*, footnote 12 at 177.

liability, which would further tend to fortify the sound policy behind Laskin's opinion.

Conclusion

The owner's right to setoff would appear well settled. Indeed, it maybe perceived to be so well settled that a barrister's chief obstacle in advancing the above argument might be to overcome the trial judge's initial reaction that the argument is even being made. Yet it is clear that notices given pursuant to section 16 of the *Act* are dramatically different in both form and substance to the notices given in the cases that purport to settle the issue. Again, it should be emphasized that the notices in the latter situations were given pursuant to an entirely different section. The attestation under oath, the existence of the charge, the mandatory amount directed to be retained by the notice, and the potential restricted artificial privity relationship highlight these differences and, as some of the leading authors on mechanics' liens are quick to point out, really equate the section 16 notice to the statutory holdback fund in terms of priority. Superimposed on the legislative argument against the owner's right to setoff is the dissenting judgment of Laskin, J.A. in *Guttman*. The fact that his sound reasoning dovetails with the protections that appear to be afforded to sub-contractors by section 16 may not be accidental. Until a clear judicial interpretation of section 16 is rendered, the future of sub-contractors' priority on their notice claim is, at best, speculative. Once a New Brunswick court becomes cognizant of the clear differences between a section 16 notice and the notices served in *Guttman* and *Canadian Comstock*, it may be forced to rethink what is perceived to be a well-settled area of law. Based on this current perception, members of the practicing bar are encouraged to attempt the suggested approach to the setoff issue at the first opportunity; quite plainly the benefits to the client of successfully advancing the argument far outweigh the consequences of initial rejection.

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