Lien Fund or Lean Fund: Setting-Off Against Part B under the Alberta Builders' Lien Act

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Those below the general contractor in the construction pyramid should be aware that an owner's express right to set-off in the prime contract might diminish protections under the Alberta *Builders' Lien Act*. Likewise, owners should note that clear language regarding set-off could significantly limit exposure on a project.

Key Takeaways:

- Clear language in a contract is crucial. Without an expressly worded right to set-off, the owner may not be entitled to set off against Part B of the lien fund.
- In the absence of clear contractual language, the test for equitable set-off may be strictly applied.
- Contractual terms allowing for a deficiency holdback may provide added protection.
- Subcontractors and suppliers should carefully review the prime contract before starting work on a project.

The Alberta *Builders' Lien Act* is a powerful tool for owners, contractors, and suppliers alike. It grants unique rights to those who contribute to the improvement of land, while simultaneously limiting the owner's maximum exposure. An owner's right to set-off for deficiencies and costs to complete under the Alberta *Builders' Lien Act* is often highly disputed. A recent decision of the Alberta Court of Queen's Bench tackles this issue head on and creates new opportunities for contracting parties to protect their interests. In the recent decision *Neptune Coring (Western) Ltd v. Sprague-Rosser Contracting Co*, 2018 ABQB 883 (CanLII) (*Neptune Coring*), Master Schlosser of the Alberta Court of Queen's Bench considered this area of the law which, in his own words, "needs some attention."

Under the Alberta *Builders' Lien Act*, when making a payment on the contract, an owner must retain 10 per cent of the value of the work actually done, or the materials actually furnished (Part A), and at any time while a lien is registered any amount payable under the contract that has not been paid (Part B). The 10 per cent under Part A is commonly referred to as the "statutory holdback" and is often uncontentious. However, determining the additional amount "payable under the contract," Part B of the lien fund, is often murky.

Taken together Part A and Part B form the lien fund. This is the owner's maximum liability on the project under the Alberta *Builders' Lien Act* to any party with whom it does not have a contract. However, the Alberta *Builders' Lien Act* imposes limits on the lien of a party who does not have a contract with the owner. A lien registered by such a claimant cannot attach so as to make the lien fund liable for a sum greater than: (i) 10 per cent of the value of the work actually done, or materials actually furnished, by the party with whom the lien claimant has a contract (Part A); and, (ii) any amount due and owing to that same party (Part B). In other words, the amount of the lien fund to which a subcontractor's lien may attach depends on the contract between the parties directly above the subcontractor in the construction pyramid. For example, as per figure 1.1, the calculation of the amount of the lien fund to which the subcontractor's (Party 3) lien may attach is determined by the contract between the owner (Party 1) and the general contractor (Party 2). The calculation of the amount of the lien fund to which the sub-subcontractor's (Party 4) lien may attach is determined by the contract between the general contractor (Party 2) and the subcontractor (Party 3).

The Alberta *Builders' Lien Act* sets out that a right to set-off can be applied against the amount "payable under the contract" (Part B). This reduces the amount to which a lienholder's claim can attach. But determining what can, and what cannot, be set-off against Part B of the lien fund has created much angst for the construction industry.

In *Neptune Coring*, Master Schlosser identified three general categories of potential set-off as follows: (i) costs overruns (the additional costs to complete); (ii) deficiencies; and, (iii) damages arising from the contractor's (or subcontractor's) default. Master Schlosser struggled, however, with finding the appropriate boundaries for these categories. For example, in the older case of *Belanger v. Pointer Construction Group Ltd.*, 1984 CanLII 1169 (AB QB), Master Funduk held that *any* legal costs arising from a contractor's default can be the proper subject matter of set-off. Master Schlosser identified that without limitation these categories could contribute to a reduction in protection contrary to the purpose of the Alberta *Builders' Lien Act*.

Accordingly, Master Schlosser set out that an owner, or higher tier party, will only have a right of set-off against part B of the lien fund under the following circumstances:

1. Contractual Set-Off: The contract contains express terms that very clearly establish a right to "set-off" against the other contracting party for specific damages; or,
2. Equitable Set-Off: The party wishing to set-off meets the requirements of the strict test for equitable set-off. That is to say that the party wishing to reduce Part B of the lien fund may only do so where its set-off goes to the very root of the affected party's claim. For example, if the owner (Party 1) wishes the set-off against what is "due and owing but unpaid" to the general contractor (Party 2), thereby diminishing the amount to which the subcontractor's (Party 3) lien may attach, the claimed set-off must go to the root of the subcontractor's (Party 3) work. The additional costs to the owner (Party 1) caused by the general contractor (Party 2) may not be the proper subject of set-off here.

Master Schlosser put it very simply: if it isn't permitted by the contract, or related to the subcontractor's work, it should not be set-off.

In *Neptune Coring*, the contractual language that was deemed to be sufficiently clear to allow for contractual set-off against Part B of the lien fund included specifically that "[t]he City may set-off these Administration Costs from any amounts due to the Contractor." By contrast, the following indemnity provision was insufficiently clear to allow for a contractual set-off:

If either party to this Contract should suffer damage in any manner because of any wrongful act or neglect of the other party, or anyone employed by a subcontractor, then the injured party shall be reimbursed by the other party for such damage.

This language was found to be too general to entitle the owner to set-off against Part B of the lien fund, and the city did not meet the strict test for equitable set-off. Accordingly, in *Neptune Coring* Master Schlosser only allowed a small portion of the owner's claim against the general contractor to be set off against Part B. Master Schlosser denied any further set-off, aside from the administrative costs expressly contemplated in the contract.

Specificity in language is crucial, and contracting parties must take care. Carefully specified terms may create a right to set-off against Part B, but may also exclude other unanticipated circumstances or items not expressly included. Conversely, language that is too general may not create the desired rights to set-off against Part B. Where the language of the contract does not expressly entitle an owner to set-off against Part B, the owner may be restricted to doing so only where its set-off goes to the very root of the affected party's lien claim. Consequently, owners and general contractors may wish to consider incorporating a "deficiency holdback" into their contracts. This would allow for the retention of an additional amount specifically for the purpose of correcting deficiencies.

The *Neptune Coring* case reminds us that subcontractors must beware. An owner's right to set-off against the general contractor in the prime contract may reduce the pool of funds otherwise available under the Alberta *Builders' Lien Act*. In effect, a contract to which the subcontractor is not a party, and has no right or ability to negotiate, may have an impact its rights and security. Where possible, before issues regarding payment arise, a subcontractor should review the prime contract to better understand the scope of the owner's right to set-off.

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