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Ontario Construction Law: Rights and Obligations

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Updated: March 2009

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Additional information about construction law in Ontario may be obtained by contacting your local Lang Michener LLP office.
Please note all monetary references are to Canadian dollars.

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INTRODUCTION

Lang Michener is pleased to present this informative overview of the obligations, rights, and contractual relationships between the parties involved in any construction project, large or small.

Although we hope you will find this information helpful, we strongly recommend that all parties to a construction project consult their lawyers before entering into a contract, and where any dispute arises. The information provided here is general in nature, and does not constitute, nor replace, proper legal counsel.

A word about “persons” discussed in this document: many parties to construction projects are, in fact, corporate entities. For the reader’s ease and convenience, we have arbitrarily referred to all parties in the masculine singular (he, his).

WHO: THE CONSTRUCTION PYRAMID

A construction project runs on money, which flows down the construction pyramid from the building mortgagee (the lender who provides the construction mortgage) to the tradespeople who actually do the work. The cash flow carries particular rights and obligations.

1. The Mortgagee: The buck starts here. The mortgagee is the creditor who lends the funds. There are two types of mortgagees:

- the first finances the purchase of the land itself, has priority over liens for improving the property, and is not required to hold back funds from the owner while construction proceeds;
- the second type finances the construction of the building, does have an obligation to hold back funds from the owner, and may lose his prior claim to an interest in the land if he fails to keep a proper holdback from the owner/developer.

2. The Owner: The owner has an interest in the land and requests an improvement to it. There are two main types of owners:

- the registered owner of the land, and
- a tenant. If the work is done at the request of a tenant, only the tenant’s interest in the land may be the subject of a construction lien unless certain notices are given before the work commences.

The owner has two obligations:

- a trust obligation, and
- a holdback obligation.

The “trust obligation” requires the owner to use money received from the mortgagee to pay its contractor on the project ahead of anyone else, including his own overhead. The “holdback obligation” requires the owner to hold back from the contractor at least 10 per cent of the value of work in place, and to deduct it from each draw for payment.

3. The Contractor: Anyone who has a contract with the owner to improve the land is a contractor. Most projects have at least two contractors:

- a general contractor who organizes the actual construction, and
- a chief consultant engineer or architect who designs the building and supervises construction.

Each contractor has a trust obligation to ensure that monies received from the owner are applied to paying sub-contractors on the project ahead of all else, including the contractors own overhead. In addition, the contractor has an obligation to hold back from each sub-contractor at least 10 per cent of the value of work the sub-contractor put in place, and deduct it from each of the sub-contractors’ draw for payment.



4. The Sub-Contractors: Anyone who has a contract with a contractor to improve the land is a sub-contractor. Each sub-contractor has a trust obligation to ensure that monies received from the contractor are applied to paying his sub-sub-contractors on the project ahead of all else, including his own overhead. In addition, the sub-contractor has an obligation to hold back from each of its sub-sub-contractors at least 10 per cent of the value of work the sub-sub-contractor put in place and deduct it from each sub-sub-contractors' draw for payment.

5. Sub-Sub-Contractors: Everyone below the sub-contractor in the construction pyramid has the same trust and holdback obligations as a sub-contractor until the mortgagee's money reaches the actual workers and material suppliers who do the work and supply the material.

6. Workers, Equipment Rentals, and Material Suppliers: Workers who appear on site, and material suppliers who can trace their equipment rentals, or construction supplies to a particular job site are entitled to register a lien claim and have the benefit of trust obligations without having any trust obligations of their own.

WHAT: OBLIGATIONS BETWEEN THE PARTIES

At the peak of the construction pyramid is a mortgagee (lender) who finances a project. The mortgagee pays an owner (or syndicate) who owns the land and acts as the developer. The owner pays a general contractor or contractors to build the project, and the general contractor pays sub-trades to do the actual work.

The *Construction Lien Act* (the "Act") contains two mechanisms designed to ensure that monies paid into a project by a mortgagee actually pay the trades doing the work, and are not misappropriated by those in the higher echelons of the construction pyramid.

1. The Act imposes a trust on the receiver of monies disbursed by the mortgagee, owner, or contractor for the purpose of construction in preference to themselves in order to ensure that monies supplied to the project are paid out appropriately down to the lowliest employee working on the site. The trust provisions of the Act protect all amounts received by an owner in financing a project by imposing a trust for the benefit of the contractor. The contractor receives those trust monies in trust for his sub-contractors to ensure they are paid. The sub-contractors each hold the monies in trust for

their sub-sub-contractors, and so on down to each employee working on site, and each material supplier to the site.

2. Those who supply services and/or material to a job site are entitled to claim a "construction lien," which is like a mortgage, against the owner's interest in the land being improved by their labour or products, in an amount equal to the contract value of their unpaid services or materials. The lien is paid out of the 10% "holdback" the Act requires those at the top of the pyramid, particularly the owner and the contractor, to keep.

1. THE TRUST OBLIGATION

In order to protect the trust monies, the Act contains a provision that holds every Director or Officer of a corporation, and any other person who has effective control of a corporation, personally liable for their corporation's breach of the trust if they actively or passively participate in that breach of trust. In other words, the corporate shell cannot protect those who receive trust monies and who apply them for purposes other than those intended by the Act. So, for example, if the owner paid his contractor 100 per cent of the contract price, and the contractor's President instructed the corporate bookkeeper to pay a corporate bank loan instead of the sub-trades who were still owed money for the work they had done, the President and the bookkeeper would both face personal liability for failing to pay the sub-trades the trust monies in question.

2. THE HOLDBACK OBLIGATION

The *Construction Lien Act* ("The Act") requires everyone who makes a payment to a construction trade on a project to keep, or hold back, monies from that trade during the course of construction. The owner keeps a holdback from the contractor,



the contractor from the sub-contractors, the sub-contractors from the sub-sub-contractors until we get to the workers who worked on site and the material suppliers to the project. For ease of explanation I will illustrate this process by reference to an owner's obligation to hold back from its general contractor.

A person who makes a payment for work done on a project is called a "payer." A payer must holdback from the payee who otherwise would be entitled to payment under their construction contract three different types of holdbacks:



- **the basic holdback.** The basic holdback provision (s. 22(1) of the Act) requires the owner to retain 10% of the value of the goods and services supplied to the site by the contractor (as determined by percentage completion of the contract price) from each progress draw otherwise payable to the contractor. This holdback can only be released 45 days after the project is "substantially completed," a defined term under the Act, provided no liens remain registered on title as of that time. "Substantial completion" usually is reached when 97% of the general contract work is completed for most projects (but see s.2 of the Act for modifications to this guideline for projects over \$500,000).
- **the notice holdback.** The notice holdback (s. 24 of the Act) relates to the owner's requirement to keep, in addition to the above-noted holdbacks, a further holdback when he has received a written notice of a lien from one of the trades on the project. Where an owner has received a written notice of lien, the owner must increase the holdback retained from the general contractor by the face amount of the lien claim, and continue to retain that amount until the lien has been discharged or vacated from title. A written notice of a lien may be a claim for lien or a letter identifying the owner and the project in question, as well as the person claiming the lien and the amount claimed owing.
- **the finishing holdback.** In order to protect the finishing trades, there is a separate 10% finishing holdback for that work done after substantial completion (s. 22(2) of the Act). The amount of the finishing holdback usually amounts to 3% of 10% of the general contractor's contract price for most projects. This holdback is released 45 days after

completion of the project, as 'completion' is defined in the Act (s.2 (3) of the Act), provided no liens are registered on title as of that time. Often the amount of the finishing holdback is so small that parties do not bother retaining it.

Please note that these statutory holdbacks are for the benefit of the sub-trades who work on the project, not the owner. They cannot therefore be used by the owner to pay for deficiencies or delay claims in most cases. Thus an owner will normally contract for the

right to keep a separate **deficiency holdback** for deficient work that will require correction.

WHAT'S A LABOUR AND MATERIAL BOND?

As part of the bidding or contracting process, an owner may require a contractor to procure two forms of "insurance" bonds to ensure the smooth completion of the project. The first is a performance bond, which protects the owner in the event of default by the contractor, by requiring the bonding company to pay the owner's damages in the event the contractor abandons the general contract. A labour and material bond requires the bonding company to pay sub-contractors in the event of default of payment by the contractor. On federal government projects sub-sub-contractors also have a right to claim against the bond.

Subsection 69(1) of the Act preserves a trade's right to sue on a labour and material bond, even though the contractor bought the policy and paid the premiums. A bond, like any other insurance policy, contains several time limits:

1. a period stipulated to file a proof of loss with the bonding company.
2. a period stipulated within which to sue the bonding company if it fails to pay.
3. an obligation of full and complete candour and co-operation with the surety/bonding company.
4. an obligation not to impair the insurer's right to sue the contractor by giving a release to the contractor or by otherwise impairing the insurer's right to sue the contractor for the amount paid under the policy.

A court may forgive non-compliance with all of the bond's requirements and allow a claim to proceed, but legal advice should be obtained with respect to any potential claims against a bond.

WHEN: LIMITATIONS TO RIGHTS

Construction trades that supply services and/or material to a job site are generally entitled to claim a lien against the owner's interest in the land being improved by their labour or products in an amount equal to the contract price of their unpaid services or materials.

For explanatory purposes, a lien can be thought of as the equivalent of a mortgage, giving the lien claimant the status of a secured creditor. The lien holder has the right to sell the owner's land to pay off the amounts claimed under the lien, provided certain steps are completed within strict time limits:

Step 1: For all those except contractors, the claim for lien is 'preserved' by the lien claimant registering a claim for lien on the **earliest** of these three (3) dates:



- a. within 45 days after a certificate of substantial completion has been published in a construction trade newspaper (usually the *Daily Commercial News and Construction Record*);
- b. within 45 days of the trade's last supply of services or delivery of materials to the project;
- c. within 45 days after the subcontract was certified as complete by the payment certifier on the project.

A contractor's lien claim has to be registered within

- a. 45 days after a certificate of substantial completion has been published in a construction trade newspaper, or
- b. completion or abandonment of its contract with the owner.

Step 2: The claim for lien is 'perfected' by issuing a Statement of Claim and registering a **Certificate of Action** against the

general contractor, owner, and, on some occasions, the mortgagees, claiming that:

- a. monies are owed to the sub-contractor by the contractor,
- b. that the lien claimant is entitled to share in the holdback held by the owner, and if same is not paid, the lien claimant's share of the holdback, and in some cases the entire amount of the debt, should be paid out of the proceeds realized by a court ordered sale of the property (which would be requested by lien claimants who were able to prove their lien claims).

The issuance of the Statement of Claim has to be done within 90 days of the earliest of the deadlines set forth in Step 1.

Because a lien claim is similar to a mortgage, mortgagees and lien claimants often dispute who should be paid first out of any proceeds of the sale of any property, and for this reason it is often a good idea to claim priority over a mortgage as part of 'perfecting' a lien claim. If priority over the mortgagee is not claimed, the mortgagee will be able to sell the "liened" property and keep the entire proceeds of the sale of the property, leaving the lien claimant with no ability to dispute or impede this process, rendering the lien claim worthless.

Although there is a method of avoiding Step 2 as a result of the rules regarding a process called sheltering, this process is not recommended for any lien over \$5,000.00.

Step 3: Expiry of the perfected claim for lien can be prevented. The lawsuit commenced by the issuance of a Statement of Claim must be "set down for trial" (i.e. put on the list of cases to be tried by a judge) within 2 years of the Claim's issuance. This is the responsibility of the lawyer handling the case.

Note that, until the Statement of Claim is served upon him, it is unusual for the owner to have notice of a lien claim. The only exception is if the owner is selling the land or receiving a mortgage advance. In both of these cases, a registered lien claim preserves the rights of the contractor or sub-contractor.

To enforce the lien claim the value of the lien is established at trial. If need be, the "liened" land is sold to satisfy the value of the lien as determined by the court, up to the lien claimants' share of the amount of the holdback.

HOW: PURSUING A LIEN CLAIM

The *Construction Lien Act* ("Act") has its roots in 18th and 19th century legislation designed to encourage rapid urban development by granting a 'lien', or a charge, in favour of bricklayers, carpenters or other workmen on the buildings they

erect in order to provide some security for their outstanding accounts. The legislation prevented the unjust enrichment of an owner with no direct contract with the trades, but whose property was improved by the value of their work.

THE LIEN PROCESS

As one of the purposes of the Act is the expeditious payment of trades who can ill afford protracted and complicated litigation, the procedure set out in the Act itself stipulates that a lien Action shall be, *as far as possible*, of a summary character, and costs will be awarded where the least expensive course is not taken. Of course “as far as possible” is a matter of argument and, accordingly, lien Actions, particularly for large amounts, or which involve numerous parties, can be as lengthy and complicated as any other form of commercial litigation. The process can be complex, and is best guided by lawyers representing each interested party. The following information provides an overview of the lien claim process.

The general rules in the Act outline the following procedure:

1. perfection of the Claim for Lien by commencement of an Action within a time period strictly stipulated in the Act;
2. service of the Statement of Claim within 90 days after issuance of the Claim for Lien;
3. service of the Statement of Defence within 20 days after service of the Statement of Claim;
4. a settlement meeting to allow the parties to decide on what issues can and cannot be settled, and how the remaining issues are to be dealt with at trial;
5. setting the Action down for trial within 2 years from the date of issuance of the Statement of Claim.

The first stage of a law suit involves an exchange of pleadings. A law suit is commenced with the Plaintiff issuing and serving a Statement of Claim which summarizes the material facts upon which the Plaintiff relies for his claim.

The Defendant’s solicitor then serves and files a Statement of Defence setting out the material facts upon which the Defendant intends to rely to defend against the Plaintiff’s Claim. If the Defendant has a claim against the Plaintiff, the Defendant may also “counterclaim” against the Plaintiff for monies the Defendant feels are due and owing by the Plaintiff.

The Plaintiff will file a Statement of Defence to Counterclaim if a counterclaim has been issued.

If a Defendant wishes to establish that he should share liability with another person, or that he should be indemnified

by another person for any liability he has to the Plaintiff, he will issue a cross-claim against that person (if that person is already a defendant to the action), or issue a Third Party Claim (if the third party is not already a party to the proceeding). A Third Party Claim has the effect of commencing a separate law suit in which more persons are added to the law suit.

The purpose of the Statement of Claim, Statement of Defence, and other pleadings is to summarize the material facts that each party seeks to establish at the trial in support of their claim or defence.

The next stage is usually a settlement meeting, particularly when there are several lien claimants. At the settlement meeting the lien claimants choose a lawyer or a committee of lawyers to investigate each lien claimant and to prosecute the Action against the Owner and, if necessary, the mortgagees. The lawyers for the owner and mortgagees then disclose the amount of the



holdback and the amount and timing of the mortgage advances, and the lien claimants seek to settle with the owners and mortgagees or at least narrow the issues. When there are only one or two lien claimants, this process is usually carried out through conversations and correspondence between solicitors.

The next stage of the process is to discover what evidence, relevant to the facts set out in the pleadings on those issues that remain outstanding after the settlement meeting, each party has. This may be done at a settlement meeting, or (with the consent of the parties or leave of the court) through the court’s ordinary Discovery process.

The purpose of the settlement meeting is to resolve or narrow the issues to be tried by the trial judge. This meeting is scheduled pursuant to an agreement between the parties to the Action or court order and may be held at the Courthouse or in a law office,

and in front of a judge or not, as the person calling the meeting elects. Where factual issues are likely to be resolved, or settlement offers are likely to be considered, clients are invited to attend.

The meeting is usually divided into 2 parts. At the first part of the meeting the solicitors for the lien claimants meet and agree to join their individual Actions into one Action, elect a lawyer or group of lawyers to conduct the consolidated lien Action, and develop a strategy for pursuing or settling the Action.

At the second part of the meeting the solicitor for the owner, and where appropriate, the mortgagees, join the solicitors for the lien claimants and attempt to determine what facts are and are not in dispute, the amount of the holdback, and the order of priority of the liens vis-a-vis the mortgages, (for example the owner sets out what liens are disputed due to timeliness, work performed, or deficiencies.

A review of all parties' documentation may take place if the matter is straight forward.

After the settlement meeting, the parties agree on a "Statement of Settlement" which is a written record for the court of those issues of fact and law which have been settled or narrowed. The Statement is binding on the parties. Those areas which are still the subject of disagreement are usually dealt with through the Discovery process.

The Discovery process involves both the discovery of each party's documentation and the discovery of what each party's testimony will be at trial. As part of this process the parties will each be required to produce an Affidavit of Documents listing all the documents they have which are relevant to the proceeding, both helpful and harmful to their own case. Each party has access to other parties' documents through rights of inspection granted by the Rules.

Each party's solicitor is also entitled to examine the other parties under oath before a court reporter in the Special Examiner's office (across from the Courthouse) and to obtain a transcript of their testimony before the trial. The questions and answers are drawn to the attention of the trial judge if a party gives evidence at the trial that contradicts that given on the Examination for Discovery for the purpose of casting doubt on the evidence given by that party at trial. The other purpose of the transcript is to give each party's lawyer a meaningful source of information upon which to evaluate the merits of their client's case, and to negotiate a



settlement. Prior to the Examinations for Discovery, lawyers have only heard the strengths and weaknesses of their client's case from the clients themselves. The Examination educates lawyers as to the strengths and weaknesses of other parties' cases and thus come to a more realistic evaluation of the outcome of any trial. Any legal opinion prior to the Examination for Discovery is therefore tentative by definition and subject to modification once the Discovery process is completed.

After the Discovery process is completed one of the parties usually asks the Court to put the action on the trial list where it waits to be called for trial. While the action is waiting for a trial date to be set, a pre-trial may be held for the

purpose of encouraging a fair settlement of the case. At the pre-trial a pre-trial judge will hear each lawyer argue the evidence and law, and will then give an opinion as to how he or she would decide the case. The pre-trial judge will not be the trial judge and the discussions at the pre-trial are strictly confidential. Pre-trials are rarely held in construction lien actions, but one may be held at the request of either party. As a pre-trial judge is usually an actual judge, the opinion rendered at a pre-trial should be carefully considered before proceeding any further.

The entire process of having an action brought to trial can take from one to five years based not only on backlog of cases waiting to be heard, but also on the number of motions required in the action. A motion is an application before a judge seeking an order requiring a party to fulfill his obligations under one or more of the steps of the process. Although motions are costly and time consuming, they are sometimes necessary to prepare a case properly for a trial.

GETTING INFORMATION ABOUT TRUST AND LIEN RIGHTS

Section 39 of the *Construction Lien Act* ("Act") provides tradespeople with the right to ask the mortgagee, owner and contractor on a project to provide an accounting of monies advanced by all the building mortgagees, the monies paid by the owner to the contractor, and by the contractor to his sub-contractor(s). This section also allows the tradesperson to obtain a copy of any labour and material bonds posted for the project, and various other forms of information. Section 39 is therefore critical to obtaining information that can allow a tradesperson to ascertain information about holdback, trust, and bond obligations on a relatively quick and inexpensive basis.

To comply with the provisions of the Act, the tradesperson must make a written demand on the mortgagee, owner, and/or contractor, as the case may be, seeking a mortgage statement from the building mortgagees, and information about any labour and material bonds, the contract price and the monies advanced under the general contract and sub-contracts, from the parties concerned. If the demand is ignored, a court order to produce this information can be obtained at the requestee's expense.

Tradespeople should obtain a copy of a building permit on the job from the owner, consultant, or the municipality. The permit often gives the legal description of the property being improved by their labour, services, or material. With that information the tradesperson can, by doing a search at the local government real estate registry office, discover who owns the property and who is financing the project with a building mortgage. With a proper legal description of the property, most law firms can obtain this information on the internet. Proper legal descriptions can sometimes be obtained by calling the local municipal tax office and providing it with the proper municipal address for the improved land.

Certificates of Substantial Completion are published in the *Daily Commercial News*. Certificates can be obtained by calling 905-752-5546 ext. 5513.

WHY: PRIORITY OF PAYMENT

Bankruptcies make it very difficult for tradespeople to recover any money unless they register a claim for lien. While a trust claim survives bankruptcy, establishing a breach of trust is often a lengthy and expensive process where there is an intervening bankruptcy. Registering a claim for lien, and perfecting that claim when the time comes, makes a tradesperson a secured creditor who has a simple claim against the holdback which is not impeded by the contracting party's bankruptcy. The holdback obligation leapfrogs the bankrupt contracting party and constitutes a direct claim against their "payer" which is unaffected by the bankruptcy.

Lien claims are important because:

1. they are the only way to preserve a claim to the holdback, which is secured by an interest in the land that is superior to the owner's and the building mortgagee's interests in the land;
2. the claims for holdback are unimpeded by insolvency proceeding, and for many tradespeople are the only quick source of payment;
3. they give the tradespeople the right to appoint a construction lien trustee through court proceedings which may result in a project being completed and sold for its true value, and thus allow them to maximize the amount of money owed to them;

4. without this claim, the tradesperson may be left to expensively pursue trust or bond claims without any guarantee of recovery;
5. owners and others cannot set-off against the holdback. The holdback is a statutorily mandated "insurance fund" that must be there to satisfy lien claims. Without a claim for lien, a tradesperson has no readily available fund to satisfy amounts due to him.

WHERE: DEALING WITH THE FEDERAL AND PROVINCIAL GOVERNMENTS

No one can register an interest in Crown land. As a substitute, the province of Ontario has a procedure whereby a written notice of lien can be served upon it, upon various crown agencies and upon municipal governments in lieu of registration of the lien against provincial and local government land.

The federal government is far less accommodating. The only protection it will afford the tradesperson is to require a contractor to post a labour and material bond on some federal projects. One has to be careful with even this limited protection, as federal government authorities may require a bond as part of their tender process, and waive the requirement of posting such a bond by the time they contract with the contractor in charge of the project. Therefore, it is prudent to ensure such a bond is in place, and obtain a copy, before commencing work. Normally these bonds have strict requirements and provide sub-contractors with limited protection. The sub-contractors' increased risk on federal





projects is normally reflected in increased bid prices on those projects, except in the case of sub-contractors otherwise desperate for work, or work experience on federal projects.

FREQUENTLY ASKED QUESTIONS

Q.: Why should I lien when the general contractor, or the party I contracted with, already has registered a claim for lien?

A: It is a common, but misplaced, belief amongst tradespeople that there is no need to register a lien claim if the contractor has registered such a claim, and included the amount the tradespeople are owed in the claim. The fallacy of this belief is demonstrated by a simple example:

- The owner signs a million-dollar contract with the contractor. The contractor sub-contracts out the work for a total of \$950,000 of sub-contracts. The work is finished, but the owner has only paid the contractor \$800,000.
- The contractor registers a claim for lien for \$200,000. The sub-trades have received \$800,000 from the contractor pursuant to the contractor's trust obligations under the Act. They are still owed \$150,000, but see no need to file claims, given the contractor's lien for \$200,000.
- The owner defends the contractor's claim for lien by asserting \$200,000 in damages due to the contractor's deficiencies and delays in completion of the work.
- The contractor goes bankrupt. The trustee in bankruptcy who takes over is ill prepared to prove the contractor's claim against the owner.
- Because the owner receives nothing, the sub-trades receive nothing from the insolvent contractor.

Now consider what happens if the sub-contractors' lien:

- The owner is not entitled to claim against the basic or finishing holdbacks, which together amount to \$100,000 on the million-dollar contract.
- The owner is in no position to seriously contest the sub-contractors' individual claims, which total \$150,000.
- The owner therefore has to distribute the \$100,000 otherwise payable to the contractor, pro-rated for each of the sub-trades who register a claim for lien, and each receive about 66 cents on the dollar. Of course the percentage recovery is higher if fewer sub-trades register lien claims. For example, if the aggregate of the lien claims of the sub-contractors only totals \$100,000, then each sub-contractor would recover 100 cents on the dollar out of the holdback.

The same logic applies to sub-sub-contractors who are tempted to rely on their sub-contractor's claims for lien.

Q.: What is the legal effect of a Letter of Intent?

A.: Letters of Intent are used for two distinct purposes.

- A common purpose is to act as written evidence of a mutual intention to create expectations between the parties about what the terms of a later, binding contract will contain, so that third party arrangements can be made with suppliers, bankers or others in advance of a binding contract being entered into.
- An equally common purpose is to allow business people to contract with each other on the basic terms of their contract without the help of legal professionals on the understanding that their lawyers will eventually be drafting more formal documents that will spell out in greater detail the terms of the contract that the parties have agreed to.

In the first case, the parties do not intend the letter of intent to be a binding contract: In the second case they intend it to be a preliminary, binding contract that will be tidied up by lawyers. Whether a letter of intent is a contract or not depends on the court's view of which type of letter of intent is involved, as both typically contemplate more formal contractual documents to be drawn up.

Letters of intent tend to be nothing but a recipe for litigation. The leading Canadian case states:

"It appears to be well settled by the authorities that if the documents or letters relied on as constituting a contract contemplate the execution of a further contract between the parties, it is a question of construction [by a court] whether the execution of the further contract is a condition or term of the bargain or whether it is a mere expression of the desire of the

parties as to the manner in which the transaction already agreed to will in fact go through. In the former case there is no enforceable contract either because the condition is unfulfilled or because the law does not recognize a contract to enter into a contract. In the latter case there is a binding contract and the reference to the more formal document may be ignored [if the parties cannot agree on the terms of the more formal document].”

Unless an express intention is made elsewhere of whether or not the parties intend to be legally bound, the parties will find themselves left in judicial hands as to whether a contract has been made or not. The danger of using a provision “subject to the execution of a formal agreement” or words to similar effect without more is illustrated by the fact that courts have considered similar facts on several occasions, and have sometimes found a contract, and other times have not. Letters of Intent therefore make lawyers rich and their clients poor.

Q.: Can I accept part payment under a contract without jeopardizing my right to claim the balance due me?

A.: The answer to this question is yes, if you take the appropriate steps to preserve your rights. This procedure should not be undertaken without the assistance of a lawyer.

Every contract requires that there be an exchange of values between the parties. This is called “consideration.” If a party does not give some consideration to the other party, then there is not an exchange of values: There is a gift from one party to another. Promises to give a gift cannot be enforced in a court of law.

Consider two scenarios:

1. Under the original contract, a drywaller agrees to install drywall in a house for \$5,000. After the drywall work is done, the owner has to pay \$5,000 to satisfy their obligations under the contract. However, a dispute arises as to whether the contract was satisfied by the work completed. If there is a *bona fide* dispute over the quality of the work, the parties may agree that the work in place is worth \$3,500. Now there is a new contract, or a new accord, that is satisfied by paying \$3,500 in full and final satisfaction of the new contract. The consideration for reducing the contract price by \$1500 is the owner agreeing that the drywaller need not complete the work to the contractual standard.
2. Under the original contract, a drywaller agrees to install drywall in a house for \$5,000. The owner simply runs out of money and wants to pay \$3,500 to fully satisfy his obligations under the \$5,000 contract. The owner normally endorses the \$3,500 cheque “full and final

payment.” The drywaller agrees to take the \$3,500 given the lack of a viable alternative at the time. Later the owner receives more funds. Can the contractor sue for the remaining \$1500 due under the original contract?

Where a creditor accepts a cheque for a lesser amount than the debt, the creditor is really giving the owner a gift of \$1500 that is not legally enforceable. Under the common law the creditor could turn around and sue for the balance. Notations on cheques, or letters accompanying them, that the cheque for a lesser amount was payment “in full,” or “in full satisfaction of all claims,” is not conclusive of an agreement that the creditor was willing to take less than full payment and release the rest of his rights. Similarly, if the creditor certifies the debtor’s cheque, but does not cash it, the effect is the same as payment. Under the common law the creditor is likely to be considered to be holding the cheque as security to be used only if payment in full is not eventually forthcoming.

In Ontario the legislature has a strong public policy of encouraging parties to resolve their difficulties out of court. Therefore the legislature has passed legislation that allows people to make part payment in full and final satisfaction of their contractual obligations despite the fact that an agreement to accept partial payment is an agreement by the creditor to gift the balance due to the debtor. Because of the public policy requirement that business people in financial hardship should be allowed to settle their debts by part payment, s. 16 of the *Mercantile Law Amendment Act* enforces such agreements, and the doctrine of estoppel will prevent a creditor from suing for the balance where the debtor has been led to believe the creditor accepted the part payment and the debtor did something to his detriment as a result, such as borrowed money from a bank for a new venture based on the belief that all of its previous debts had been paid.

Consider the facts of *Champlain Ready-Mixed Concrete v. Beaupre*, [1971] O.R. 568, (Ont. C.A.), where the creditor



amended the debtor's endorsement on a cheque for part of the debt which was stated to be "payment in full." The creditor crossed out the words "in full," and added the words "on account, balance \$430.85." The creditor eventually notified the debtor that his cheque had not been accepted as payment in full. The issue was whether the creditor could sue several months later for the \$430.85 otherwise due. The Ontario Court of Appeal said "... while the silence of a creditor may be some evidence which is to, be considered with all other evidence in deciding whether or not there has been express acceptance, in my view it is not a factor which is singly governing the rights of the parties." Rather, the debtor had "a very heavy onus. He must prove an express acceptance of part performance." This follows the wording of s. 16 of the *Mercantile Law Amendment Act*.

16. "Part performance of an obligation either before or after a breach thereof **when expressly accepted by the creditor in satisfaction or rendered in pursuance of an agreement for that purpose**, though without any new consideration, shall be held to extinguish the obligation."

Accordingly, a debtor who wants to make a part payment in full satisfaction of past debts requires an agreement in writing, or other well evidenced agreement, between the parties to establish that the cheque has been accepted as a release of further obligations, or, alternatively, that the creditor allowed the debtor to believe that such a release had been agreed to, and the debtor has suffered damages beyond the obligation to re-pay the balance due as a result. For example, if the debtor represented that he had paid off all of his previous debts in full, and would be in default of the terms of a bank loan if the old debt resurfaced, a court may stop ("estop") the creditor from asserting a claim for the balance.

The best policy is one that rejects small cheques that purport to satisfy the entire debt. If cheques that almost satisfy the debt are cashed or certified, an immediate request for the balance should be issued to the debtor so there is no estoppel argument from the debtor, who might claim to have been misled into believing the terms of the debt had been satisfied and that he had acted accordingly. This is a classic example of where legal advice should be sought in every case.

Q.: Can an Owner Accept a Non-Compliant Tender Bid?

A.: Owners normally draft tenders that appear to allow them to accept or reject any bid at their discretion. Contractors, who often spend considerable sums preparing a bid, appear to have no recourse when their

bid is not accepted, while the owner can force the same contractor to fulfill the terms of any bid they have accepted. However, appearances are deceiving.

In *M.J.B. Enterprises Ltd. v. Defence Construction (1951) Limited*, [1999] 1 S.C.R. 619, the Supreme Court of Canada considered the effect of the statement, commonly found in tender documents, that "the lowest or any tender shall not necessarily be accepted." That type of clause is generally referred to as a "privilege clause." In this case, the owner ignored a bid that complied with all of the requirements of the government's tender in favour of a non-compliant bid for a lower price. The owner relied on the privilege clause to support his right to do this.

The Supreme Court of Canada rejected the owner's right to do this. The Court found that the mandatory requirements of a tender are mandatory on both the owner and the bidder, and that a privilege clause only allowed the owner a freedom to select amongst those bids that complied with the mandatory parts of the bid.

While the appropriate tender language may grant the owner a wide discretion regarding which compliant bid should be accepted, the discretion is not uncontrolled the court. Discretion is measured by subjective, or objective, standards, and is always "subject to a requirement of honesty and good faith." As one court has noted:

Provisions in agreements making payment or performance subject to the "discretion," "the opinion" or the "satisfaction" of a party to an agreement or a third party, broadly speaking, fall into two general categories. In contracts in which the matter to be decided or approved is not readily susceptible of objective measurement – matters involving taste, sensibility, personal compatibility or judgment of the party for whose benefit the authority was given – such provisions are more likely to be construed as imposing only a subjective standard. On the other hand, in contracts relating to such matters as operative fitness, structural completion, mechanical utility or marketability, these conditions are generally construed as imposing an objective standard of reasonableness.

A contractor or tradesperson who has lost a bid is not without rights. Claims by tradespeople for lost profits or lost expenses in preparing a bid that has not been accepted by the owner are becoming more common.

