CONSTRUCTION LIENS AND COLLATERAL MORTGAGES - SO YOU THOUGHT YOU HAD PRIORITY

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You've searched title, and everything is clear. Your lender advances funds to you knowing it will have security up to the amount of funds advanced to date. But when is an advance an advance?

A set of cases, which has not received much attention from the real estate bar, provides that, in certain common circumstances, funds which have been factually advanced by a lender to a borrower (who may or may not be the owner of the lands being improved) will not be considered to have been "advanced" for the purposes of Section 78 of the *Construction Act*, with the result that the lender will lose full priority to any future construction liens which may arise.

This paper is not intended to be a full discussion on the priorities of construction liens. Instead, it will focus on a specific loss of priority where a collateral mortgage secures a guarantee or is additional security for loans to an affiliated entity, or where a mortgage is registered after the first lien arises, to secure a pre-existing debt.

Nature of an "advance"

Before discussing the cases, a brief review of the *Construction Act* is necessary. The priority issue discussed in this paper arises from interpretation of "when an advance was made" as per subsections 78(3), (4) and (6) of the *Construction Act*. Section 78 provides for priority of mortgages over construction lien: "save and except for the exceptions in that paragraph, construction liens have full priority over any mortgage". A key aspect to many of the exceptions in Section 78 of the *Construction Act* is when funds have been "advanced".

Generally speaking, a lien "arises" at the time of supply of improvements or services. Such a lien is then preserved by registration of the lien against title, and is perfected by registration of a certificate of action within the appropriate timeframe (subject to sheltering). For the purposes of determining priority of a mortgage, different subsections apply to prior mortgages[1] and subsequent mortgages[2], and various other scenarios. For the purposes of this article, we consider both prior mortgages and subsequent mortgages generally. In both such circumstances, assuming that no lien has been preserved or perfected, a mortgage has priority to the lesser of (i) the actual value of the property at the time when the first lien arose (for a prior mortgage); and (ii) to the extent of any advance made in respect of that mortgage (except deficiencies in the holdback). Knowing what constitutes an "advance" made in respect of a mortgage is then a critical requirement to ensuring your client obtains enforceable security.

An advance for the purposes of the *Construction Act* has been defined as occurring "when the owner, or the owner's delegate, acquires actual control of the money."[3] This is not as difficult to determine where the mortgage is a conventional mortgage, and is generally a case of identifying the time that funds are released to the borrower. In the case of a collateral mortgage, the question can become more complicated. A collateral mortgage may in some cases secure a loan agreement whose debtor is a third party with no connection to the lands being charged securing a number of credit facilities, including prior debts, revolving lines of credit, and letters of credit facilities, or it may serve as security for other obligations, such as a guarantee. Is a debt which pre-dated the mortgage considered to have been advanced for the purposes of that mortgage? At what time are the monies secured by the guarantee considered to have been advanced? These are all questions that arise out of the nature of a collateral mortgage, without many answers from the case law. As Justice Wilton-Siegel wrote in *Jade-Kennedy Development*

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[1] *Construction Act*, RSO 1990, c C 30, s 78(3) and (4).
[2] *ibid*, s. 78(5) and (6).
[3] *Marsil Mechanical v A Reissing – Reissing Enterprise Ltd*, [1996] OJ No 279, para 14.

Corp (Re)[4], "[t]here is little case law on the principles that determine whether monies advanced or otherwise paid in respect of a mortgage constitute an 'advance made in respect of that mortgage.'"[5] To date, there are only 3 Ontario cases which appear to directly consider this issue in the context of collateral mortgages: (i) *561861 Ontario Ltd. (cob Robert Excavating) v. 1085043 Ontario Inc.*[6], (ii) *XDG Ltd. v. 1099606 Ontario Ltd.*[7] and (iii) *Jade-Kennedy Development Corp (Re)*.

561861 Ontario Ltd. (cob Robert Excavating) v. 1085043 Ontario Inc.

This case concerned the priority of a mortgage registered in favour of Dorothy O'Byrne. Dorothy had lent her brother, Angus O'Byrne, $100,000 so that he could purchase his estranged wife's interest in their matrimonial home. Although the mortgage itself only referenced the lands which comprised the matrimonial home, Angus owned an additional 200 acres of adjacent land, and it was thought that the mortgage would attach to all of the lands. Angus subsequently sold the property to 1085043 Ontario Inc. for development of a golf course. The final payment of $100,000 was to be paid by Angus taking back the matrimonial home and some other 40 acres of lands free and clear of encumbrances, and it appeared that 1085043 Ontario Inc. was to pay out Dorothy as of the consideration.

At closing, Dorothy's mortgage was discharged, the property was conveyed to 1085043 Ontario Inc., and a new first mortgage was registered in favour of Desjardins with a second mortgage in favour of Dorothy. Construction liens were eventually registered against the property and a vesting order issued pursuant to a court ordered sale. The vesting order did not recognize any encumbrance by Dorothy or any monies owing to her. Dorothy argued before the

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[4] [2016] OJ No 6238.
[5] *ibid*, para 37.
[6] [1998] OJ No 2925.
[7] [2002] OJ No 5307.

court that her mortgage should have priority against any construction lien claimants as a prior mortgage.

Justice Chadwick rejected Dorothy's arguments and found full priority for the lien claimants. He wrote:

> "I am satisfied on the evidence before me that Mrs. O'Byrne did not advance any funds as required by s. 78(3) of the Construction Lien Act and as such would not be entitled to priority over the lien claimants.
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> The mortgage registered on title reflects the agreement she had with her brother Angus O'Byrne and did not benefit the land in question. There were no monies advanced by her, all monies had been advanced on the prior mortgage in 1991 which was subsequently discharged."[8]

Notwithstanding that Dorothy's mortgage constituted a prior mortgage which arose even before the lien claimants had commenced any work, she was denied from having any priority.

XDG Ltd. v. 1099606 Ontario Ltd.

561861 Ontario Ltd. (cob Robert Excavating) v. 1085043 Ontario Inc. was subsequently relied upon on in the decision in *XDG Ltd. 1099606 Ontario Ltd.* This case concerned the priority of lien claimants as against a mortgage registered in favour of General Electrical Capital Canada Inc. ("**GECC**"). Euro United Corporation ("**Euro United**") was indebted to GECC pursuant to a credit agreement. An amendment to the credit agreement resulted in 1099606 Ontario Ltd. (an affiliate to Euro United) providing a guarantee and mortgage to GECC as additional security. The mortgaged property was subsequently sold and the lien claimants brought an application to determine priority as between themselves and GECC.

In finding for the lien claimants, Justice Gordon wrote:

> "As previously stated, the mortgage was provided as collateral security with respect to the prior indebtedness of Euro United. No advance was made to 109 nor did 109 benefit in any manner whatsoever. The statutory provisions refer to

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[8] *ibid*, paras 23-24.

amounts advanced, not amounts secured: See 561861 Ontario Ltd. v. 1085043 Ontario Inc."[9]

Again, the lien claimants were provided with full priority over GECC's mortgage as a result of no "advance" being considered to have been made to 109, and as a result, no advance having considered to have been made under the mortgage.

Jade-Kennedy Development Corp. (Re)

Jade-Kennedy Development Corp. (Re) provides the latest development of the above cases. The proceeding was brought to determine the relative priority of lien claimants and various mortgagees that lent money to Jade-Kennedy Development Corporation ("**Jade**"). Jade was the owner and developer of various condominiums and vacant properties forming the "South Unionville Square Project." Various mortgages were registered and outstanding against the properties at the time the properties were sold, as follows:

1. a first mortgage in favour of Laurentian Bank, which had been largely repaid except for the outstanding amount of $50,000 in professional fees;
2. a second mortgage in favour of Am-Stat Corporation, which provided that it was made jointly to Jade and Milliken Development Corporation, on properties owned by each of them which secured each of their joint and several obligations;
3. a third mortgage which had been assigned to MarshallZehr Group Inc., which mortgage secured a guarantee by Jade of certain credit facilities made available to 144 Park Ltd. Of particular note, this mortgage secured $3,600,000, and it was noted that shortly after registration, an advance of $3,600,000 was made to 144 Park Ltd. on account of its credit facilities.

[9] XDG *supra* note 7, para 94.

Justice Wilton-Siegel found that the first and second mortgages had priority over the lien claimants, whereas the third mortgage did not. In so finding, he described his rationale as follows [***emphasis added***]:

> "Absent special circumstances, I am not persuaded that an advance under a mortgage loan, or a secured loan facility, constitutes an "advance made in respect of" a collateral mortgage given to secure a guarantee by a third party of a borrower's obligations under the mortgage loan or the secured loan facility. I reach this conclusion for three reasons.
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> ***First***, an advance is made under a particular secured loan facility or mortgage loan. When repayment of that advance is guaranteed by a third party who has provided a collateral mortgage to secure the third party's guarantee, the amount of the advance would also be secured under the collateral mortgage indirectly via the guarantee. However, I do not think that an advance to a borrower under a mortgage loan, or in favour of borrower under a secured loan facility, can also be said to be "an advance in respect of" the guarantee or any collateral mortgage that secures the guarantee. Rather, ***the advance is made to the borrower in each case, not the guarantor, even if the advance also increases the amount owing under the guarantee***.
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> I note that, in the italicized sentences noted above in the decision of the Divisional Court in XDG Ltd., I believe that the Divisional Court reached the same conclusion as the basis for its decision. I would suggest that, in fact, the foregoing analysis provides a more appropriate basis for the decision in XDG Ltd. than the timing of advances, which was the basis of the trial court judge in that case.
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> ***Second***, as the circumstances pertaining to the Collateral Mortgage demonstrate, there is an inherent problem in respect of a collateral mortgage granted after an initial advance under an underlying loan. Insofar as the collateral mortgage purports to secure the initial advance as well as any subsequent advances, ***the principle in XDG Ltd. would suggest that the collateral mortgage does not secure the initial advance***. It is therefore necessary to argue, as MarshallZehr does (discussed below), that the collateral mortgage secures only advances made after delivery of the collateral mortgage.
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> ***It is not feasible, however, to separate advances in this manner***. Advances are essentially fungible. To approach the amount secured under a collateral mortgage in such manner, it would be necessary to establish a principle to determine, in respect of payments made on the underlying loan, how amounts are to be applied under the loan agreement in order to determine whether or not there are any advances outstanding at the time of enforcement proceedings that represent advances made after the grant of the collateral mortgage. I am not persuaded that such an approach is practical given the number of problematic scenarios that could arise depending upon the principle selected for such determination.

> ***Third***, ***more significantly, this treatment of advances is inconsistent with the concept of the guarantor's obligations under the guarantee which are secured by the collateral mortgage***. Such obligations are expressed in terms of a guarantee of the borrower's obligations in respect of the loan, not in terms of the borrower's obligations in respect of particular advances. Accordingly, a typical guarantee does not distinguish between obligations in respect of advances made before or after the delivery of any collateral mortgage given to secure the guarantor's obligations. Unless specific provision is made in the guarantee, all advances give rise to obligations under the guarantee that are thereby secured under the collateral mortgage, regardless of the timing of such advances, subject only in certain cases to a maximum liability."

To the extent that professional fees under the first mortgage were contractual obligations under the terms of the credit facilities secured thereunder, Justice Wilton-Siegel granted priority and treated same as advances.[10]

With respect to the third mortgage assigned to MarshallZehr Group Inc., Justice Wilton-Siegel held that priority was in favour of the lien claimants due to the fact that the loan and advances for the purpose of the *Construction Act* were secured by mortgage was between 144 Park Ltd. rather than the registered owner, Jade-Kennedy Development Corporation. This was in spite of the significant advance which followed registration of the collateral mortgage and MarshallZehr Group Inc.'s arguments that this advance would not have occurred but for the provision of the collateral mortgage. He wrote "it is not possible, nor was it intended, to segregate the $3.6 million advance to 144 Park from all other advances made to that party. On its own terms the Collateral Mortgage secured the obligation of the Borrower, as guarantor, to pay all amounts owing pursuant to its guarantee to an aggregate liability of $3.6 million. It does not purport to secure only the amount owing pursuant to the particular advance of $3.6 million."[11]

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[10] *ibid*, para 63. A more suitable answer may be that costs are not "advanced" for the purposes of Section 78 of the *Construction Act*, but are instead costs to be allowed by the Court pursuant to its powers under other sections of the *Construction Act*. This was the finding of Master Sanders in *David Schaeffer Engineering Ltd v DTA Investments Inc*, [1998] OJ No 587.

[11] *ibid*, para 70.

The same rationale applied to Justice Wilton-Siegel's rationale in providing priority to the Am-Stat Corporation second mortgage. Both borrowers under the Am-Stat Corporation mortgage were, in Justice Wilton-Siegel's words "liable as a primary obligor in respect of the full amount of the Am-Stat Advance, rather than as a guarantor…"[12], and each of the collateral mortgage securing Am-Stat Corporation's loan secured "one and the same Indebtedness."[13] As a result, it was "not possible, as a legal or a practical matter, to distinguish between proceeds of the Am-Stat Advance paid to the Borrower and proceeds paid to Milliken."[14] Mr. Justice Wilton-Siegel, therefore, approved the situation as having co-borrowers and permitting the advance of monies to go to one borrower only based on their joint direction, without impacting and the fact that same would still be considered an "advance" for the purpose of Section 78(6), where the proceeds were not used for the Project in question.

It should be noted that the lien claims in this case had attempted to convince the court that advances were required to be made for the purpose of the improvement. This was rejected by Mr. Justice Wilton-Siegel (paragraphs 44-47).

Interpretation and Suggestions

These cases highlight a few practical principles. Firstly, monies secured under a collateral mortgage securing a guarantee has now been held, in a few cases, not to constitute an advance for the purposes of Section 78 of the *Construction Act*, with potentially disastrous results for a lender.

Secondly, it appears that a mortgage, even given by the owner of the property under improvement to secure advances that were made to secure pre-existing advances, will not qualify either as a prior mortgage or a subsequent mortgage for priority, as the courts have held

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[12] *ibid*, para 76.
[13] *ibid*, para 79.
[14] *ibid*, para 79.

that the money secured under these mortgages will not be deemed to be an "advance" for the purposes of Section 78. A relatively simple solution to the collateral mortgage problem lies in structuring the loan secured by the mortgage to obligate all covenantors as if they were co-borrowers, rather than differentiating between guarantors and borrowers. The co-borrowers can then direct where the funds are to be advanced. i.e. to the borrower whose property is not under construction. As per the situation of the Am-Stat mortgage in Jade-Kennedy, this should work if it was structured as such at the outset. If there is already a pre-existing loan, one would have to consider amending the terms of the loan to add the "guarantor" as a borrower under the loan. However, in those circumstances, the priority over construction liens would only be retained, at best, in respect of advances subsequently made under the new mortgage that would be granted by the co-borrower in mid-stream of the loan.

Thirdly, the cases have held that pre-existing debt of any kind at the date of mortgage registration, may lose priority to construction liens.

Especially careful concern should be taken when additional security is being taken to secure non-performing or increased credit facilities. In these circumstances the transaction will often involve a different entity providing security for a pre-existing facility as was the case in *XDG Ltd. v. 1099606 Ontario Ltd.* In such circumstances, it is suggested that the transaction:

1) provide that the underlying loan agreement expressly treat the different entity as a co-borrower;

2) eliminate any concept of a guarantee from the documentation to be provided, the co-borrower's obligation to pay flowing from the underlying loan agreement rather than any stand-alone guarantee; and

3) where the security is intended to secure pre-existing debt obligations to the extent possible, the loan will need to be repaid and restructured so that a fresh advance is made under the mortgage.