



Mortgage Priorities and Construction Liens

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Construction Lien Act

The Construction Lien Act (the “Act”) provides financial protection to those who supply services or materials to a construction project and are not paid. The financial protection is significant as it extends to situations and parties where no contract or direct interaction has occurred. Accordingly the Act is given a strict interpretation as to who receives such benefits. However, once rights are found to apply, the benefits are liberally interpreted.

The Act provides financial protection in the form of a claim for lien that may be registered against the owner’s interest in the property. Furthermore, the Act requires an owner to maintain certain holdbacks, e.g. statutory holdback being 10% of the value of work done under the contract, which is to be maintained as a security pool lien claimants may look to for payment in the event of default.

A contractor or subcontractor is entitled to a claim for lien upon it first supplying services or materials to the improvement. A claim for lien is only registered against title when a payment default or dispute arises on the improvement. The act of registering a claim for lien serves to preserve and give notice of the contractor’s or subcontractor’s lien rights in the property.

One cannot contract out of one’s obligations under the Act. For example, a mortgagee owes an obligation to those who contribute services or materials to an improvement on the mortgaged property despite not knowing who they may be. A mortgagee’s obligations may stem from its intentions in providing the lending facility. From a practical perspective, priority disputes are only a concern when there is limited value in the property. As lien claims typically arise on troubled projects a mortgagee has much to lose in a priority dispute with lien claimants.

The Act is complex and the application of the law and concepts to specific situations requires legal advice, as a mistake or failure to comply with the Act is usually fatal. This paper is intended to provide a general awareness of construction law issues faced by mortgagees.

Mortgagee as ‘Owner’

The *Construction Lien Act* has a broad definition of “owner” and if a mortgagee is not careful its actions may be sufficient to attract the obligations of an owner. A construction lien is a claim against the owner’s interest in the property. The consequence to a lender whose conduct also makes it an owner is significant as it will lose all priority of its mortgage to lien claimants. An “owner” includes:

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2

*“... any person having an interest in the premises at whose request and:
a) upon whose credit, or
b) on whose behalf, or
c) with whose privity or consent, or
d) for whose direct benefit,
an improvement is made to the premises but does not include a home buyer”*

There is no hard test to determine who is an owner. A lender should be cautious of the degree of control and the direction it gives on a construction project. A participating mortgage increases the likelihood of a lender being considered an owner. Direct dealings with trades and suppliers, involvement in day-to-day operations, and other elements of project control are all factors that the court will consider.

Mortgage Priorities

When considering priorities the basic proposition is that lien claimants have priority over all interests affecting the owner’s interest in property. Accordingly, mortgagees have a subsequent priority to lien claimants unless they can fit within the express exceptions found in section 78 of the Act. In practice, however, the judicial approach has been to hold mortgagees to a heavy onus when establishing a priority over lien claimants.

The reasoning behind the complex priorities between mortgagees and lien claimants is because the property value is increased from the joint contributions of advances by a lender and by the services or materials of lien claimants. Where an owner becomes insolvent and cannot meet its obligations, the Act attempts to balance the competing interests to the security in the property.

The Act provides a comprehensive regime for resolving priorities between mortgagees and lien claimants. There are four types of mortgages in the Act and varying priority issues for each:

- i) building mortgage;
- ii) prior non-building mortgage;
- iii) subsequent non-building mortgage; and,
- iv) home buyer’s mortgage.

The rights of a lien claimant against a mortgagee differ significantly based on the type of mortgage. For the reasons set out below, it is generally important for the lender to make appropriate enquiries to determine the purpose of the funds, when the project will be commenced, and the value of the property before the project.



Building Mortgage

If a lender has a building mortgage the exposure can be onerous. Lien claimants have priority over a building mortgage to the extent of any shortfall in the holdbacks the owner is obliged to retain under Part IV of the Act. The Act defines a building mortgage as a mortgage taken by a mortgagee “with the intention to secure the financing of an improvement”.

A common misconception of some lenders is that their risk is limited to 10% of monies advanced. This is clearly not the case. The statutory holdback is based on the value of the improvement and not the amount of money advanced. Furthermore, Part IV of the Act provides for a ‘notice holdback’, as it is commonly known, wherein the owner is required to create an additional holdback equal to the value of a claim for lien when advised.

The priority rights of lien claimants are independent of the timing of registration of the building mortgage. Similarly, the priority rights of lien claimants are not impacted by the date of advances on the mortgage. The priority rights of lien claimants further extends to mortgages taken to refinance a building mortgage.

Prior Non-Building Mortgage

This is a mortgage where the funds are lent for reasons other than to finance the project. A prior non-building mortgage is defined as a mortgage registered on title prior to the “time when the first lien arose in respect of this improvement”. This is not to be mistaken with when a lien is first registered against title. A claim for lien arises when a party first supplies services or materials to the project.

Exactly when lien rights arise is often not easy to determine. The courts have held that the supply of services includes the supply of a design, plans, drawings or specifications that enhance the value of the land, demolition services, excavation, and earthworks.

The lender’s risk to a lien claimant is different depending on whether the advances are made prior or subsequent to the first lien. Prior advances have priority to lien claims to the extent of the lesser of: (i) the value of the premises at the time the first lien arose; and (ii) the total advanced before the start of the project. Subsequent advances retain priority unless a mortgagee has notice of a lien. When a claim for lien is registered on title it is deemed to be notice to the world. The priority over advances crystallizes and are available to all liens whether registered or not at the time of the advances.

Subsequent Non-Building Mortgage

If the lender registers its mortgage after the time the first lien arose it will be a subsequent non-building mortgage. Lien claimants will have priority over a subsequent mortgage to the extent of any deficiency in holdbacks required to be kept by the owner under Part IV. In addition to priority over deficiencies in the holdback, lien claimants have priority to all advances made in the face of notice of a claim for lien. Again priorities of advances



crystallize at the time of the advance and all lien claimants will have priority over advances that are made in the face of a single lien.

Home Buyer's Mortgage

The priority rules in favour of lien claims do not apply to a home buyer's mortgage. A home buyer's mortgage is one used to buy a residential home, whether or not the home constructed at the time the home owner enters into the agreement of purchase and sale, not more than 30% of the purchase price is paid prior to the conveyance, and the conveyance occurs once the property is ready for occupancy.

Enforcement Issues

Construction Lien Trustee

The Act permits the appointment of a Construction Lien Trustee which is akin to a court ordered receiver. A trustee can sell property free and clear of liens. If the lien claimants have claimed priority over the mortgagee, then the Trustee usually gets court authorization to sell the property free and clear of all claims (including mortgages) and pays money into court. Any priority disputes are then resolved in the lien action.

Power of Sale

Despite anything in the charge terms of the mortgage, a lender cannot sell the property free and clear of a claim for lien. A lender wanting to sell the property must address all lien rights, registered or not. Since lien rights exist by the act of supplying services or materials to the project, a lender should wait 45 days after it takes possession to ensure all lien rights have expired. Where there is a registered claim for lien the Act provides for a mechanism of vacating the lien from title by payment of money into court as a substituted security.

Receiver

Where a lender appoints a receiver, it is in no better legal position to transfer the property than the lender. The lien claimants must be dealt with before a sale of the property. A lender might consider a court appointed receiver or a Construction Lien Trustee.

Priorities Amongst Lien Claimants

With few exceptions, all lien claimants hired by the same party form a class of lien claimants who share on a pro rata basis. The class of lien claimants at the bottom of the construction pyramid has priority over the classes of lien claimants above. In effect, the priority structure amongst lien claimants favours those who are farthest removed from the owner.



One exception is the special priority provided to workers or a workers trust fund. A special priority is given for the value of 40 regular working days over non-workers in the same class.

Another exception is where a lien claimant has registered a general lien. In determining priority within a class of lien claimants, a general lien is treated rateably over the various properties subject to the lien and postponed in favour of other members of the class.

Summary

In assessing risk a lender is advised to maintain a comprehensive view of the project as priorities of liens will relate to all works to the project from beginning to end. A lender may consider a number of means to protect itself against lien claim priorities, including:

- Police holdback by requiring the borrower to deposit 10% of each advance (or preferably each payment certificate where applicable) with the lender to be held as security to fund holdback obligations;
- Appoint a monitor to ensure compliance with the Act (with caution not to fall into the definition of ‘owner’ under the Act);
- Requiring a financial guarantee bond or holdback deficiency bond;
- Minimize owner’s continued holdback obligations as soon as possible by having major subcontractor contracts certified substantially complete as the project progresses;
- Ensure appropriate margins are maintained;
- Secure personal guarantees from the owner; and,
- Secure secondary collateral apart from the property where the project is taking place.

Most importantly, the lender must realize that the holdback obligations of the owner are ongoing throughout the project and therefore a holdback deficiency typically remains an outstanding risk until all lien rights have expired at the end of the project.

The *Construction Lien Act* attempts to balance the unique challenges of the construction industry. In doing so it balances the interests of lenders, owners, and those who contribute services and materials to the improvement. The rights and obligations of the Act generally require strict compliance and can be a minefield for lenders who fail to comply. Thorough risk assessment requires an appreciation of types of mortgages, potential challenges to priority, and an appreciation of the rationale behind the Act.

