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COMPETING PRIORITY CLAIMS IN THE CONSTRUCTION LIEN ACT

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INTRODUCTION

The construction lien provides a special form of security to certain specified participants in the construction pyramid, including the owner, mortgagee, general contractor, sub-contractors, sub-sub-contractors, workers and material suppliers.

Not surprisingly, there is often a "competition" between the security interests of lien claimants and mortgagees, as well as other types of creditors such as taxation authorities.

While the interaction between federal insolvency legislation and provincial lien legislation often gives rise to priority disputes, the intention of the *Construction Lien Act,* R.S.O. 1990, c. C-30, as amended (the "*CLA*") is to ensure that lienholder's rights cannot be prejudiced by any other person once it has protected those rights in accordance with the applicable statutory provisions.

The statutory priority scheme set out in the *CLA* serves to recognize the fact that construction is financed both by mortgagees and unpaid trades, workers and suppliers.

PRIORITY OF LIENS OVER EXECUTIONS – SECTION 77

In accordance with section 77 of the *CLA*, liens arising from an improvement have priority over all judgments, executions, assignments, attachments, garnishments and receiving orders, except those executed or recovered upon before the time when the first lien arose, in respect of the improvement.

MORTGAGE PRIORITIES – SECTION 78

Section 78 prescribes the priorities as between construction liens and other secured interests. Section 78 acknowledges that construction projects carry risks that are borne both by mortgagees and unpaid trades. The general priority rule is prescribed by subsection 78(1) of the *CLA* which provides that the liens arising from an improvement will have priority over all conveyances, mortgages or other agreements affecting the owner's interest in the premises. Certain exceptions to this general rule are also prescribed by section 78. In short, a lien will have priority over others taking an interest in the property unless a priority can be obtained pursuant to one of the priority exceptions set out in section 78. It is important to note that if a lien claimant's priority is established pursuant to subsection 78(1), all other liens arising from that improvement and subsequently registered will have priority over mortgage advances. Mortgagees should not advance in the face of a lien. A mortgagee must ensure that liens have been properly vacated or discharged before making an advance.

Section 78 protects the holdback. Even if no liens are registered, a mortgagee can lose priority with respect to "building mortgages" to the extent that the owner fails to maintain the holdback funds required by the *CLA*. A special priority is also provided to lien claimants as against subsequent mortgagees to the extent of a deficiency in the holdback.

A common misconception in the construction industry is the belief that a mortgagee has a legislative obligation to maintain a holdback for the benefit of lien claimants. This is not the case and it is simply the priority in the property secured by the mortgage that is affected by the

failure of the owner to maintain the holdback. The only instance where a mortgagee will ever be liable to lien claimants for any amount whatsoever is if the owner defaults under its mortgage, the mortgagee commences proceedings to sell the property under power of sale pursuant to its rights as mortgagee, and the property to which the liens attach is sold to a third party purchaser. In *Vecero* v. *C. Wood Inns Marketing Inc.* (1995), 27 C.L.R. (2d) 74 (Ont. Div. Ct.), since the mortgagee was neither an "owner" or "payer" within the meaning of the *CLA*, the court found that certain funds that the mortgagee had retained did not constitute "holdback" funds as only payers are required to holdback funds. Accordingly, the court held that the lien claimants were only entitled to be paid out of the proceeds of sale once the property was sold.

Section 78 also distinguishes between prior and subsequent mortgages. A prior mortgage is described in the *CLA* as one that was registered before any lien arose under the Act. Subsequent mortgages have priority over liens only for advances made under them before registration of the first lien or receipt by the mortgagee of the first written notice from a lien claimant that claims a lien on the subject property.

SECTION 78 EXCEPTIONS

s.78(2): Building Mortgages:

A building mortgage is a mortgage taken by the mortgagee with the intention to secure the financing of an improvement and any mortgage taken out to repay that mortgage. Liens arising from an improvement have priority over a building mortgage to the extent of any deficiency in the holdbacks required to be retained by the owner, irrespective of when the mortgage was registered.

In determining whether a mortgage is, in fact, a building mortgage, it is the intention of the mortgagee, not the mortgagor, which will be relevant to the categorization of the mortgage. (See *Northway Developments Inc.* v. *1200946 Ontario Inc.*, [1998] O.J. No. 3082 (Ont. Gen. Div.).

Often, a bank will agree to take a mortgage with a dual intention of financing the acquisition of the lands and the financing of the construction on the lands. In these cases, the bank will often take a single mortgage for more than one purpose. The onus is then on the bank to establish its intention very clearly. To the extent the bank can establish the dual intention of the loan, the bank will have priority for advances which it can prove were made to allow the purchase of the land as opposed to financing the improvement. A good example is found in *Royal Bank v. Lawton Developments Inc.* (1993), 13 C.L.R. (2d) (74) Ont. Gen. Div. revd. on other grounds (1996), 27 O.R. (3d) 417 (C.A.), in which the mortgagee financed the acquisition of the lands and the construction of a condominium project. Justice Lane recognized that the *CLA* will provide a mortgagee with priority for those advances which the mortgagee can prove were made in the carrying out of its intention to finance the land as opposed to its intention to finance the building. In this case although the bank had assessed its risk on the basis of a single project, the loan facility had three distinct segments. Royal had advanced some $3.5 million for the purpose of acquiring the lands. Justice Lane concluded that the bank had the intention of providing the borrower with a single mortgage for different purposes. The $3.5 million advance had priority over the lien claimants.

An example as to how competing claims to a pool of funds available from the sale of an improved property financed by a building mortgage is set out below.

> The Mortgagee approves a $5 million building mortgage for Owner Inc. to be used for the renovation and modernization of its warehouse facilities. A mortgage is registered on title on January 2, 2007. This is the only mortgage on title. Owner Inc. hires GC Ltd. as the general contractor on the project. GC Ltd., in turn, hires various sub-contractors to carry out different parts of the scope of work. On March 2, 2007, construction begins.
>
> GC Ltd. experiences financial difficulties and on December 2, 2007, it is petitioned into bankruptcy by its creditors. It is discovered that GC Ltd. has not paid its sub-contractors despite receiving payments from Owner Inc. The Sub-Contractors registered liens on title to the premises totalling $2 million. It is determined by the Court that the holdback the Owner should have retained for the benefit of the Sub-Contractors was $400,000.00.
>
> Owner Inc. also experiences financial difficulties and has gone into default on its mortgage. In July, 2008, the Mortgagee commences power of sale proceedings and ultimately finds a buyer who purchases the property.

How are the proceeds of the sale disbursed?

> Scenario #1 – If the property is sold for $6 million, the proceeds of the sale would be distributed as follows:
>
> - $400,000.00 to lien claimants, distributed *pro rata* (to satisfy minimum holdback that should have been maintained by Owner Inc.
> - $5 million to Mortgagee in repayment of the building mortgage.
> - A further payment of $600,000.00 to the lien claimants, again to be distributed *pro rata.*
>
> Scenario #2 – If the property is sold for $4 million, the proceeds of the sale would be distributed as follows:
>
> - $400,000.00 to lien claimants, distributed pro rata (to satisfy minimum holdback that should have been maintained by Owner Inc.
> - $3,600.000.00 to Mortgagee in repayment of the building mortgage.
> - Mortgagee suffers a loss.
> - No further payments to Lien Claimants.

s.78(3): Prior Mortgage, Prior Advances:

A mortgage registered prior to the time when the first lien arose in respect of an improvement loses priority to the lien claimants to the extent that the total amount advanced prior to the time the first lien arose exceeded the actual value of the premises at that time. The priority of a prior mortgage only extends to the actual value of the lands and premises at the time the first lien arose. The construction lien will have priority over the prior mortgage to the extent of the increased selling value of the land resulting from the materials supplied or work performed. Section 78(3) acknowledges that any increase in value of the premises resulting from the improvements to the premises should benefit the unpaid trades people who financed the improvement.

What constitutes a prior mortgage is illustrated in *Haflidson* v. *Salandy* (2002), 16 C.L.R. (3d) 284 (Ont. Master). The defendants, Patricia Salandy, Edwin Despot, and Murron Jacques**,** purchased real property in 1994 for $240,000. On June 28, 1994, a mortgage in the amount of $233,700 was registered in favour of London Life Insurance Company ("London Life"). The value of the property at that time was $240,000. The Plaintiff, Donald Wayne Haflidson, c.o.b. as Haflidson Manufacturing & Construction Ltd. ("Haflidson"), registered a claim for lien of $57,200 on October 10, 1997 for renovations that he made to the property between July 1, 1994 and September 1, 1997. He subsequently perfected his lien by commencing a lien action on November 24, 1997 in which he claimed priority over the mortgage. London Life maintained that the mortgage had priority over the lien, and brought a motion to dismiss the claim made against it by Haflidson.

Master Albert granted the relief being sought by London Life. Since the London Life mortgage was registered prior to the time when services and materials were first provided, the mortgagee had priority over Haflidson's lien to the extent of the lesser of the actual value of the premises and the amount advanced under the mortgage. At paragraphs 5 and 6 of the decision, Master Albert states:

> Section 78 of the Construction Lien Act gives rise to the presumption that a lien claim has priority over a mortgage. The presumption is rebuttable where the mortgage was registered prior in time to when the first lien arose, but only to the lesser of the actual value of the premises at the time the first lien arose (in this case $240,000), and the total of all amounts that prior to that time were advanced under the mortgage (in this case $233,700).
>
> According to the registered claim for lien services and materials were first provided on July 1, 1994. The mortgage was registered June 28, 1994. Accordingly, the London Life mortgage was registered prior in time to when the lien arose. Consequently, London Life has a priority over the lien claimant to the extent of the lesser of $240,000 (the value at the time of the mortgage advance) and $233,700 (the amount advanced under the mortgage). That is, London Life has a priority over Mr. Haflidson's lien claim to the full extent of the mortgage.

On this basis, the court found that there was no triable issue as against London Life and dismissed the lien action as against London Life.

The court has found that "actual value" and "market value" are one in the same. As such, the "actual value" of the property is the "most probable price that a property would bring in a competitive and open market, under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably." (see, for example the decision in *Avenue Structures Inc.* v. *Pacific Empire Development Inc.* (2000), 4 C.L.R. (3d) 42 (Ont. Master)).

The decision in *Park Contractors Inc. v. Royal Bank of Canada* (1998), 38 O.R. (3d) 290 (Ont. Gen. Div.) is particularly illustrative of how "actual value" can cause the priority afforded a prior mortgage to be lost. In this case, an industrial company obtained mortgages from the Royal Bank on environmentally contaminated lands. The company subsequently decided to close down its operations and attempted to make the plant saleable. The plaintiff lien claimant provided equipment and labour to carry out environmental remedial work. When it was not fully paid, the plaintiff commenced a lien action against the company. As the story goes, the company went bankrupt and the mortgagees sold the land and buildings under its security. Pursuant to section 78(3) of the *Construction Lien Act*, the prior registered mortgage had priority over the lien to the extent of the actual value of the property at the time the first lien arose. However, because of the contamination of the land and the unknown cost of the environmental clean up work when the lien arose, the Ontario Court determined that the property had no actual value at that time. The end result was that the lien claimant had priority over the mortgagee for its entire claim despite the fact that the Royal Bank had a prior mortgage; namely, a mortgage registered prior to the time when the first lien arose.

For the purposes of the *CLA*, the courts have held that an advance is made not when the mortgagee releases the funds; rather, an advance is complete once the owner acquires actual control over the funds advanced. In other words, if conditions must be fulfilled, then there will be no "advance." In *Marsil Mechanical v. A. Reissing* (1996), 26 C.L.R. (2d) 148 (Ont. Gen. Div.), the mortgagee delivered funds in escrow to its own solicitor with instructions to subsearch title and verify that the mortgagee had a first charge. The court held that the mortgagee had not advanced before discharge of a lien. The date that the mortgagee releases funds from its own account did not constitute an advance.

s.78(4): Prior Mortgage, Subsequent Advances:

A mortgage, (which is not a building mortgage) registered prior to the time when the first lien arose in respect of the improvement has priority over the liens to the extent of any advance made after the time the first lien arose provided that there was no preserved or perfected lien against the premises when the advance was made and the mortgagee had not received a written Notice of Lien. Each advance made under a mortgage is to be treated separately.

The perils of advancing in the face of perfected liens is well illustrated in *J. Sousa Contractor Ltd. v. Kinalea Development Corp.* [1996] O.J. No. 1337 (Div. Ct.). Kinalea Development Corporation undertook certain construction on premises that it owned. The defendant, National Trust Company, financed the construction project and held a $2.2 million mortgage on the title to

Kinalea's property. Nine advances were made under the mortgage before a lien was registered. The tenth advance by National Trust was made at a time when a lien was still registered on title although the mortgagee ascertained that it had been paid and a discharge had been signed. The release for the lien was subsequently registered on title prior to the time that a group of secondary liens were registered on title to the property (the "Secondary Liens"). The owner failed to maintain the required holdbacks and the property was ultimately sold under power of sale. The proceeds were insufficient to cover all of the competing claims. The issue before the court was whether the Secondary Liens had priority over the mortgagee to the extent of the tenth advance.

The trial judge held that the lien claimants had first priority to the extent of the holdback deficiency as the mortgage was a building mortgage subject to the priorities set out in section 78(2). The mortgagee had second priority to the extent of the first nine advances. The lien claimants had third priority to the extent of the tenth advance and the mortgagee had fourth priority to the extent of the balance of the mortgage. The trial judge stated:[1]

> In my view, the priorities established by s. 78(4) of the Act make it such that a mortgagee can safely make advances under the mortgage, subject to the holdback provisions, only if no lien is registered against title or if he has received no written notice of a lien. However, in a case such as this one when a lien remains preserved or perfected by registration, the mortgagee makes any advance at its peril since all liens arising from the improvement will have priority over the advance whether they arose before or after the advance is made and whether they were registered or not at the time of the advance.

The Divisional Court agreed with the analysis of the trial judge.

Contrast this decision with the decision in *Akimov v. K-W Housing Co-operative Inc.* (1984), 47 O.R. (2d) 794 (H.C.). In this case orders were obtained vacating registration of the liens upon the filing of bonds. The liens were no longer "preserved" and accordingly advances made under the mortgage were unaffected by the liens.

Not only will a mortgagee lose priority for an advance made in the face of a registered lien, that priority will also be lost as against all subsequent lien holders. In *Boehmers* v. *794561 Ontario Inc.* (1995), 18 C.L.R. (2d) 255, 21 O.R. (3d) 771, 122 D.L.R. (4th) 596, 77 O.A.C. 276 (C.A.); affirming (1993), 11 C.L.R. (2d) 99, 14 O.R. (3d) 781, 105 D.L.R. (4th) 473 (Ont. Gen. Div.), the defendant, 810650 Ontario Limited, was the owner of a parcel of land on which a 55-unit townhouse development was built. The co-defendant, 794561 Ontario Inc., acted as the general contractor on the project. The general contractor defaulted on payments to its many subcontractors on the project with the result that 18 lien claims were filed against the property. The defendant, Royal Life, registered a mortgage on September 7, 1989 for a face amount of $3,895,000. As well as dealing with issues regarding the timeliness of certain liens registered on

[1] See *J. Sousa Contractor Ltd. v. Kinlea Development Corp.* (1994), 17 C.L.R. (2d) 94 at para. 16 (Gen. Div.)

title, the court also had to resolve the priority issues as between the proven lien claims and advances under a mortgage held by the defendant, Royal Life.

It was conceded that the Royal Life mortgage was used in part to acquire the land and in part to finance construction. It was further conceded that the first three advances made under the mortgage (on September 7, November 27, 1989 and January 8, 1990) were made prior to the registration of the first lien on January 25, 1990 (the "Moffatt & Powell lien") and would rank ahead of the lien claimants. Royal Life chose to make a fourth advance in February in the face of Moffatt & Powell lien. Royal Life vacated this lien after they made the fourth advance. Five more mortgage advances were made after the clearance of the Moffatt & Powell lien. Within days of the last advance, other liens were registered. The priority of the fourth advance made by Royal Life was challenged by the lien claimants.

The court dealt with the priority issue on an advance-by-advance basis. The court held that Royal Life lost priority for the fourth advance as against all liens arising out of the improvement, and not just against the Moffatt & Powell lien. Vacation of a lien does not give a mortgagee any fresh entitlement to priority. If the mortgagee loses priority for an advance, that loss is permanent, not temporary, and the later advances must always remain below the priority gained to the lien claimants.

s.78(5): Subsequent Mortgages:

Liens arising from the improvement have priority over a mortgage registered after the time when the first lien arose in respect of an improvement to the extent of any deficiency in the holdbacks required to be retained by the owner. It is important to note that subsection 78(5) does not refer to "preserved" or "perfected" liens. The priority addressed by this subsection refers to simply to liens which have arisen. Pursuant to section 15 of the Act, liens "arise" when the person first supplies materials or services to the improvement. This means that if lienable services or materials are provided before a mortgage advance, the mortgagee loses priority to the extent of deficiencies in the holdback.

This would have been the result in the decision of *Royal Bank* v. *Lawton Developments Inc.* supra, had the *CLA* at the time of the decision provided that architectural drawings were lienable. The defendant, Lawton Developments Inc. ("Lawton"), purchased a condominium project and obtained funding from Royal Bank. The bank registered a first mortgage for approximately $10,000,000, with approximately $3,500,000.00 being advanced upon closing. The purchase price included certain plans and specifications obtained by the previous owner necessary for the construction of the condominium project.

After construction began, two groups of liens were registered on title to the property. The first group, registered in the middle of 1991, was vacated upon the posting of appropriate security. A second group of liens was registered in June and July of 1992, at the time when the building's construction was halted entirely. It was in a state of approximately 95 per cent completion at the time construction ceased. The lands and buildings were eventually sold at a loss.

A motion was brought by certain lien claimants to determine whether or not they had priority over the interests of the Royal Bank of Canada under the mortgage.

As discussed above, the lien claimants claimed priority pursuant to s.78(2) on the basis that the mortgage was a building mortgage.

The lien claimants also relied upon s.78(5), asserting that the first lien arose prior to the closing of the purchase by Lawton because of the existence, at that time, and the inclusion in the transaction, of building drawings which included architectural, engineering, mechanical and electrical drawings. The court held that on the evidence tendered, the plans and drawings were prepared by an architectural firm and caught by the then subsection 3(4) of the *CLA* which provided that architects and employees thereof did not have a lien. Accordingly, the mortgage was not affected by s. 78(5).

This decision was appealed to the Ontario Court of Appeal, which granted a motion for the introduction of new evidence necessary to deal fairly with the issues between the parties in determining the application of s. 78(5) of the *CLA*. The outcome of this case is unknown as there is no reported Appeal decision and the case was likely settled.

s.78(11): The "Home buyer" Exception

Notably, section 78(2) and 78(5) do not apply to mortgages given by or assumed by a home buyer. It is important to distinguish between an "owner" and a "home buyer". "Home buyer" is a defined term in the *CLA*:

> "home buyer" means a person who buys the interest of an owner in a premises that is a home, whether built or not at the time the agreement of purchase and sale in respect thereof is entered into, provided,
>
> (a) not more than 30 per cent of the purchase price, excluding money held in trust under section 53 of the *Condominium Act*, is paid prior to the conveyance, and
>
> (b) the home is not conveyed until it is ready for occupancy, evidenced in the case of a new home by the issuance of a municipal permit authorizing occupancy or the issuance under the *Ontario New Home Warranties Plan Act* of a certificate of completion and possession; ("acquéreur d'un logement")

s.78(6): Subsequent mortgages

Priority is given to lien claimants over advances made by a mortgagee after receipt of a notice of lien or after a lien has been registered. In addition, liens will have priority over a subsequent mortgage to the extent of any deficiency in the owner's holdback. However, a lienholder's right to priority over the mortgage to the extent of any deficiency in the holdback will not prevent the mortgagee from having priority under subsection 78(6) for advances made under a subsequent mortgage prior to its receipt of a written notice of lien or prior to the registration of a lien. Section 78(6), like section 78(4) focuses on when knowledge of the lien is acquired. Section 78(4) applies specifically in respect of mortgages registered prior to the time when the lien first arose, while section 78(6) applies to mortgages registered after the lien. Section 78(6) will protect a mortgagee unless when the advance was made there was a preserved or perfected lien against the premises or the lien claimant gave proper written notice of a lien. Just because

a mortgagee may be aware that an improvement is being made or that trades may not have been paid does not constitute notice.

"Written notice" means that the notice must include certain basic requirements. In *Schwegel v. Nelson,* [2003] O.J. No. 6039 (Sup. Ct.) an affidavit that stated: "To the best of my knowledge and belief the list of trades people owed money by me regarding work and materials done and put on the property as of today are two labourers owed roughly two thousand dollars" failed to provide the proper notice. The court indicated that at a minimum, the written notice, in order to comply with s. 78(6) must:

1. identify the trade or supplier;
2. contain a statement that work has been done or materials supplied with respect to improvements;
3. specify the premises;
4. state that an account is owing and has not been paid;
5. specify the amount owing which forms the basis for the lien;
6. identify the owner or other person who owes the amount claimed; and
7. such notice must be authored or sent by or on behalf of the person who possesses the lien.

PRIORITY BETWEEN LIEN CLAIMANTS – SECTION 80

No priority exists among lienholders of the same class. Lienholders of the same class are defined under section 79 as lienholders who contract directly with, or who are employed by, the same person. Section 80 of the *CLA* addresses the priority of lien claimants within the same class as well as between classes. The lien of every member of a class has priority over the lien of a payer of that class. In other words, subcontractors have a right to payment of their claims out of the holdback in priority to the claim of a general contractor. Section 80 states:

80 (1) **Priority between and within class** - Except where it is otherwise provided by this Act,

(a) no person having a lien is entitled to any priority over another member of the same class;

(b) all amounts available to satisfy the liens in respect of an improvement shall be distributed rateably among the members of each class according to their respective rights; and

(c) the lien of every member of a class has priority over the lien of the payer of that class.

(2) **Where conveyance or mortgage void -** Any conveyance or mortgage in respect of the premises to any person entitled to a lien on the premises, in payment of or as

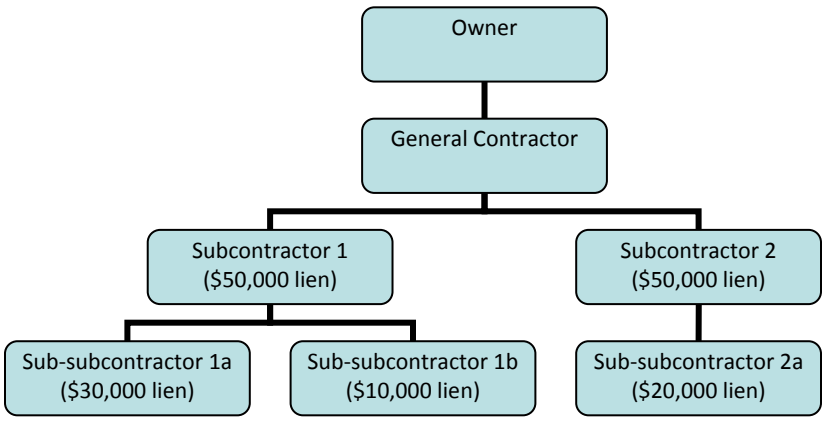
security for that claim, whether given before or after that lien arises, is void against all other persons entitled to a lien on the premises.

This section ensures that all lien claimants of a particular class are treated equally and that funds flow from the "bottom up" so that parties on the lower rungs of the construction pyramid are paid before those above them on the pyramid. Subsection (c) precludes a lien claimant from circumventing the priority accorded to the lien claimant over the lien claim of its payer, by obtaining additional security on the premises, although other forms of security not related to the premises may be obtained.

Any amount available to satisfy liens in respect of an improvement must be shared pro-rata among the members of each class. All lien claimants who have supplied services or materials to the same payer comprise a class. A claimant who supplied to more than one payer is a member of more than one class. A lien claimant's pro rata share of holdback is calculated as follows:

Amount Available for Distribution to Class of Lien Claimants Amount of Lien Claims by Class of Lien Claimants	x 100 = Percentage of Funds to be Paid to Each Lien Claimant

The principles set out in section 80 of the *CLA* are best illustrated in the following example. In a standard construction project, a typical pyramid might resemble the following:



Assume that the general contractor abandons the project, all of the subcontractors and sub-subcontractors register liens on the project (in the amount indicated above), and it is determined that the holdback the owner should have maintained is $100,000.00.

Subcontractor 1 and Subcontractor 2 are members of the same class. Because their liens are for the same amount, in accordance with sections 80 (1) (a) and (b) they would be entitled to equal shares of the holdback funds, being $50,000.00 each. However, because there are lien claimants beneath them in the pyramid, section 80(1)(c) must also be considered.

As set out above, the lien of every member of a class has priority over the lien of the payer of that class. Therefore, the liens of Sub-subcontractor 1A and 1B must be satisfied before Subcontractor 1 receives any payment. As such, the holdback funds to which Subcontractor 1 is entitled would be distributed as follows:

- $30,000.00 to Sub-subcontractor 1A
- $10,000.00 to Sub-subcontractor 1B
- $10,000.00 to Subcontractor 1

The holdback funds to which Subcontractor 2 is entitled would be distributed in the same manner:

- $20,000.00 to Sub-subcontractor 2A
- $30,000.00 to Subcontractor 2

That lien claimants are to be treated as a class was made clear in *Ashco Paving Inc.* v. *Brant Q.E.W. Developments* [2005] O.J. No. 3071, 44 C.L.R. (3d) 281 (Ont. Sup. Ct. Just.), a case in which the owner, Brant Q.E.W. Developments ("Brant") settled the claims of a number of the lien-claimants and sought to reduce the amount of security which was posted to vacate all of the liens registered on the property. In dismissing the owner's motion, Madam Justice Mossip made the following comments: (see para 4)

- "The holdback belongs to lien claimants as a class. The security stands to the credit of all the lien claimants. The owner chose to release portions of the holdback funds to certain lien claimants while others received nothing. The spirit of the CLA treats all lien claimants equally, subject to the principles of priority distribution on a pro rata basis set out in Section 80 of the CLA;
- In choosing to pay-out certain of the lien claimants, the owner has already undermined the ability of the responding lien claimants to this motion to challenge the timelines or quantum of those liens. Further, the remaining lien claimants lost the ability to share pro rata in the security that was released to the lien claimants the owner settled with; and
- The Court should in the circumstances of this case exercise a certain degree of caution and protect as best it can the remaining lien holders who I said have been prejudiced and their positions compromised by the reduction in the statutory holdback because of the owner settling with some of the lien claimants."

Section 80(1)(c) ensures that subcontractors will be paid in priority to the contractor above them in the pyramid. A subcontractor's entitlement to recover to the full extent of the contractor's lien is not contingent upon the contractor preserving and perfecting its own lien claim. In *George and Asmussen Ltd.* v. *MCM Holdings Inc.*, [1992] O.J. No. 103, 6 O.R. (3d) 645 (Gen. Div.), the court concluded that it would be unfair if the rights of a "class" were dependent upon the actions of their payer as this interpretation might "leave members of that class at the mercy of an unscrupulous contractor". In this case, instead of filing a lien, the contractor had

chosen to accept a mortgage on another of the owner's properties. The court held that the subcontractor was entitled to be paid out of the share which the contractor would have been entitled to receive had it filed and proved a lien on a pro rata basis with members of the contractor's class.

WORKERS' PRIORITY – SECTION 81

The *CLA* gives the lien claims of labourers a special priority over other lien claimants in the same class. This special priority is limited to the extent of 40 regular working days' wages. The issue of the worker's special priority is one that comes up frequently in construction litigation. Section 81 of the *CLA* states:

> (1) **Worker's Priority -** The lien of a worker has priority over the lien of any other person belonging to the same class to the extent of the amount of forty regular-time working days' wages.
>
> (2) **Worker's Trust Fund -** Where monetary supplementary benefits are payable to a **workers'** trust fund instead of to a worker, the trustee of the workers' trust fund is subrogated to the rights of the worker under this Act with respect to those benefits.
>
> (3) **Desire to defeat workers' priority void -** Every device to defeat the priority given to workers by this section is void.

This section seems to support the interpretation that the labourer is entitled to priority for 40 days' wages, whenever earned. For example, the 40 days' wages do not have to be earned consecutively. Due to weather there may be instances when wage earners work only a few days a week. The 40 days' wages are not limited to the 40 days immediately preceding the filing of the lien.

The decision of Master Sandler in *I.B.E.W. Trust Fund, Local 353 v. 779857 Ontario Inc.* (2004), 36 C.L.R. (3d) 48 (Ont. Master) is one of the few decisions the court has released with respect to section 81 of the *CLA.* This project was a condominium project. The owner, 779857 Ontario Inc. ("779") retained Triple A Electric & Mechanical Corporation ("Triple A") to perform all the electrical work. Triple A employed unionized workers from Local 353. The jobsite was shut down for a two week period commencing on December 20, 2002 and continuing over the Christmas holidays and was re-opened on January 2, 2002. The workers' claim for lien was registered on February 10, 2003 and for its timely preservation the "supply of services" had to be last supplied on or after December 28, 2002. On this day, approximately 20 workers returned to the job site but completed no actual electrical work. Rather, the workers attended an on-site meeting held by the foreman, unpacked their tools, and re-packed their tools when they were advised that Triple A was terminated. Three of Triple A's material suppliers liened the project as did Local 353. The court had to determine whether the attendance of Triple A's workers at the job site on January 2 and the activities they did on this day constituted a "supply of services" within the meaning of the *CLA*. Master Sandler found that the January 2nd activities did constitute a "supply of services" and, accordingly, the lien was preserved in time. As a

result, the workers' and union trustee's lien claim had priority under s. 81(1) over the lien claims of the other members of the lien class.

One question that is posed by Master Sandler but left unanswered is whether each worker's claim should be treated as an individual claim, or whether or not they should be treated as a group with the proviso that as long as one or some members of the group "supplied services" within 45-days of preservation of the (united) lien, then all their lien claims for wages and monetary supplementary benefits are to be considered in time. This issue still remains unresolved.

SUBORDINATION OF GENERAL LIEN CLAIMS – SECTION 82

Section 82 of the *CLA* tries to strike a balance between a lien claimant with a general lien and a lien claimant with a lien on only one property (on which a general lien is also registered). Section 82 of the *CLA* modifies the general rule that all amounts available to satisfy the liens in respect of an improvement are to be distributed ratably among the members of each class. The section reads:

> Where a general lien is realized against a premises in an action in which other liens are also realized against the premises,
>
> (a) the general lien shall rank with the other liens according to the rules of priority set out in section 80 only to the extent of,
>
> (i) the total value of the general lien, divided by,
>
> (ii) the total number of premises to which the person having the general lien supplied services or materials under contract or subcontract; and
>
> (b) in respect of the balance of the general lien, it shall rank next in priority to all other liens against the premises, whether or not of the same class.

One example which helps to illustrate this principle is taken from the well-known text, *Construction Builders and Mechanic's Liens in Canada*[2]. In this example, Subcontractor A supplied labour and materials to twenty lots, fifteen of which were sold at the time it registered its lien. Subcontractor B supplied labour and materials to the five remaining lots only. If we assume that neither Subcontractor A nor Subcontractor B had been paid, and that their contracts were for the same amounts with respect to each of the lots at issue, the claim of Subcontractor A would be four times that of Subcontractor B. If they were allowed to share pro-rata in the proceeds of sale of the five lots, Subcontractor A would receive a share considerably larger than that paid to Subcontractor B. Under section 82 of the *CLA*, both subcontractors receive the same share, because Subcontractor A's lien is allowed to rank on the distribution only to the extent of one-quarter of its total claim. On the other hand, under this example, if the proceeds of sale of the five remaining lots amounted to more than the value of the materials

[2] *Construction Builders' and Mechanics' Liens in Canada*, 7th ed. Bristow, Glaholt, Reynolds and Wise, p. 833

and services supplied by both subcontractors on these lots, Subcontractor A would be entitled to have the surplus proceeds applied against the balance owing to it under its general lien with respect to the materials and services applied to the fifteen previously sold lots.

This is a seldom used section of the *CLA* and, in fact, there has been no reported decisions of which the writer is aware dealing with the priority scheme set out in this section.

PRIORITY OVER INSURANCE PROCEEDS – SECTION 83

In accordance with section 83 of the *CLA*, where a premises that is subject to a lien is destroyed in whole or in part, any amount received by the owner or a mortgagee by reason of any insurance on the premises shall take the place of the premises that was destroyed and is to be distributed in accordance with the priority scheme set out in Part XI of the *CLA*.

Section 83 does not automatically establish a trust in favour of the lien claimants in respect of insurance proceeds. In *A. Topazzini Construction Inc.* v. *National Frontier Insurance Co.* (1995), 20 C.L.R. (2d) 11, [1995] O.J. No. 1594 (Ont. Gen. Div.), the mortgagees and the holders of construction lien claims each claimed priority over the unpaid insurance proceeds. The court held that the insurance proceeds only became a trust subject to the priority scheme of the Act when the proceeds were received by the owner or mortgagee.

A restaurant building encumbered by two mortgages was destroyed by fire. Both mortgages contained an insuring provision providing, among other things, that losses were payable to the mortgagees. After the fire, the owner hired Topazzini to construct a new restaurant on the lands. The mortgagee was not a party to this contract. Certain payments were made by the insurance company to the owner and mortgagees. These cheques were endorsed back to the owner who used part of the proceeds to bring the mortgages into good standing and the balance of the proceeds to pay for the reconstruction of the restaurant.

A further payment was returned to the insurer after the principal of the owner was charged with arson. The insurer paid the balance of the coverage amounting to $125,000 into court. The lien claimants maintained that they had priority over the mortgagees in respect of the insurance money paid into court for the following reasons:

- A mortgagee cannot claim insurance proceeds where the premises have been restored;
- The insurance proceeds were impressed with a trust pursuant to the CLA in favour of unpaid contractors;
- The conduct of the mortgagees amounted to a promissory estoppel in favour of the lien holders;
- The mortgagees were owners within the definition of owner in the *CLA*.

The Court held that the mortgagees had priority over the balance of the insurance funds. The mortgagees had elected to take the proceeds of insurance, while at the same time accommodating the owner by advancing insurance proceeds received for reconstruction while the owner obtained new financing, provided that the mortgagees agreed that there was

sufficient equity in the construction to make the advances. When the owner was charged with arson the mortgagees were entitled to decline making further advances and to apply the remaining insurance proceeds to the mortgage. The proceeds paid into court did not constitute trust monies. The insurance money only becomes trust money under the *CLA* when it is "received" by the owner and paid to the contractor.

PRIORITY OVER PROCEEDS OF SALE – SECTION 84

Where an interest in the premises is sold or leased under court Order of by a trustee, the proceeds of the sale are to be distributed in accordance with the priorities set out in Part XI of the *CLA*. This section pools all monies received on the sale or lease of liened premises with all money or security in court for the purposes of distribution under the *CLA*.

PRIORITIES ON INSOLVENCY – SECTION 85

Persons who have supplied services or materials to an improvement for a bankrupt enjoy priority over trust funds as trust beneficiaries. Money which is impressed with a trust remains the property of the beneficiaries of the trust and does not become part of a bankrupt's estate. Generally speaking, the holdback monies or trust funds held by a corporation that is bankrupt or who has filed for protection under the *Companies' Creditors Arrangement Act* ("*CCAA*") cannot form part of the assets or estate such that it would be available for distribution to all classes of creditors (see *Canadian Asbestos Services Ltd.* v. *Bank of Montreal* (1992), 5 C.L.R. (2d) 54 (Ont. Gen. Div.)).

Section 85 of the *CLA* sets out the priorities that are to be followed if insolvency occurs:

(1) Where a payer becomes insolvent, the trust fund of which that payer is trustee shall be distributed so that priority over all others is given to a beneficiary of that trust who has proved a lien and a beneficiary of a trust created by section 8 that is derived from that trust, who has proved a lien.

(2) Priority in the distribution of trust funds among those who have proved liens shall be in accordance with the respective priorities of their liens as set out in this Part.

(3) The remaining trust funds shall be distributed among the beneficiaries of that trust and the beneficiaries of trusts created by section 8 that are derived from that trust, whose liens have not been proved, in accordance with the respective priorities to which those liens would have been entitled as set out in this Part, had those liens been proved.

CRA SUPERPRIORITY

There has long been a struggle between lien claimants and the Canada Revenue Agency ("CRA") with respect to whether a lien claimant or the CRA had priority over holdback funds that were maintained by a general contractor, or other payer, in accordance with the *CLA*. These disputes were usually negotiated on a case by case basis with the Department of Justice acting on behalf

of the federal government. In many instances, the Department of Justice would agree to share the holdback funds with the lien claimants. However, the lien claimants would be at the mercy of the Department of Justice as no definitive ruling or practice had been released which would eliminate this uncertainty.

In early 2009, a trio of cases was brought before the British Columbia Supreme Court to determine whether the CRA was entitled to a "super-priority" to various funds that certain general contractors held back from their subcontractors. The three cases were *PCL Constructors Westcoast Inc. v. Norex Civil Contractors Inc. et al.*, *Condura Forming Ltd. v. Menkis Construction Ltd. and Condura Forming Ltd. and Roberto Farinha (Defendants by Counterclaim)*, and *Binar Investments Inc. v. Norex Civil Contractors Inc. et al*. All three cases were dealt with at the same time and the British Columbia Supreme Court released one decision indexed as *PCL Constructors Westcoast Inc.* v. *Norex Civil Contractors Inc.,* [2009] B.C.J. No. 142 (S.C.).

The facts in all three cases were very similar. The general contractors hired subcontractors to provide construction services. The subcontractors hired sub-subcontractors to assist them in completing work under the contracts with the general contractors. The subcontractors defaulted on their obligations under the contracts and the general contractors terminated the contracts. The subcontractors owed CRA in respect of employee withholdings and GST. At some point, the general contractors received Notices of Assessment or a Requirement to Pay ("RTP") from the CRA. The sub-subcontractors, who remained unpaid, registered construction liens against the property on which they worked. In each of the three cases, the money held by the general contractors was either holdback funds or contract funds that would have been due and owing to the subcontractors had the general contractors not been asserting a set-off claim. The general contractors paid the holdback funds into court to discharge the liens of the sub-subcontractors. CRA claimed that the funds paid into court must have formed part of the holdback fund and that CRA was the beneficial owner of those funds.

Generally, the positions of the parties in all three actions can be summarized as follows:

Position of the CRA

- A deemed trust in the property of the subcontractors arises in favour of Her Majesty for any payroll deductions withheld by an employer at the time the deduction is made, and despite any other security interest in or other priority to the subcontractor's assets provided by law;
- Alternatively, holdback funds were either beneficially owed to the subcontractors, or owed to the subcontractors under the terms of the respective contracts until at least the time the RTP was delivered;
- Alternatively, the holdback funds are subject to the RTP because they are "payable" to the subcontractor, payment simply being suspended temporarily by the provincial construction lien legislation; and
- With respect to setoff arguments made by some of the general contractors, the CRA stated that setoff was a defence to a claim for judgment and is therefore irrelevant to

the question of the CRA's claim to the holdback funds. When the deemed trust which arises in favour of Her Majesty, it arises at the time when the subcontractor makes payroll deductions from its employees. At that time, the property was no longer available to the general contractor to claim setoff from.

Position of the General Contractors

A deemed trust could only attach to the property belonging to the defaulting subcontractors at the time it arose, and because the subcontractors had no right to the holdback funds at any time, the trust could not have attached to those funds;

The general contractors' statutory liability to the sub-subcontractors for the holdback funds is direct and, as such, there are no payments from the general contractor to the subcontractor which the CRA could "intercept" via the RTP; and

Certain general contractors claimed a right of setoff as against the defaulting subcontractor on account of the costs incurred to complete and remedy the work of the defaulting subcontractor. The generals submitted that an RTP does not attach to funds affected by a setoff claim.

Position of the Sub-subcontractors

Each sub-subcontractor joined with the general contractors in asserting that because nothing was owed to the subcontractors, there was no debt or property available for CRA to claim a beneficial interest in. They argued that their lien claims entitled them to be paid out of the holdback, and that the CRA had no legal basis for interfering with this entitlement.

Lien legislation in British Columbia, the *Builders' Lien Act* ("BLA"), is very similar to the legislation found in Ontario. The relevant sections are:

Section 4:

- The person who is primarily liable on a contract under which a lien may arise under the *BLA* is required to retain a holdback equal to 10% of the greater of the value of the work provided under the contract and the amount actually paid under the contract. That holdback is charged with liens in favour of every person engaged by the person from whom the holdback is retained.

Section 6:

- If the subcontractor defaults on the contract, a contractor is forbidden from applying the holdback fund against any claims it may have against the subcontractor until the possibility of any lien arising under the subcontractor is exhausted.

Section 9:

- The subcontractor is entitled to receive the holdback fund upon completion of the project or expiration of the holdback period specified in s. 8.

Section 23:

- Allows the contractor to discharge the liens by paying the holdback into court, in which case any liens held by the sub-subcontractors attach to the funds paid into court.

Section 34:

- Limits the liability of the Contractor to the greater of the money owed to the subcontractor and the amount of the holdback.

Using this framework, the Court dealt with each of the arguments raised by the CRA.

Deemed Trust

The Court found that the "trust" created by the *BLA* is a fund designed to limit the liability of a contractor to various sub-subcontractors and in which the subcontractor has a beneficial interest. However, the subcontractor's entitlement to the fund is conditional in that it cannot lay claim to it until the lien rights set out in section 9 expire and money is owed to it under the contract. The Court held that until an entitlement to the holdback funds arises, the subcontractor's interest in the fund is a conditional right, and no more than that. "When the subcontractor's right is appropriated by Her Majesty, Her Majesty's interest is exactly the same" and, as such, the Court held that the CRA was not entitled to seize the holdback in priority to the lien claimants. (see para. 63)

RTP

Based on the same reasoning used in dealing with the "deemed trust" argument, the Court held that the RTP does not give the CRA a greater claim to the holdback funds. As is the case with deemed trusts, the Court stated that Her Majesty's interest under the RTP only arises the moment the general contractor becomes "liable to make a payment" to the subcontractor. Since a general contractor would only pay the holdback to a subcontractor after lien rights had expired, or after satisfying any liens that were registered by sub-subcontractors, the lien claimants would have priority to be paid out of the holdback funds.

Setoff

In a situation where the subcontractor defaults on the contract, section 6 of the *BLA* prohibits a contractor from applying the holdback fund against any claimed setoff until the possibility of liens against the fund has been exhausted. Accordingly, the usual chain of priority where a subcontractor can establish entitlement to the holdback would be as follows: a contractor is required to maintain a 10% holdback fund; sub-subcontractors have priority to this fund through the *BLA* lien scheme; once their claims are satisfied, the holdback is payable to the subcontractor, subject to any claims to setoff from the contractor.

However, in circumstances where a super priority claim is asserted by CRA, once a sub-contractor's entitlement to the holdback arises so that funds paid into court are charged with the liens of the sub-sub-contractors, CRA takes priority over the lien claimants by virtue of the deemed trust provisions of the *ITA* and/or CRA's garnishment mechanism pursuant to the RTP. Accordingly, on the facts of the three cases, because the contractor's set-off claims exceeded

the value of the holdback the subcontractors could not establish a right to the holdback. That being the case, CRA also had no right to the holdback.

The Court noted the arbitrary result that could arise with respect to lien claimants. Whether or not a lien claimant can access the holdback fund depends entirely on validity and extent of the payer's set-off claim. Where the set-off claim of the payer exceeds the holdback, the lien claims have priority to CRA's claim. However, where the set-off claim is smaller than the holdback, that portion of the holdback (after deduction of the set-off claim) that would otherwise have been paid to the general contractor or subcontractor can be seized by CRA. The lien claimants are restricted to the remainder (the amount of the payer's set-off claim).

IMPORTANT LESSONS FOR MORTGAGEES, OWNERS AND LIEN CLAIMANTS

Part XI of the *CLA* constitutes a code for determining priorities as between owners, mortgagees and lien claimants. This code generally favours lien claimants. Such a priority only seems fair where the lien claimant has financed the value of improvements to the property. The exceptions to this general rule are carefully prescribed. There are some clear principles that emerge from the caselaw discussed in this paper:

- To be safe, if a lien is registered on title and is not properly vacated or discharged in accordance with the procedure set out in the *CLA*, do not advance monies under a mortgage no matter how small the quantum of the lien.
- If a preserved or perfected lien is registered on title, a mortgagee loses priority for any subsequent advance, not only for that lien, but in respect of all subsequent liens. Before any advance is made a title search must be made to determine if any liens are on title.
- If a mortgage is a building mortgage, mortgagees will always take second place to deficiencies under the holdback – the holdback is sacrosanct. Mortgagees can protect themselves where the loan is not a building mortgage by requesting a statutory declaration from the borrower. Where a loan is a dual purpose loan, mortgagees should be careful to clearly prescribe in the mortgage which part of the advance relates solely to the financing of the improvement. If a lien claimant is in doubt about the purpose of the loan, the lien claimant should make a section 39 request.
- Liens will have priority over a subsequent mortgage if there are deficiencies in the holdback. It may be impossible for a mortgagee to ensure that lienable services or materials were not provided prior to the registration of the mortgage that would take priority to the mortgage to the extent of deficiencies in the holdback. It is our view that "liens" caught by subsection 78(5) do not necessarily need to be preserved or perfected. Accordingly, mortgagees would be well advised to obtain proof that holdbacks have been properly accounted for. A mortgagee could request a statutory declaration from the mortgagor stating that no lienable services or materials have been provided prior to the registration of the mortgage or inspect the property to determine if construction is already underway.

- It is important for mortgagees to properly monitor project construction. Mortgagees should be requesting information about progress payments and copies of the certificates for each progress payment. This will allow the mortgagee to monitor accruing holdback amounts.
- It is critical for a lien claimant to provide proper written notice of a lien to a mortgagee.
- Any payer in receipt of holdback funds receiving Notices of Assessment or a Requirement to Pay ("RTP") from the CRA should pay the holdback into court and consider adding CRA as a party to the lien proceedings so that the competing claims of the lien claimants and CRA can be properly considered. The payer should assess the extent of its right to set-off. The validity and extent of the payer's set-off claim affects the amount of the holdback that can be claimed by a lien claimant.