LAW REFORM COMMISSION OF BRITISH COLUMBIA

REPORT ON MORTGAGES OF LAND: THE PRIORITY OF FURTHER ADVANCES

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To The Honourable Brian R. D. Smith, Q.C.
Attorney General of the Province of British Columbia:

The Law Reform Commission of British Columbia has the honour to present the following:

REPORT ON MORTGAGES OF LAND: THE PRIORITY OF FURTHER ADVANCES

Section 24 of the *Property Law Act* restates, in statutory language and in a slightly modified form, the old equitable rules respecting the "tacking" of further advances under a mortgage of land. Section 24 fails to meet the needs of contemporary commercial financing in two important areas. These are where advances are made under a running account arrangement between the parties, and where the advances are to enable the construction of an improvement on the mortgaged property. In both cases an enhanced priority for the mortgage lender is recommended.

In the context of construction financing, the Report also considers the implications of the recent division of the Court of Appeal in *Yorkshire Trust Co.* v. *Canusa Construction Ltd.*

CHAPTER I INTRODUCTION

A. Mortgages Generally

Many people, for both business and personal purposes, feel the need to obtain the use of property despite a present inability to pay for it. In such a case credit may be sought. Credit involves a willingness of a person, the creditor, to make a loan to the person seeking credit, the debtor. The creditor hopes and expects the debtor will repay the amount loaned, usually with an additional amount in the form of interest to compensate the creditor for allowing the debtor the use of the money.

But lending money can be hazardous. The debtor may default; he may go bankrupt; and although it appeared to the creditor that the debtor had sufficient assets to discharge the loan, it may be that there are numerous creditors all claiming repayment of large amounts. A person may be quite willing, in principle, to lend money in return for the interest on the loan, but in practice he will often be prepared to do so only if some way can be found to minimize the risk of never seeing his money again.

The grant of a security interest to the creditor in certain assets belonging to the debtor is an attempt to reinforce the creditor∗s prospect of receiving repayment of the loan. In essence, what the creditor gets is a right to reimburse himself out of these assets if the debtor fails to pay. Although a debt may be secured in a number of different ways, large debts are frequently secured by the taking of some kind of security interest in land. The most popular form of security interest in land is the mortgage.

The kind of mortgage that is familiar to most people is the mortgage given, usually to an institutional lender, to secure the purchase price of residential property. Many home buyers are unable to afford the full purchase price for a home, and the difference between the amount of money the buyer has available and the purchase price is provided by a lender who then takes a

mortgage on the property. Less familiar to the general public is the fixed charge on land created under a corporate security instrument such as a debenture. Despite the different terminology these are also "mortgages" and the discussion which follows is applicable to them.

The borrower need not look to a single lender to meet his need for credit. In theory, land in British Columbia can be subject to a virtually infinite number of mortgages. In practice, the number of mortgages on a particular piece of land seldom exceeds three. The amount secured by two or three mortgages is usually equal to the total value of the land, thereby exhausting its usefulness as security for further loans.

The priority of various mortgage lenders with respect to a piece of land is determined by the order in which their mortgages have been registered in the Land Title Office. Where the borrower is in default,[2] the holder of the mortgage which was registered first is entitled to see his debt fully satisfied out of the land before the second mortgage lender can assert rights against the property under his mortgage and so on.

The willingness of a financier to lend money on the security of a second or third mortgage depends very much on the amount secured by the first mortgage and its relationship to the total value of the property. From his point of view it is important that the amount secured by the first mortgage should be

easily ascertainable and that this amount should not be permitted to increase in a way which would prejudice his position under the second mortgage. In the case of a simple residential mortgage those conditions are usually satisfied. In the business context, however, there are situations in which the prior mortgage lender, for sound business reasons, is prepared to lend further money to the borrower. He will wish to enjoy a priority with respect to these further advances over any mortgage or other intervening interest that may have been registered between the time the first mortgage was registered and the time the later advance is made.

In the situation described above, there is a clear competition between the interests of the first mortgage lender and the intervening encumbrancer. The way in which these competing interests should be balanced is the subject matter of this Report.

B. Tacking

Resolving the competing interests of a first mortgage lender and of an intervening encumbrancer with respect to further advances of money was one limb of a somewhat obscure body of equity law known as "tacking."[3] The first limb of the doctrine of tacking ceased to be of practical importance in British Columbia many years ago.[4] It provided a mortgage priority rule which has been almost wholly overtaken by the order-of-registration priority rules of the *Land*

Title Act. The second limb of the doctrine of tacking, that dealing with further advances, continues to retain its significance.

Briefly stated, the common law rule was that the prior mortgagee could, with respect to further advances, enjoy priority over an intervening interest if the advances were made without notice of that intervening interest. [8] Registration, under the *Land Title Act,* of the intervening interest did not constitute notice to the prior lender for this purpose.[6]

The common law position appeared to prevail in British Columbia until the enactment of section 24 of the *Property Law Act*[7] in 1978. The section abolishes the common law rules concerning the tacking of further advances, replacing them with a set of statutory rules.[8] It does not represent a radical departure from the prior law. Rather, its main function seems to be to restate the common law position in a way which harmonizes with our land title system. The full text of section 24 is set out as Appendix A to this Report.

For the purposes of the discussion which follows, an overview of section 24 of the *Property Law Act* may be helpful. Briefly stated, the effect of abolishing the common law rules concerning tacking means that a mortgagee can claim priority for his further advances only in the circumstances described in section 24(1). That provision first requires that all the advances for which priority might be claimed be "contemplated by and in accordance with the mortgage." The section provides only for priority to be claimed over suse-

quently registered mortgages and judgments. The section is silent on the mortgagee∗s priority *vis-a-vis* other types of intervening interest.

Section 24(1) also requires that one or more of the following conditions be satisfied:

(a) the subsequent mortgagee or judgment holder had entered into a subordination agreement;
(b) the first mortgagee had received no notice in writing that the intervening interest had been registered;
(c) the intervening interest has not been registered; or
(d) the mortgagee is contractually bound to make the further advances.

A consideration of section 24 raises several questions. Is the range of interests against which the priority can be asserted satisfactory? Does section 24 prevent a mortgage lender from asserting priority for further advances in circumstances where, as a matter of policy, he ought to have such priority? Conversely, are there circumstances in which the section confers a priority for a further advance when that priority is unfair?

All of these issues were considered in a Working Paper circulated for comment and criticism in March *1985* by the Law Reform Commission. The operation of section 24 was examined and a number of proposals for improvement were made. In particular, two special types of mortgage were identified as calling for special treatment. These were the mortgage to secure a running account, and the construction mortgage. In the Working Paper it was proposed that lenders should enjoy an enhanced priority with respect to further advances made in these kinds of economic arrangements. We anticipated that one consequence of an enhanced priority for advances under a mortgage to secure a running account and the construction mortgage would be the stimulation of business and construction financing.

8 Analogous legislation has been enacted in other jurisdictions. *See, e.g., Registry Act,* R.S.O. 1980, c. 445, s. 68 (Ont.); *Mortgages Act,* C.C.S.M. c. M-200, s. 17 (Man.); *Law of Property Act,* (1925) 15 Geo. 5,c. 20, a. 94 (U.K.).

While the Working Paper did not attract a large volume of response, those submissions which we received were thoughtful and detailed and we derived a good deal of assistance from them. It is fair to say that a majority of respondents were sympathetic with the general thrust of our tentative proposals although a number of comments and suggestions were made on points of detail. Some of these are discussed later in this Report in the appropriate context.

In the following chapters we provide something of an historic overview of the law in relation to further advances and describe our general approach to reform. We then turn to more specific issues and develop our final recommendations.

CHAPTER II IS THE GENERAL APPROACH OF THE LAW TO FURTHER ADVANCES SATISFACTORY?

A. Introduction

If one were to attempt to draft an "ideal" set of rules respecting the priority of further advances, starting afresh and unencumbered by any loyalties to an existing legal regime, there are two basic approaches that might be taken to this task. Both would involve creating a general rule and then creating a series of exceptions to it where those exceptions could be justified on the basis of social policy.

The first approach might involve setting out a general rule that a mortgagee is entitled to priority over later interests for all advances made under the mortgage irrespective of when those advances are made. This general rule would then be qualified by necessary exceptions.

A second approach would involve a general rule that the mortgagee is subordinated with respect to any advances made after a competing encumbrance has come into being; again with appropriate exceptions and qualifications. As the previous chapter illustrates, the present law has adopted the second approach. The purpose of this chapter is to set out some of the considerations which led to this position and then to offer our own views on the desirability of a significant change in approach.

B. The Historical Arguments

It cannot be said that the present legal position has the force of great antiquity. Indeed, it dates only from 1861. Before that time, there was strong support for the view that the law favoured the first approach: priority for all further advances. This view rested principally on the case of *Gordon* v. *Graham,* decided in 1716. The report of the case is terse:

16. A. mortgages to B. for a Term of Years, to secure a Sum of Money already lent to A., as also such other Sums as should hereafter be lent or advanced to him. A. makes a second Mortgage to C. for a certain Sum, with Notice of the first Mortgage; and then the first Mortgagee, having Notice of the second Mortgage, lends a further Sum, &c. *Per Cowper,* Lord C.: The second Mortgagee shall not redeem the first Mortgage, without paying as well the Money lent after, as that lent before the second Mortgage was made; for it was the Folly of the second Mortgagee, with Notice, to take such Security. .

During the nineteenth century, the authority of *Gordon* v. *Graham* came to be widely doubted. First, it was questioned whether it had been correctly reported and, even if correctly reported, whether it correctly stated the law. Finally, in 1861, the issue came before the House of Lords in the leading case of *Hopkinson* v. *Rolt.*

In *Hopkinson* v. *Rolt,* a landowner, indebted to a commercial banker, entered into a mortgage expressed to "secure the sums due and which shall from time to time become due" from the landowner. A second mortgage was subsequently entered into with another creditor and notice of the second mortgage was given to the banker. On the land-owner∗s bankruptcy, a dispute arose

as to the priority of the banker with respect to advances made under the first mortgage after he had received notice of the second mortgage.

The three law lords who heard the case were divided, with a majority favouring priority for the second mortgagee. All the judges addressed policy

implications of the priority rule. Lord Campbell, the Lord Chancellor, observed:[3]

I must say that the doctrine [in *Gordon* v. *Graham]* seems to me to be contrary to principle. Although the mortgagor has parted with the legal interest in the hereditaments mortgaged, he remains the equitable owner of all his interest not transferred beneficially to the mortgagee, and he may still deal with his property in any way consistent with the rights of the mortgagee. How is the first mortgagee injured by the second mortgage being executed. . . ? The first mortgagee is secure as to past advances, and he is not under any obligation to make any farther advances. He has only to hold his hand when asked for a farther loan. Knowing the extent of the second mortgage, he may calculate that the hereditaments mortgaged are an ample security to the mortgagees; and if he doubts this, he closes his account with the mortgagor, and looks out for a better security.

Lord Chelmsford agreed and elaborated on the reasons why priority should be given to the second mortgagee:[4]

I do not feel restrained, therefore, by the deference which is justly due to Lord Cowper∗s high authority from questioning freely the doctrine which he is supposed to have sanctioned. The reason upon which the doctrine proceeds is, "that it was folly of the second mortgagee with notice to take such security." Now, what is this but to say that a mortgagee, by taking a security for advances which may never be made, may effectually preclude a mortgagor from afterwards raising money in any other quarter? And, as the first mortgagee is not bound to make the stipulated farther advances, and with notice of a subsequent mortgage, he can always protect himself by inquiries as to the state of the accounts with the second mortgagee, if he chooses to run the risk of advancing his money with the knowledge, or the means of knowledge, of his position, what reason can there be for allowing him any priority? What injustice is done to him by postponing him to the second mortgagee under such circumstances? But, on the other hand, if it is to be held that he is always to be secure of his priority, a perpetual curb is imposed on the mortgagor∗s right to encumber his equity of redemption.

The dissenting judge, Lord Cranworth, would have sustained the rule in *Gordon* v. *Graham.* He stated:[5]

I certainly had understood that in such a case, excluding all special circumstances, the first mortgagee would be secure for any subsequent advances covered by his security, even though he had notice of the second mortgage. This is so laid down on authority, has, I believe, been often acted on, and seems to me perfectly just and reasonable.

Mortgages are but contracts; and when once the rights of parties under them are defined and understood, it is impossible to say that any rule regulating their priority is unjust. If the law is once laid down and understood, that a person advancing money on a second mortgage, with notice of a prior mortgage covering future as well as present debts, will be postponed to the first mortgagee, to the whole extent covered or capable of being covered by the prior security, he has nothing to complain of. He is aware when he advances his money, of the imperfect nature of his security, and acts at his peril.

It is noteworthy that both priority positions were defended by their proponents on the basis that the subordinated party under the particular priority rule could always protect himself so long as the rule were settled and understood. If the priority rule favoured the first mortgagee, the second mortgagee could always protect his position by avoiding the "folly" of lending money on precarious security. If the priority rule were to favour the second mortgagee, the first mortgagee is able to protect his position by refusing to make further advances once he has notice of the second mortgage. On what basis then was the court to select one priority rule in preference to the other?

The judges of the majority looked beyond the impact of the priority rule on the secured parties and focused instead on the position of the borrower. It was noted that a priority rule which favoured the first mortgagee was capable of creating a situation where the first mortgagee had advanced funds equal to only a fraction of the value of the mortgaged property but might refuse to make any further advances. In the absence of a rule which assured a subsequent secured party of priority, the borrower would be disabled from obtaining further credit and the

value of his equity of redemption would be rendered useless as security. For this reason, they favoured a rule under which the second mortgagee had priority.

Lord Cranworth, on the other hand, viewed the issue simply as one of freedom of contract. He saw no reason why the first mortgagee should be deprived of the priority for which he had bargained and of which the second mortgagee was aware. A priority rule favouring the first mortgagee was commercially convenient:[7]

> The rule. . . is a convenient rule, causing injustice to no one. It has, probably, been often acted on, and to depart from it may, I think, retrospectively cause great injustice, and prospectively prevent advances of money by bankers or others, where such advances might be safely and usefully made;

C. Analysis and Conclusion

The competing policies which occupied the House of Lords in *Hopkinson* v. *Rolt* are very much with us over 120 years later, and the arguments on both sides of the question retain their validity. The question to be confronted is whether the way in which the competition was resolved, which may have been appropriate 120 years ago, remains valid today.

A preliminary point to note is that the priority rule, whatever it may be, is largely irrelevant in most mortgage transactions. Numerically, the vast majority of mortgage loans are purchase-money transactions which enable the borrower to buy his or her home. Invariably, the mortgage transaction involves a single advance of funds by the lender and the question of further advances simply does not arise.

There seem to be two principal contexts in which further advances are likely to be made and the priority to be enjoyed by the lender with respect to them is of importance. The first is where the mortgage money is made available to enable the borrower to construct an improvement on land. For convenience, we refer to this as a "construction mortgage." Normally, the lender under a construction mortgage will advance the money to be secured in stages which match, roughly, the borrower∗s need for the money and the extent to which the improvement has been completed. The other circumstance in which further advances may be made is where a mortgage secures a "line of credit" under which the borrower∗s indebtedness fluctuates.

For reasons set out in greater detail in subsequent chapters, it is our view that, in these two contexts, the balance struck by *Hopkinson* v. *Rolt* is no longer appropriate and that the law should be changed to give greater weight to commercial convenience. A preliminary question is whether this is best achieved through a restatement of the general principle in a way which favours (with exceptions) priority for first mortgagees for all advances. Or, is the

proper course to retain the general rule as stated in *Hopkinson* v. *Rolt,* but to create further exceptions in the areas of concern to us?

There is respectable precedent for the first course of action. The status of further advances was an issue confronted by the framers of modern personal property security legislation and it was concluded that the rule in *Hopkinson* v. *Rolt* was so inconvenient that it was discarded entirely. A modern Canadian version of this legislation, the *Uniform Personal Property Security Act, (U.P.P.S.A.)* contains a number of provisions which are relevant to the status and priority of further advances. These provisions are set out in Appendix B to this Report. The cumulative ef-

fect of these provisions is that a secured party can claim priority over subsequently acquired interests for all advances whenever made. This rule is subject to two exceptions. A judgment creditor who has caused the property to be seized, or a buyer of the property, may give notice to the secured party, the effect of which is to deprive the secured party of his priority for later advances.

While it is tempting to follow the pattern of modern personal property security legislation, it is our view that we should not do so. A reform measure so sweeping would go far beyond the concerns we have identified as calling for change and might lead to unforeseen consequences. The *U.P.P.S.A.* innovations with respect to further advances took place in the context of a general restatement of the whole of the law of personal property security and was part and parcel of many innovations. We are not in the process of attempting anything so comprehensive with respect to mortgages of land and we think caution dictates a more restricted approach.

In the next two chapters we will therefore be examining running accounts and construction mortgages with a view to developing recommendations which assume that the basic statutory rules governing further advances will not undergo any radical alteration in principle. The thrust of these recommendations will be to create exceptions to the rule in *Hopkinson* v. *Rolt* rather than altering the rule itself.

CHAPTER III MORTGAGES TO SECURE A RUNNING ACCOUNT

A. Introduction

Credit arrangements can take a variety of forms. In many cases a credit transaction is a "one shot" affair which involves a single advance of money or money∗s worth by the credit grantor. Other types of credit arrangements will contemplate a continuing flow of dealings between debtor and credit grantor which may extend over a lengthy period of time. During the course of these dealings the credit grantor will, from time to time, provide the debtor with money or money∗s worth and the debtor will make payments to the credit grantor toward discharging or reducing his indebtedness. Under this type of arrangement the debtor is sometimes said to have "a line of credit."

There are many familiar examples of such arrangements. In the consumer context, the third party credit card and the revolving charge account which a consumer might maintain with a major retailer are well known. In the business setting, a retailer might establish a line of credit with a wholesale supplier under which goods are supplied by the wholesaler from time to time on agreed terms of payment.

Credit provided by financial institutions, such as banks, provides another example. A typical way of structuring a line of credit is for a current account to be opened in the borrower∗s name with the lender agreeing to accommodate an "overdraft" up to some agreed maximum. The borrower then treats the account like any other bank account, depositing money in it from time to time and drawing on it as needed.

There is no universally accepted compendious term to describe arrangements of this type, but the expression "running account" is one which is frequently used. It will be observed that the notion of the further advance is an integral part of a running account between the credit grantor and his debtor. Every time a fresh charge is made on the credit card, a cheque is honoured while a current account is in an overdraft position, or a wholesaler supplies goods to a retailer on terms, it can be said that a further advance is being made. For the purposes of the legal relationship be-

tween the debtor and the credit grantor *per se* that characterization is unimportant. It acquires significance, however, when the credit grantor has gone a step further and taken a mortgage to secure the amount due on the account as it may exist from time to time (usually up to some maximum which is the stated "face value" of the mortgage). That brings it squarely within the rules concerning further advances.

B. The Position of a Running Account under Section 24 of the Property Law Act

The special nature of the mortgage given to secure a running account is given recognition in section 24 of the *Property Law Act*.[2] Subsection (2) provides:

(2) Where a mortgage is expressed to be made to secure a current or running account, it shall not be deemed to have been redeemed by reason only that

(a) advances made under it are repaid; or

(b) the account of the mortgagor with the mortgagee ceases to be in debit, and the mortgage remains effective as security for further advances and retains the priority given by this section until the mortgagee has delivered a registrable discharge of the mortgage to the mortgagor; but, if the mortgagor is not indebted or in default under the mortgage, the mortgagee shall, on the mortgagor∗s request and at the mortgagor∗s expense, execute and deliver to the mortgagor a registrable discharge of the mortgage.

This provision is directed at a very particular problem that might arise when a mortgage is given to secure a running account. If, at some point, the account has a nil balance, (that is the indebtedness of the borrower has been discharged) it might be argued that the mortgage itself is discharged and that no later advances could revive its efficacy as security. Such an argument might be raised by a second mortgagee in an attempt to defeat the first mortgagee∗s priority with respect to an advance made after the account has been reduced to a nil balance but before the second mortgagee gives notice of his interest. In essence, he would attempt to argue that the first mortgagee is unsecured with respect to that advance. The purpose of section 24(2) is to lay such an argument firmly to rest.

Other than as stated above, section 24(2) confers no enhanced priority to the credit grantor whose running account is secured by a mortgage. He merely "retains the priority given by this section" which means potential subordination to a subsequent mortgagee who gives notice.

C. An Enhanced Priority?

A number of arguments can be made that section 24 of the *Property Law Act* should go significantly further than it does in improving the position of a lender whose mortgage secures a running account. Of particular concern is the lender∗s priority position *vis-a-vis* a later mortgagee of the same property. Some of these arguments are explored below.

1. THE PRESENT PRIORITY RULE DISCOURAGES CREDIT GRANTING

A major argument for change is the proposition that enhanced priority would make the mortgage of land a much more attractive security vehicle for commercial lenders. As the law presently stands the mortgage of land is less useful than it might be for securing a running account because the flow of dealings between lender and borrower can so easily be interrupted by an intervening interest. While we have no studies or statistics to confirm it, the possibility exists that there are large numbers of small entrepreneurs who find that their ability to obtain credit from institutional sources is significantly impaired because they are unable to provide security of a kind which satisfies the requirements of potential lenders.

A change in the law which assured the lender of priority over subsequent mortgagees with respect to *all* his advances (up to the face value of the mortgage) would, we think, undoubtedly tend in the direction of encouraging the extension of credit to those who cannot presently obtain it. This, we believe, would be a useful development, particularly in times when stimulating an economic recovery is a matter of high importance. How significant an impact such a measure would have on credit granting is difficult to say.

In the Working Paper we specifically invited comment on whether such an innovation would stimulate credit granting. While the response was not unanimous, a majority who commented, including a group acting as spokesmen for commercial lenders, agreed that it would encourage the extension of credit.

2. THE PRESENT LAW TENDS TO ENCOURAGE COMPLEX ACCOUNTING ARRANGEMENTS

Consider the following situation:

January 1

A borrower (B) establishes a line of credit with a lender (L1). B∗s indebtedness under the running account is secured by a mortgage on Blackacre. At this time L1 advances $5,000. Blackacre is worth $10,000.

February 1

B approaches a second lender (L2) and borrows a further $10,000 which is advanced immediately. L2 is secured by a second mortgage on Blackacre, notice of which of given to L1.

March 1

L1 advances a further $5,000 to B.

April 1

B repays L1 *$5,000.*

December 1

B becomes bankrupt and it is necessary to ascertain the priority position of L1 and L2.

The example illustrates a situation in which property worth $10,000 purports to secure indebtedness totaling $15,000. Obviously either L1 or L2 is going to be unsecured to the extent of $5,000.

Clearly, on February 2, the loser would have been L2. L1 had priority for the advance made on January 1 and L2 was secured only as to $5,000 of the $10,000 advance he made on February 1. The priority position would not be altered by L1∗s March 1 advance although he would be unsecured with respect to that advance. What then is the impact of the April 1 repayment?

The priority position of the parties after the April repayment would depend on whether that repayment is identified with discharging the January 1 advance with respect to which L1 was secured, or the March 1 advance with respect to which L1 was not secured. An appropriation of the repayment to the January 1 advance would obviously favour L2∗s interests. He would want to argue that the only monies outstanding were those advanced after he had given notice of the February 1 mortgage and therefore he, L2, has priority as to the whole of his $10,000 advance and L1 is unsecured.

L1, on the other hand, would wish to take the position that the April 1 repayment was identified with discharging the advance made on March 1, the January 1 advance remaining intact and enjoying its original priority. Which argument then, would prevail?

The answer shifts with circumstances and the agreements between, and conduct of, the parties. The general rules concerning the appropriation of payments in a running account were explored fully by this Commission in a Report entitled *Competing Rights to Mingled Property: Tracing and the Rule in Clayton∗s Case.* For present purposes, it is necessary only to outline the general principles.

A debtor and creditor may agree at the outset of their relationship how payments are to be appropriated. That agreement may call for repayments to be appropriated to earliest advances, most recent advances or according to some other formula devised by the parties. Frequently, special provision is made for payments to be appropriated first to interest.

In the absence of any agreement between the parties, it is open to the payer (the debtor) to specify how the payment is to be appropriated as between early advances and later advances. Where the payer has not made such an appropriation, it is then open to the payee (the creditor) to make this appropriation.

Where neither debtor nor creditor has made an appropriation with respect to a payment, then the law will fall back on a presumption regarding running accounts known as the rule in *Clayton∗s* case. This presumption is that repayments are appropriated to the earliest advance. In our earlier Report, we observed that:

> the rule in *Clayton∗s* case is based upon elementary accounting principles and in the usual course, it is a practical and accurate description of banking practice.

To return to our example, it will be seen that the application of the rule in *Clayton∗s* case would favour L2. L 1, however, has it within his power to oust the application of the rule in *Clayton∗s* case either through the terms of the agreement under which credit was first extended, or through a specific appropriation of the April 1 repayment. It is in his interest to appropriate in that way, and if he is well-advised he will do so, defeating L2∗s claim to priority and enhancing his own.

There are several observations which might be made about the rights of appropriation in this context. First, in some circumstances, the priority which section 24 of the *Property Law Act* appears to give to the second mortgagee may be illusory. Second, a manipulation of the appropriation rules by the first mortgagee yields a result which is not always consistent with sound accounting practice and, if carried out over an extended period of time, may yield a state of accounts which can be unraveled only with the greatest difficulty. Third, the first mortgagee runs a risk that by appropriating repayments to the most recent advances of credit, any action to enforce a claim for the earliest advances may become statute-barred through effluxion of time.

There may, therefore, be much to be said for permitting the first mortgagee to do simply and directly what can be done now in some circumstances, but only at the cost of complex appropriation arrangements.

3. DIFFICULTIES WHERE THE SECOND MORTGAGE SECURES A RUNNING ACCOUNT

The example in the previous section presumed that L2 advanced a fixed amount on February 1 and that no further advances were contemplated. What are the rights of the parties where the second mortgagee, say L2, also seeks to secure a running account and proposes to make a number of further advances coupled with interim repayments? The difficulties lurking in such a situation were touched on by Lord Cranworth in *Hopkinson* v. *Rolt:*

> ...to depart from [the rule in *Gordon* v. *Graham*] may ...cause great injustice...where, as in this case, the second mortgagee is like the first, a security for future as well as present advances, great difficulty must arise in settling the priorities of the two mortgages in respect of future advances.

This suggestion did not trouble Lord Chelmsford:

Difficulties were raised in argument as to the mode in which the alternating priorities between the respective mortgagees might have to be adjusted. But the simple answer to these suggestions is, that the advances must have priority according to the order in which they are made.

But is this solution as "simple" as Lord Chelmsford suggests?

Once there are two mortgages, each securing a running account, with each mortgagee having notice of the other, as a matter of practice before the lender under either mortgage could safely make an advance, it would be necessary to inquire of the other as to his state of accounts with the debtor. This would be highly inconvenient. An alternative might be to require that each mortgagee, upon making an advance, give notice of that fact to the other mortgagee. This would be no less inconvenient.

The common law position is, however, probably as Lord Chelmsford pronounced it. Has it been altered by section 24 of the *Property Law Act?* Arguably it has. Section 24(1) is silent about the timing of advances under the second mortgage and a close reading of the section suggests that once the second mortgagee has registered and given notice of his interest to the first mortgagee, he can make his advances under the second mortgage whenever he chooses and enjoy priority without regard to any intervening advances that may have been made by the first mortgagee. He can only lose his priority for further advances under the second mortgage if a third mortgagee enters the scene. The wisdom and fairness of this result might be questioned.

4. FULL PRIORITY FOR THE FIRST MORTGAGEE SHOULD NOT INHIBIT THE ABILITY OF THE BORROWER TO OBTAIN ALTERNATIVE FINANCING

The rationale underlying the decision of the majority in *Hopkinson* v. *Rolt* was that to give the first mortgagee full priority for all further advances would inhibit the ability of the borrower to raise further credit on his remaining equity in the mortgaged property. Does this rationale retain its validity today? Consider the following situation:

A borrower (B), seeking to expand his business, enters into an arrangement with a financial institution (Li) for a line of credit up to a maximum of $200,000. This arrangement takes the form of a running account and B mortgages Blackacre to secure his indebtedness on the account. Blackacre is worth $200,000. Li advances $10,000 under this arrangement and then refuses to make any further advances but B needs further money to carry out his plans.

In this example, B is obviously creditworthy and L1's refusal to make further advances may be totally unrelated to B∗s creditworthiness. What then are B∗s prospects of obtaining credit from a second lender, L2? The view in *Hopkinson* v. *Rolt* was that it was essential that L2 be guaranteed priority over any further advances that might be made by L1. If that were not the case, L2 would be insecure and would be reluctant to extend credit to B. B would be unable to get the credit he needs from either L1 or L2 even though Blackacre would provide ample security for additional advances.

There is, however, an unstated assumption in *Hopkinson* v. *Rolt:* L1's mortgage would continue to encumber Blackacre. It could not be redeemed or discharged without L1∗s agreement, except in compliance with the terms of the first mortgage which would probably involve the expiration of its term at some future date. This may have been true of the mortgage in issue in *Hopkinson* v. *Rolt* but in British Columbia the borrower∗s rights where a mortgage secures a running account appear to be somewhat different.

It is in the nature of a running account that it can be paid down to a nil balance and when that occurs, the borrower, under section 24(2) of the *Property Law Act* has an absolute right to compel the mortgagee to execute and deliver a registrable discharge of the mortgage. Thus, the

borrower and a second lender have it within their power to remove a prior lender from the picture entirely and to give the second lender the top priority he would want. Given the ability to do this, the main argument against giving the first lender priority for all his further advances loses much of its force. In the example given above, a likely sequence of events would be that B would enter into an arrangement with L2 involving a second mortgage of Blackacre to secure L2∗s advances. L2 would then advance sufficient funds to discharge L1's mortgage. That discharge would be registered and L2∗s mortgage would then have top priority and secure all L2∗s subsequent advances.

There may be circumstances in which B∗s need for credit is so great that neither L1 nor L2 is prepared to assume the full burden of providing that credit. In that kind of situation the obvious solution is for L1 and L2 to enter into a subordination agreement under which they define their own priority position for the purposes of credit extended to B.

The analysis set out above breaks down somewhat when the borrower and the mortgagor are not the same person. This might occur, for example, where a third party guarantees a borrower∗s indebtedness under a running account arrangement and gives a mortgage to the lender securing any liability which might arise under the guarantee. In such a case there is no legal mechanism whereby the mortgagor can compel payment of the running account down to a nil balance and bring in a new lender. In these circumstances, the fears expressed by Lord Chelmsford have some weight.

The range of circumstances in which this will be a problem is, however, much narrower than it might first appear. Many cases which involve a mortgage of land given to secure a personal guarantee arise in circumstances where the guarantor is an entrepreneur who conducts his business through the medium of a closely held limited company. Essentially, he guarantees the debts of a company of which he is the sole or majority owner. He would, therefore, exert a substantial measure of control over the company and would, in reality, be able to arrange alternative financing with the same ease as if he were principally liable.

D. Conclusions

1. GENERAL

It is our conclusion that persuasive reasons exist for a modification of the priority position of a credit grantor whose mortgage secures a running account. He should have priority for all advances secured by the mortgage, whenever made, notwithstanding that an intervening encumbrance has come into being and he has notice of it. Such a reform measure, in essence a major exception to the rule *inHopkinson* v. *Rolt,* would, we believe, be beneficial. It should tend to encourage the extension of credit to businessmen who are otherwise worthy of it, discourage the complications which flow from unorthodox appropriation arrangements and simplify priorities where two competing mortgages both secure a running account. Moreover, this position would be consistent with the priority rules of emerging personal property security legislation. It would provide a uniform priority rule in cases where in a single

security instrument, the lender takes security in both real and personal property.[8] This, we think, would be a beneficial development.

This conclusion is fortified by a development in Alberta which emerged after our Working Paper was circulated. On June *5, 1985* Royal Assent was given to an act amending that province∗s *Land Titles Act* 13 "Instrument" includes a judgment; *see Land Titles Act, supra,* n. 9, s. 1(1). through the addition of a provision in the following terms:

(1.1) Upon registration of a mortgage that provides for a revolving line of credit up to a specific principal sum, the mortgage obtains priority in accordance with section 16 of this Act for all advances and obligations secured pursuant to the terms of the mortgage notwithstanding

(a) that the advances and obligations are made or incurred subsequent to the registration, after December31, 1982, of any other instrument or caveat, and
(b) that at any time during the term of the mortgage there may not be any outstanding advances to be secured.

The effect of this amendment is to give explicit recognition to the position of the running account lender and to assign an appropriate priority to his advances.

2. JUDGMENTS

The discussion so far in this chapter has been directed at the situation where the intervening interest is a second mortgage. But, the intervening interest might also take the form of a judgment registered under the *Court Order Enforcement Act.* The arguments which favour an enhanced priority for further advances over the interest of a second mortgagee are less clear-cut when applied to this type of intervening interest.

Here arguments can be raised in support of the present priority position. If the new priority rule we propose extended to priority over judgments, the borrower would, in effect, be permitted to "hide behind" the mortgage lender so as to defeat or impair the rights given to the judgment holder under the *Court Order Enforcement Act.* The priority rule proposed diminishes the priority of encumbrancers whose rights arise by agreement with the borrower. So long as the rules are well understood, that cannot be said to work a hardship. But the holder of a judgment who has registered it against the mortgaged property is, in a sense, a non-consensual mortgagee and to dilute his priority rights is arguably bad policy.

In the Working Paper we proposed that a subsequent judgment creditor should enjoy a somewhat greater measure of protection than the subsequent mortgagee, for the reasons outlined above. A number of our respondents disagreed with this conclusion. A number of arguments were advanced against it: it would create an anomaly to favour a judgment creditor over a mortgagee; judgment holders can look to other creditor∗s remedies to satisfy their claims which may be denied the mortgagee and the proposed priority scheme could give rise to a circular priority structure.

We also note that the recent Alberta amendment, referred to above, would give the running
account lender priority over the holder of a registered judgment.

At the same time, another argument has emerged in favour of the priority position proposed in the Working Paper. The priority which our proposal would have accorded to a judgment, *vis a vis* a running account lender, is the same as that he would have under new personal property security legislation. The result would be, therefore, that when a lender, in the same security instrument and with respect to the same indebtedness, takes security over both personal property and real property, similar priority results would flow with respect to both competing subsequent mortgagees and judgment creditors. To depart from the proposal made in the Working Paper could create the anomalous situation where, with respect to the same advance, the judgment creditor had priority over the lender with respect to goods, but was subordinate to him with respect to land. This, we believe, should be avoided.

We are not persuaded that a retreat from the proposal made in the Working Paper is called for. On the whole, we believe that the present rule under which registration of a judgment and notice of its registration cuts off the mortgagee∗s priority for any further advances, strikes an appropriate balance where the mortgage secures a running account.

3. RECOMMENDATION

The Commission recommends that:

1. Section 24 of the Property Law Act *be amended to provide that, notwithstanding subsection (1), where a mortgage is expressed to be made to secure a current or running account, the mortgagee shall, for all further advances made under the mortgage up to a maximum amount stated in the mortgage, have priority over any subsequent mortgagee.*

CHAPTER IV CONSTRUCTION MORTGAGES

A. Construction Mortgages Generally

A construction mortgage secures money loaned to assist a land owner in building. Almost invariably, the money secured by a construction mortgage is disbursed in a number of advances which are timed to coincide with various stages of completion of the building.

There are two principal reasons why the money is advanced in stages. First, the borrower has no immediate need for the whole of the money. From his point of view, it is not sensible to receive immediately the whole of the amount to be lent to him, and to pay interest on it, when he will not need the money until some date in the future. The second reason lies in the peculiar nature of the property which secures the mortgage. It significantly increases in value once the building has been completed. For example, a parcel of bare land on which a building is to be erected may be worth $100,000. Once the building has been erected, the land and improvements may be worth $2,000,000. This has important implications for the lender. If he were lending, say, $1,500,000 for construction purposes and advanced the whole of that amount immediately solely on the security of a mortgage over the land, he would be badly undersecured. By advancing the money in stages, as construction proceeds, he attempts to maintain a rough equivalence between the actual amounts secured and the value of the security.

It is frequently the case, however, that while a building is under construction, the value of the security is worth much less than the amount which it has been necessary to advance. For example, a lender may have advanced half the money contemplated by a construction mortgage, and he may be secured by the value of the land and a half completed building. The difficulty is that a half completed building may be worth little more than no building at all. The lender therefore wishes to be in a position to continue to make further advances under the mortgage (assuming they are all applied to the completion of the building) so that ultimately the value of the security will catch up to and exceed the amount actually advanced.

The implications for the construction mortgagee of the present rules concerning the priority of further advances are obvious. Construction mortgages do not enjoy any favoured position under section 24 of the *Property Law Act* and, as the law presently stands, any intervening encumbrancer who registers a second mortgage or a judgment and gives notice to the construction lender can, in effect, deprive him of the right to make the advances necessary to complete the project and make himself fully secure. Under section 24 of the *Property Law Act,* the only way the lender can be assured of priority for his advances is to enter into a binding commitment to make them. For sound business reasons, few lenders are prepared to enter into such a commitment.

These priority rules cannot but have an adverse effect on the willingness of commercial lenders to make money available for construction purposes. It is beginning to be recognized elsewhere that the peculiar nature of construction financing calls for a special set of priority rules which are somewhat more favourable to the construction lender.

B. The Uniform Simplification of Land Transfers Act

In the United States, the National Conference of Commissioners on Uniform State Laws has promulgated, and recommended for adoption, two

separate but related uniform Acts aimed at simplifying and reforming real property law: the *Uniform Land Transactions Act*[2] *(U.L.T.A.)* and the *Uniform Simplification of Land Transfers Act*[3] *(U.S.L.T.A.)*. Both pursue similar policies with respect to rights of construction lenders. The essential difference between them is that the *U.S.L.T.A.* deals with the priority of a mortgagee *vis-a-vis* the claimant under a construction lien (a right similar to a claim under the British Columbia *Builders Lien Act)*. The *U.L.T.A.* is silent on the priority of construction lien claimants. For this reason it is convenient to focus our attention on the relevant provisions of the *U.S.L.T.A.*

The first feature to note is that the *U.S.L.T.A.* has moved in the direction of personal property law by adopting the terminology of "security interest" and "security agreement" in preference to terms having their roots in the word "mortgage." The Act recognizes a specific type of interest known as the "construction security interest" in section 3-103. Its definition and a related definition on which it relies are set out below.

(1) "Construction security interest" means a security interest created by a security agreement that contains a legend on the first page clearly stating that it is a "Construction Security Agreement" and that secures an obligation which the debtor incurred for the purpose of making an improvement of the real estate in which the security interest is given, if the instrument recorded to perfect the interest states that it is a construction security interest.

(25) "Security interest" means a consensual interest in real estate which secures payment or performance of an obligation....

The priority of advances under a recorded security interest are governed by section 3-209. It provides:

Notwithstanding sections 3-201 and 3-302 [rights of a purchaser of the property], subject to the provisions on priority of a construction lien (Section *5-209),* a recorded security interest takes priority as of the date of its recording as to advances or obligations thereafter made or incurred under the security agreement:

(1) [if made pursuant to a commitment]

(2) *[Idem.]*

(3) [if made for the protection of the security interest.]

(4) if made under a security interest to enable completion of the agreed improvement of the real estate whether or not the advances or obligations exceed the secured maximium amount stated in the instrument or the secured creditor has knowledge of the intervening interest.

The official comment to that section provided by the Commissioners states: 4 *Ibid.* at 250.

This section is designed to provide a means whereby the holder of a security interest can make payments for construction or maintenance and be protected as to those payments against holders of intervening security interests. Major policy reasons for this priority are the encouragement of construction; the encouragement of completion of construction projects despite cost overruns; and the prevention of abandonment of buildings.

As section 3-209 indicates, construction liens are singled out for special treatment in section 5-209. The relevant clauses of that section provide:

(b) Except as provided in subsection (c), a construction lien has priority over subsequent advances made under a prior recorded security interest if the subsequent advances are made with knowledge that the lien has attached.

(c) Notwithstanding knowledge that the construction lien has attached, or the advance exceeds the maximum amount stated in the recorded security agreement and whether or not the advance is made pursuant to a commitment, a subsequent advance made under a security agreement recorded before the construction lien attached has priority over the lien if:

(1) the subsequent advance is made under a construction security agreement and is made in payment of the price of the agreed improvements,

(2) the subsequent advance is made or incurred for the reasonable protection of the security interest in the real estate, such as payment for real property taxes, hazard insurance premiums, or maintenance charges imposed under a condominium declaration or other covenant, or

(3) the subsequent advance was applied to the payment of any lien or encumbrance which was prior to the construction lien.

(d) To the extent that a subsequent security interest is given to secure funds used to pay a debt secured by a security interest having priority over a construction lien under this section, the subsequent interest is also prior to the construction lien.

The official comment to section 5-209 states:[5]

> [A]n advance made with knowledge of an attached construction lien does not take priority over the lien even though it was committed without knowledge of the attached lien or before the lien attached. But, under subsection (c), if the advance is made under a construction security interest and is actually applied to payment of the price of the improvements, the construction advance has priority over prior attached mechanics∗ liens whether or not the advance was made pursuant to a prior commitment. Construction security interest is defined by Section 1-201(1). The rule of subsection (c) is based on the assumption that, more often than not, it is to the interests of lien claimants as a class to have the construction lender continue to supply funds to the project, even though some claimants might gain by a rule which gave them priority over the lender.
>
> If the holder of a construction security interest makes an advance to the owner which is diverted to some purpose other than payment of a prime contractor or some lien claimant on the job, the advance has not been "made in payment of the price of the agreement improvements," and the construction lender∗s priority would be determined, not by subsection (c)(1), but by subsection (b).

A policy which unites these provisions of the *U.S.L.TA.* is that a mortgage lender should be entitled to priority for money which is advanced and which has been applied for the purpose of protecting his security and, in the context of construction loans, that includes funds advanced for the purposes of completing an improvement. Advances purported to be made under a construction security interest which are not applied for that purpose do not enjoy this priority. There also seems to be an unstated assumption which is relevant. Money advanced to complete an improvement enhances its value and, unless there has been some drastic miscalculation as to the worth of the completed improvement, the increased value will operate to the benefit of those whose interests may be subordinated to that of the construction lender. The balance struck by the *U.S.L.T.A.,* therefore, cannot be said to be manifestly unfair to parties whose interests are in competition with those of the construction lender.

It is fair to say that, at this stage, we are sympathetic with the overall policy direction of the provisions of the *U.S.L.T.A.* outlined above. Below, more detailed consideration is given to a number of issues raised by the *U.S.L.T.A.*

C. Liens Under the Builders Lien Act

Section 24 of the *Property Law Act* is not the only enactment which touches on mortgage priorities where further advances are involved. An important provision is also found in section 6 of the *Builders Lien Act* (formerly titled *Mechanics∗ Lien Act).* Subsections (1) and (2) provide:

> **Liens on mortgaged premises**
>
> 6. (1) A registered mortgage has priority over a lien to the extent of the mortgage money *bonafide* secured or advanced in money prior to the filing of the
>
> claim of lien, but in proceedings for the enforcement of a claim of lien the court may order the sale of mortgaged land at an upset price of not less than the amount secured under all registered mortgages having priority over the claim, costs and the costs of the sale, and the mortgages shall be satisfied out of the proceeds of the sale according to their respective priorities and in priority to the lien to the extent mentioned and subject to subsection (2).
>
> (2) Advances or payments made under a mortgage after a claim of lien has been filed shall rank after the lien, but any mortgagee who has applied mortgage money in payment of a claim of lien which has been filed is subrogated to the rights and priority of the lien claimant who has been paid as mentioned to the extent of the money applied.

This provision is something of an analogue to section 24 of the *Property Law Act.* Section 24 attempts to define priorities where the rights of a mortgage lender, with respect to further advances, are in competition with those of a subsequent mortgagee or judgment holder. Section 6 of the *Builders Lien Act* attempts to set priorities where the competing interest is that of a builder∗s lien claimant. There are, however, some differences in the treatment accorded a builder∗s lien. The most important difference is there is nothing analogous to section 24(1)(b) of the *Property Law Act* which requires written notice to the mortgage holder as a condition of priority for the subsequent interest.

Two observations might be made about the practical effect of section 6(1). First, as noted above, under section 6(1) of the *Builders Lien Act,* the mere filing of a lien claim is sufficient to

give that claim priority over any further advances and the lien claimant is not required to notify the mortgage lender of the lien claim. The result is that no mortgage lender financing a construction project can safely make any further advances during the course of the project without first having checked in the Land Title Office for liens that may have been filed. We understand that it is the practice of a majority of lenders to make such a pre-advance title search to ensure that their priority position is secure.

A second implication of the priority rule is that it places a powerful weapon in the hands of lien claimants. The mere filing of a lien by only one of many suppliers, subcontractors or workers is sufficient to halt the flow of money to the whole construction project and bring it to a halt. In 1972 this Commission submitted a Report on builder*s lien legislation which made a number of recommendations for its improvement.[7] No recommendations were made in respect of section 6 but in a discussion of whether the Act should be repealed, the following observations were made:

> One of the most serious problems of the Act is that the filing of a lien can have such serious consequences for the owner in terms of slowing down work on the job that the threat of filing can be a powerful weapon in the hands of an unscrupulous subcontractor. This would not be such a serious problem if there were a process available to the owner or contractor by which, on the giving of adequate security, liens could be summarily removed. Under the present law, this can only be done by paying the lien claimant or by paying into Court the amount of the lien claim, even though the claim may be in excess of the maximum possible amount of the owner*s liability. This situation could be improved by establishing the necessary interlocutory procedure. But it is unlikely that the possibilities for blackmail inherent in the Act can ever be completely removed as long as everyone engaged on the construction project has the right to encumber the owner*s title.

We have little doubt that a dilution of the priority strength enjoyed by the claimant of a builder*s lien would significantly diminish the potential for what the 1972 Report referred to as "blackmail" by lien claimants. It would also, however, have the effect of reducing the pressure which could be applied to

enforce the speedy payment of legitimate claims. While we recognize the force of this argument, we believe, on the whole, the balance presently struck by the *Builders Lien Act* is not the appropriate one.

The priority strength given to lien claimants as against construction lenders does, we believe, more harm than good to the construction industry and its participants which the Act seeks to protect. How far is it fair or sensible that subcontractor A should, by filing a lien, be able to cut off the flow of funds to subcontractors B, C, D and E who have no complaints?

The difficulties created by the present priority structure emerge in their most acute form where there is a major breakdown in the construction project such as where the owner/developer, the head contractor, or both, become insolvent. When this happens in the middle of the project, usually there is no equity in the land or the improvement itself to which liens can attach. The liens do, however, have a "nuisance value" and their notional priority can render abortive reasonable attempts to salvage the project and bring it to completion.

D. Priority as Against Other Interests

In the previous chapter relating to advances on a running account, we recommended that the lender*s priority for further advances should prevail only over the rights of a subsequent mortgagee. The rights of other types of intervening encumbrancers such as the holder of a registered judgment would remain unchanged. Do the considerations which lead to that conclusion with respect to a running account apply with equal force to a construction mortgage? On the whole, we believe they do not.

The principle which underlies the special status given the construction lender is that he should have priority for all money advanced for the legitimate protection of his investment, a factor which is not relevant to advances on a running account. This protection would be severely weakened if a broad range of intervening interests were permitted to assert priority. This argues that a construction lender should have priority for all further advances, whenever made, over any intervening encumbrance notwithstanding that the lender knew of the encumbrance.

E. The Working Paper Proposal

In the Working Paper, we made a proposal for such priority in the following terms:

> Section 24 of the *Property Law Act* be amended to reflect the principle that where a construction mortgage has been registered under the *Land Title Act,* the mortgagee, with respect to any advance made under the mortgage after its registration up to a maximum amount stated in the mortgage, has priority over the interest of any intervening encumbrancer, including the claimant of a builder∗s lien, to the extent that the money advanced was in fact used to enable the completion of an improvement on the land or to discharge indebtedness arising out of the construction of the improvement.

Most of the comment which we received on this proposal was favourable. The comment of those who were critical of it, or which suggested modifications or improvements to it, fell into three categories.

1. OBJECTIONS IN PRINCIPLE

The proposal made in the Working Paper stimulated a vigorous response from a group who spoke for the construction industry. Given the erosion of their priority position implicit in the proposal, their concern is understandable. Their submission was a lengthy one and it is difficult to do justice to it in the confines of this Report. The essence of their message, however, seemed to be that construction lenders are entities with substantial economic resources. They are well able to look after their own interests while the participants in the construction industry are not, and the latter require the protection which the present priority rules give them. They suggest that there are a number of ways in which construction lenders can preserve their position which are not necessarily open to all potential lien claimants. In this regard, they assert that the lender is better placed to assess the creditworthiness of the owner/developer; the lender might extract collateral security such as personal guarantees and charges on unrelated property; lenders can require bonding at various levels and the lender is better placed to spread the risk of, and absorb the loss arising from, a construction project which has foundered.

Some, or all, of these factors may be present in various projects at various times. They do not, however, answer the basic point of principle which led the Commission to conclude, provisionally, that an alteration in the priority structure was called for. Typically, when a construction project comes to a halt and liens are filed, the value of the partially completed structure is well below the amount which has been advanced and with respect to which the lender is *bona fide* secured. At that stage, the owner/developer has no equity in the project to which the liens can attach. The lien claimants would have only the "statutory holdback" to which they may look for payment.

If the lender were allowed to continue to make his advances, with full priority, the builder∗s lien claimant is no worse off than would be the case if the partially completed building were sold—a course of action which would also cause a loss to the lender. Depending on the state of accounts at the end of the day the lien claimant may conceivably be better off. We have difficulty in seeing how this represents a dangerous inroad on the rights of builder∗s lien claimants. What they do lose is the "nuisance value" associated with the filing of a lien, a characteristic which is difficult to defend in any event.

We are not, therefore, persuaded to retreat from the basic thrust of the proposals set out in the Working Paper. As we indicated above, it received the support of the majority of those who responded.

2. POLICING THE APPLICATION OF FUNDS

The proposal in the Working Paper stipulated that the construction lender∗s priority should be *"to the extent that the money advanced was in fact used to enable the completion of an improvement..."* This formulation led to expressions of concern in some of the submissions sent to us. It was suggested that the proposal would place too great a burden on the construction lender to "police" the application of the funds to construction purposes.

To properly understand this concern it is necessary to examine the particular way that legal relationships are structured within major construction projects. Typically, these consist of an interlinking series of contractual chains which, when diagramed, assume something akin to the shape of a pyramid. At the apex of the pyramid is the construction lender and immediately below him

are the owner and head contractor in that order. From there the pyramid branches out to various sub-contractors and below them sub-sub-contractors and possible sub-sub-sub-contractors where a major project is involved. In addition, any of those parties lower in the pyramid may engage workers or material suppliers who have rights under the *Builders Lien Act.*

A characteristic feature of this kind of structure is the fact that any particular participant in the construction project is in privity of contract only with a very limited number of other participants. This limits the kind of control that can be exerted with respect to financial accountability.

In the normal course of a construction project, the construction lender at the top of the chain, will make an advance to the owner. The owner will usually disperse the whole of this (less any holdback) to the head contractor who in turn will disperse the funds among his various sub-contractors with respect to their accounts that come due at that particular stage of the project. The sub-contractors in turn pay their sub-sub-contractors and so on down the chain. Typically, an advance made by a mortgage lender will eventually filter down to the bottom of the pyramid until those at the bottom, such as material suppliers, get paid. When that occurs through all limbs of the pyramid there is little doubt that the requirements of the proposal, as presently drafted, have been met. The money advanced has in fact been used to enable completion. The core idea is that the money advanced remains within the construction pyramid. This result is reinforced by the provisions of the *Builders Lien Act* which constitute funds in the hands of the head contractor, and those subcontractors below him, as trust money. The beneficiaries of this trust are all the persons lower in the pyramid who, it is expected, will eventually be paid from that money.

What happens, however, when events do not proceed in the orderly fashion described above? Suppose, for example, a sub-sub-contractor, who is responsible for sheet metal work, receives money from the sub-contractor who engaged him (the heating contractor) as a result of the lender∗s advance. Instead of using it to pay the material supplier who provided the sheet metal, he uses the money to buy a fur coat for his wife. Here, money has escaped from the construction chain and, arguably, it has not been applied to the completion of the project in a way which satisfies the proposal.

Another example would be where the sub-sub-contractor places the money he has received from the heating contractor into his general account. Before he is able to write a cheque to the material supplier in satisfaction of the latter∗s account, the bank seizes the money which it

purports to set off against the sub-sub-contractor∗s overdraft. This occurs quite regularly in practice and the state of the case law is such that, in a large number of cases, the bank gets to retain the money free of the statutory trust imposed on it by the *Builders Lien Act.*

The question is whether these kinds of occurrences would take the advance outside of the proposal with a consequent loss of priority to the construction lender. This is the basic concern expressed by our correspondents. They see a very real danger that it would and that there is very little the mortgage lender could do to protect himself. The difficulty the lender faces is that he has very little *de facto* control over the way advances are dispersed as they work their way toward the bottom of the pyramid. He is in privity of contract with the owner and can exercise a high degree of control to make sure

the money is not misapplied at that level. He is also in a position to exert a significant degree of *de facto* control over the head contractor to see that funds are properly dispersed to the various sub-contractors. At the sub-contractor level, and lower, however, the construction lender∗s ability to direct the way in which money is handled and dispersed is much weaker. It was questioned whether our proposals should visit a potential loss of priority on the lender for a diversion of funds which he would not, in reality, be able to prevent.

It was suggested to us, in some submissions, that we might consider some sort of procedure under which the lender could rely on a "certificate of application." While we appreciate the concerns that have been raised, we do not believe that a certificate procedure is the proper response.

Rather, we have reconsidered the way in which the proposal has been framed to see whether its basic aims could be achieved without requiring the "policing" which it was suggested might flow from the wording of the proposal. The alternative which suggests itself is to give the construction lender priority for *"all funds advanced bona fide for the purpose of enabling the completion of the improvement."* Under this test, the lender would lose priority only if he were somehow involved in, or were aware of, events which would result in the advance being diverted to other purposes at some level of the construction pyramid. The question of "policing" for the purpose of ensuring priority will not arise.

In practice, it would still be very much in the lender∗s self interest, so far as it lies within his control to see that advances are in fact applied to completion. When funds are not so applied, the value of his security is correspondingly diminished, a situation he naturally wishes to avoid.

3. PREFERENTIAL PAYMENT OF LIEN CLAIMANTS

In the Working Paper proposal the use of money advanced to enable the completion of an improvement was one of two permissible applications of funds. The second was *"to discharge indebtedness arising out of the construction of the improvement."* One group which corresponded with us were concerned that explicitly to permit the discharge of existing indebtedness was an invitation to the lender to attempt to give one lien claimant preference over another. The submission stated:

> We should like to see a distinction drawn between advances for future costs, and advances in payment of the price of improvements already made or materials previously supplied, or to discharge a builder∗s lien in respect thereof. Your Paper appears to approve the provisions contained in Section 5-209(c)(1) and (3) of the U.S.L.T.A. We do not think such preferences ought to be permitted. We think it undesirable and potentially disruptive to permit a practice which would give one lien claimant a preference over another. If the purpose be to neutralize claimants who might otherwise close down the project, we think that can be accomplished by obtaining the type of relief which you mention at page 37 of your Paper (a stay of execution, adjournment of proceedings).We feel the Court has sufficient flexibility in such matters so that no special provisions are needed.
>
> Paragraph 3 in your list of proposals (page *59* of your Paper) provides for priority:

> "...to the extent that the money advanced was in fact used to enable the completion of an improvement on the land or to discharge indebtedness arising out of the construction of the improvement."

That language would appear to be broad enough to give priority for advances made to pay prior construction costs, or the claims of some, but not all of those persons having claims at the date of the advance. If our view is accepted then it would be sufficient if the priority were given to the extent that the money advanced is used to satisfy the costs which shall be incurred to complete the construction project. Another way of illustrating our concern is to suggest that at the end of your paragraph 3, there be a proviso that priority shall not be given for advances made to satisfy existing liens or past obligations.

In general terms, your proposal as it appears in the Paper constitutes an erosion of the rights of builder∗s lien claimants. We accept that erosion insofar as completion costs are concerned, since, for the reasons expressed in your Paper, the result would likely be to enhance the. value of the uncompleted improvement and thus improve rather than reduce the recovery of such claimants. The ability to pay accounts and claims for work already done or materials already supplied, however, would completely undermine the scheme of distribution in the *Builders∗ Lien Act* and enable the construction mortgagee to prefer one lien claimant or supplier over others in his own best interests. For example, it was suggested during our discussion of your Paper that if the construction mortgagee was a bank it would (or might) see to the payment of accounts due to its own customers.

This extract from the submission articulately describes the justification for introducing a refinement to our proposal.

We agree with the authors of this submission. First, the purpose for which the priority is given is the *completion* of the project. The satisfaction of an account for work which has already been done does not enhance the value of the project. Second, we agree that, in this particular context, it is undesirable to create a situation in which one lien claimant might be preferred to another for reasons unconnected with the completion of the project. It follows from this, therefore, that we favour modifying our original proposal by deleting the final passage referring to the discharge of prior indebtedness.

The submission quoted above suggested that our recommendations go a step further by adding a provision that priority should not be given for advances made to satisfy existing liens or past obligations. Is this further step necessary or desirable? On the whole, we believe it is not. There may be occasions where a lien claimant occupies something akin to a monopoly position in his particular line and will insist on being paid before he does any further work. Whether or not a payment made in those circumstances would be made *"bona fide* for the purpose of enabling the completion of the improvement" is something which would depend very much on the facts of the individual case and the answer may vary with circumstances. We think this is an area in which some flexibility may be called for. It is our conclusion that a modification of our proposal to meet this concern should not go beyond the deletion of the reference to past indebtedness.

The Commission recommends that:

2. section 24 of the Property Law Act *be amended so as to provide definitions similar to the following:*

> *(a) "construction mortgage" means a mortgage which is clearly expressed to be a "construction mortgage and that secures an obligation which the mortgagor incurred for the purpose of making an improvement on the land over which the mortgage has been granted;*
>
> *(b) "builders lien" means a lien claim arising under the* Builders Lien Act.

3. Section 24 of the Property Law Act *be amended to reflect the principle that where a construction mortgage has been registered under the* Land Title Act, *the mortgagee, with respect to any advance made under the mortgage after its registration up to a maximum amount stated in the mortgage, has priority over the interest of any intervening encumbrancer, including the claimant of a builder's lien, if the advance was made* bona fide *for the purpose of enabling the completion of an improvement on the land.*

4. Section 6 of the Builders Lien Act *be amended:*
(a) to provide that its operation is confined to mortgages other than construction mortgages, and

(b) to specify that the priority of a builders lien vis-a-vis *a construction mortgage shall be determined in accordance with section 24 of the* Property Law Act.

F. Enforcement Rights of Intervening Encumbrances

The recommended priority position does raise other questions concerning the position of the holders of subordinated second mortgages, judgments, and builders∗ liens. What would be their rights between the time their interests were registered and completion of the project? Nothing in the recommendation alters their procedural rights. Those rights would simply attach to the fluctuating value of the borrower∗s equity in the property and the improvement. It would remain open to any of them to attempt to proceed to enforce their interests.

The outcome of such proceedings would, however, likely be influenced by the value of the property and the amount which had been advanced under the construction mortgage. If such an application were brought at a time when the construction lender was under-secured, the borrower∗s equity having a nil value for the time being, the court would probably be most sympathetic to an application to stay execution on any order made, or to adjourn the proceedings until the construction has been completed.

If the value of the property exceeds the amount secured by the construction mortgage then there may be no reason why the court should not permit the holder of the subordinate charge to exercise his rights, since the construction lender would not be prejudiced. The debtor himself, however, might point to the potential increase in the value of the property if the project is completed as grounds which justify a stay or an adjournment for his benefit. We believe that the court has sufficient flexibility in such matters that no special provisions are called for.

CHAPTER V BORROWINGS BY A RECEIVER: THE *CANUSA* CASE

A. Introduction

The issue of the status of advances by a construction lender arose in a somewhat different context than that discussed in the previous chapter in a case decided by the British Columbia Court of Appeal in 1984. This case, *Yorkshire Thust Co.* v. *Canusa Construction Ltd.,* 3 R.S.B.C. 1979, c. 224. emerged too late to receive consideration or comment in the Working Paper which preceded this Report. The decision in *Canusa* seems to be regarded as a controversial one. It prompted a submission to the Ministry of the Attorney General that legislation be enacted which would, in effect, overrule the effect of the decision. The comments and recommendations of the Commission on this submission were sought by the Ministry. Since our work on the priority of further advances would have a direct bearing on the need for, and desirability, of such a measure, we agreed that we would formally offer our advice on this issue.

B. The Canusa Case

The full reasons for judgment of the Honourable Mr. Justice Macfarlane, with whom Mr. Justice Hinkson and Mr. Justice Macdonald concurred, are set out as Appendix C to this Report. The facts may be summarized as follows.

The appellants were construction lenders who were secured by a first mortgage which contemplated advances up to *$7.5* million to the owners of certain land (one of which was Canusa) to finance the construction of a building. The mortgage provided that the whole of the principle and interest should be payable on demand. Construction commenced and advances were made under the mortgage. Before the building was completed, the borrowers fell into an unspecified default, and demand was made under the mortgage. At the date of demand *$5.3* million had been advanced under the mortgage. It was estimated that an additional $2.2 million was required to complete the project. Five days after the demand, a petition for foreclosure was filed. Two claims for builder's liens had been filed prior to the date the petition was filed. At least one further claim was registered after that date. It is not clear whether the first two claims were filed before the demand was made under the mortgage, and whether they may, in fact, have stimulated that demand.

In its petition, the mortgagee expressly applied for the appointment of a receiver/manager. One feature of the application for the appointment of the receiver/manager was significant. It proposed that the receiver/manager should be empowered to borrow up to *$2.5* million to facilitate the completion of construction. It was expected that on completion the property could be sold at a gross price slightly in excess of the amount required to redeem the mortgage costs.[2] It was proposed further that the receiver∗s borrowings should be secured by the land and the improvement *in priority to all other charges.*

In seeking this order the appellants relied on section 36 of the *Law and Equity Act.*[3] It provides that:

...a receiver/manager [may be] appointed. . . and the order may bemade. . . on terms and conditions the court thinks just.

The petitioner characterized special priority for the receiver∗s borrowings as a "term or condition" which the court had the discretion to impose on all parties to the proceedings. In opposing the application, the respondents contended that section 36 must be read subject to sections 6 and 11 of the *Builders Lien Act.*[4] Section 6 was set out in the previous chapter of this Report and section 11 provides:

11. Subject to this Act, when a claim of lien has been filed. . . it takes effect from the date of commencement of the work or when the first materials are furnished or placed for which the lien is claimed, and it takes priority over all judgments, executions, attachments and *receiving orders* recovered, issued or made after the lien takes effect. [emphasis added]

Both the trial court judge and the Court of Appeal agreed with the respondents. The reasons for judgment of Mr. Justice Macfarlane of the Court of Appeal concluded with the following observations:

...[S.] 36 of the *Law and Equity Act* was not intended to empower the court to negate the unambiguous expression of legislative will found in the *Builders Lien Act.* . . The Order which was sought in this would have preserved the priority of the appellants while in the end result, subjecting the lien holders to a loss or diminution of their security. ...

I agree with the Chambers judge that if the Court did have jurisdiction to make an order appointing a receiver/manager with the powers in question that it would be appropriate in the circumstances not to exercise a discretion in favour of making such an order. However, I would have chosen a different basis for exercising my discretion. . . . The order is a form of equitable relief. Essentially it is an order to be made for the purpose of the protection or preservation of property for the benefit of persons who have an interest in it. Here, it appears, the only persons who stand to gain from the making of the order are the appellants. In the circumstances of this case the application appears to be but a device by which the mortgagees, who have refused to advance any further monies, and to take any further risk, seek to have the project completed for the purposes of preserving and protecting their own financial position rather than that of others having an interest in the project. The advancement of such narrow and selfish interests does not appeal as a reason for exercising equitable jurisdiction. . . . On the material before us I would not have considered it either just or convenient to grant the order in the terms in which it was sought.

C. Some Preliminary Observations

There are two limbs to the decision in *Canusa.* The first concerns the court∗s jurisdiction to stipulate the special priority over builders lien claims sought for the receiver∗s borrowings. The court held that no such jurisdiction existed. Whether or not the court should have such a jurisdiction is the central issue addressed in this chapter.

The second limb of the decision concerns the criteria which should govern exercise of the discretion on the facts of the case, presuming the discretion exists. Given the earlier conclusion that it does not, the court∗s observations are essentially *obiter dicta.* Nevertheless, it is this aspect of the judgment which we find most troubling.

While the reasons for judgment do not explicitly state that the value of the partially completed building would be less than the construction lender had advanced, we suspect this to be the case. No purpose would be served by the application otherwise. In the previous chapter, we adopted the view that the construction lender has a legitimate commercial interest in taking steps to see that the value of the security will "catch up" to the amount which he has advanced. It
was our conclusion that this interest was one worthy of protection

by the law and led to our conclusion that the construction lender should have priority for all his advances made for construction purposes over intervening encumbrance including builders lien claims. It follows that we cannot agree with the Court of Appeal∗s characterization of the lender∗s action as seeking "the advancement of such narrow, selfish interests." In our view, the steps taken by the lender in seeking special priority for the receiver∗s borrowings were a legitimate and proper response to a difficult situation that was created, at least in part, by a priority rule which we recommend be altered.

One other point also calls for some comment. The closing passage of the judgment refers to the lenders seeking to protect their own financial position only, "rather than that of others having an interest in the project." It is our reading of the terms of the order which was sought that the receiver∗s borrowings would have priority over *all* prior charges. This would include the applicants∗ own mortgage. In other words, the construction lenders were prepared to see their own priority position subordinated to that of the receiver insofar as funds were borrowed for completion of the project. The lender was not seeking to undermine the priority of the builders lien claimants while leaving its own untouched. It should be observed that the lender would probably still be secured in the event priority had been given to further borrowings. As matters stood, however, no subsequent interests were secured by the value of the incomplete project. Completion of the project had the potential for increasing its value so that subsequent interests could be satisfied.

D. A Special Priority for a Receiver∗s Borrowings?

As we indicated in the introduction, the *Canusa* decision raised concerns among those involved with construction financing. These concerns led to a submission that the *Law and Equity Act* be amended in a way which would reverse the effect of *Canusa.* The suggested amendment was prefaced with the following observations:

> ... [I]n our practice, we often encounter circumstances where, if the receiver or receiver/manager were able to borrow sufficient funds, a property may be completed, protected or enhanced with positive results for all those (including lien claimants) having an interest in that property. You will readily appreciate that a partially completed building, or one in need of urgent repair, suffers a severely diminished value in the market place in comparison with the value to be obtained from the completed structure or one saved from the deteriorating consequence of non-repair.

The solution suggested in the submission was that section 36 of the *Law and Equity Act* should be modified by renumbering the existing provision as subsection (1) and by adding, as subsection (2) a provision which would read as follows:

(2) Notwithstanding the *Builders Lien Act,* the court may authorize and empower a receiver or receiver/manger appointed by it to borrow money on terms and conditions the court thinks just for the purposes of protecting and preserving lands and premises and constructing or completing construction of buildings and improvements situate thereon and may order that the money so borrowed shall have priority over a claim of lien filed under the *Builders' Lien Act.*

E. Arguments in Favour of Adopting the Suggested Amendment

1. THE CANUSA DECISION CREATES AN ANOMALY IN RECEIVERSHIP LAW

One commentator, speaking of *Canusa,* stated that "the Court of Appeal decision was contrary to practise and to the understanding the profession and

the financial community had as to what the law was."[6] We have been told that, until *Canusa,* orders in the terms sought in that case were made with some regularity in the British Columbia courts and that *Canusa,* therefore, represented a departure from previous practice. Assessing the accuracy of this assertion has given us some difficulty. The source of this difficulty is that proceedings of this kind tend seldom to surface in the reported cases. In most instances, because an order authorizing a receiver to borrow money with a special priority is likely to benefit everyone, applications tend to go by consent or, at least, are unopposed. In this way, a pattern of practice develops without a potentially contentious legal issue ever being tested. Parties come to rely on this practice as representing the true state of the law.

It is arguable that the law should reflect the reasonable and popular expectations of those who must operate within its strictures. A sudden departure from those expectations is an unfortunate development which could lead to significant commercial disruption.

Viewed from the perspective of receivership law, the powers of a receiver/manager to borrow and the priority sought to be attached to those borrowings the amendment would appear to be justified. *Kerr on Receivers* states the general proposition this way:[7]

If a receiver and manager requires money to enable him to carry on the business entrusted to him, the court will give him liberty to borrow upon the security of the property in his control and as a first charge upon the whole undertaking, in priority even to debentures, where the money is required for the preservation of the assets and good will.

How does this general principle apply in the context of a construction project which has foundered? If the debtor, into whose shoes the receiver/manager has stepped, has a business which consists of developing and improving land, then the completion of a building would appear to fall squarely within the concept of "carry[ing] on the business entrusted to him." Thus, borrowing for that purpose would appear to be a proper exercise of a receiver/manager∗s powers and the court would be justified in authorizing him to proceed. It can also be argued that completing a building can be identified as a "preservation of the assets" of the debtor. While there appears to be no authority directly on point which upholds this view, it seems to have been accepted by implication both in *Canusa* and by the Supreme Court of Canada in *Baxter Student Housing Ltd.* v. *College Housing Co-op Ltd.* In those cases the power of a receiver/manager to borrow or to accept an advance under an existing encumbrance, for the purposes of completing construction as a general incident of the receiver/manager∗s powers, was not questioned.

It follows, then, that under section 36 of the *Law and Equity Act* the court appears to have the power, in the construction context, to assign to the borrowings of a receiver/manager priority over a wide range of prior encumbrances. The exception of builders liens from that range of en-

cumbrances is anomalous, and constitutes an undesirable fetter on the powers of the court to assist parties in extricating themselves from the consequences of financial difficulties.

2. THE SUGGESTED AMENDMENT SERVES THE PUBLIC INTEREST

The argument under this heading is that it is in the public interest that buildings under construction are completed within a reasonable time. As one observer, in a slightly different context, commented:[9]

> It is in the community∗s interest that construction projects be completed with as few delays as possible. The completed job is a benefit to the economy and the more quickly it becomes available for use the more benefit will be derived. A delayed project means temporary unemployment, inefficient use of expensive construction equipment and it probably stands as an eyesore in the community.

A project which is never completed means that valuable resources have been wasted. Moreover, delay in completing a building risks physical deterioration which will entail additional expense to correct. Again, resources are wasted.

F. Arguments Against Adopting the Suggested Amendment

1. THE AMENDMENT IS UNNECESSARY

In the previous chapter it was recommended that the construction lender should have his priority over intervening encumbrances (including builders liens) where those advances are made for construction purposes. Where a receivership intervenes, whether the receiver was appointed at the instance of the construction lender or some other person having an interest in the property, the advances can as easily be made to the receiver as to the original borrower. The necessary priority to protect such advances would be built into that situation and there would be no need to clothe the receiver with borrowing powers of a special priority. The purpose of the priority for these advances is to give the construction lender an opportunity to protect his interest by making advances which will permit the value of the security to catch up with the amount which he has advanced.

By definition, therefore, the suggested amendment is only likely to be invoked where the order seeks to give priority, not to the original construction lender, but to a new lender. The new lender is typically a third party who has no stake in the project requiring protection. It may be argued that the case for giving such a lender priority over a builder∗s lien claimant is much weaker than the case for priority for the original construction lender. On its face, it directly contradicts the priority scheme inherent in our land title system.

This argument taken to its logical conclusion would lead to a view that the present powers of the court to attach special priority to a receiver's borrowings are unnecessarily wide. The court should never be empowered to clothe the borrowings of a receiver with priority over advances made by an earlier lender, without that lender∗s explicit consent.

2. THE SUGGESTED AMENDMENT WOULD BE INEFFECTIVE

As pointed out earlier, there were two limbs to the *Canusa* decision. The first limb was a holding that the court had no discretion to order that a receiver∗s borrowings should rank ahead of a builder∗s lien claim. The second limb concerned the exercise of such a discretion if it existed. The suggested amendment to the *Law and Equity Act* would clearly overrule the first limb of *Canusa.* It would provide the discretion which the court held was missing. It would do nothing, however, with respect to the second limb.

A court asked to exercise its discretion under the amendment would be doing so under the shadow of a very strong directive from the Court of Appeal that, in a fact pattern like *Canusa,* an order should not be made. The interest of the first mortgagee was, after all, characterized as "narrow and selfish." Thus, in exactly the kind of situation where the proponents of the amendment would see it as most useful, it would not help them. An amendment in the form suggested, this argument would conclude, would be stillborn.

It is not only in British Columbia that financial difficulties may arise in connection with a construction project. In other jurisdictions these problems have been dealt with through a legislative solution embodied in builder∗s lien legislation. In Ontario, for example, the *Construction Lien Act* contains the following provisions:

> 70. (1) Any person having a lien, or any other person having an interest in the premises, may apply to the court for the appointment of a trustee and the court may appoint a trustee upon such terms as to the giving of security or otherwise as the court considers appropriate.
>
> (2) Subject to the supervision and direction of the court, a trustee appointed under subsection (1) may,
>
> (a) act as a receiver and manager and, subject to the *Planning Act* and the approval of the court, mortgage, sell or lease the premises or any part thereof;
>
> (b) complete or partially complete the improvement;
>
> (c) take appropriate steps for the preservation of the premises; and
>
> (d) subject to the approval of the court, take such other steps as are appropriate in the circumstances.
>
> 80. (7) Despite anything in this Act, where an amount is advanced to a trustee appointed under Part IX as a result of the exercise of any powers conferred upon him under that Part,
>
> (a) the interest in the premises acquired by the person making the advance takes priority, to the extent of the advance, over every lien existing at the date of the trustee∗s appointment; and
>
> (b) the amount received is not subject to any lien existing at the date of the trustee∗s appointment.

The appointment of a trustee under provisions similar to these is analogous to the appointment of a receiver/manager under the *Law and Equity Act.* The trustee∗s powers and duties are, however, set out comprehensively and clearly. They are arguably broader than those of a receiver/manager.

H. Our Conclusions

We have a good deal of sympathy with the difficulties which face lenders in the kind of situation which arose in *Canusa.* Most of these difficulties, we believe, stem from the failure of section 24 of the *Property Law Act* and of the *Builders∗ Lien Act* to recognize the special character of construction financing and to provide an appropriate set of priority rules. In the previous chapter we recommended that the existing priority rules be altered. The implementation of these recommendations would, we believe, keep the *Canusa* problem from arising in the vast majority of cases. The construction lender will usually be prepared to continue to advance funds to enable the completion of the project so long as that lender is assured of an appropriate priority.

The question we confront, therefore, is whether the law should also accommodate those cases where it is necessary to bring in a new lender to finance the completion of a building. On balance, we think it is fair that it should. One factor which impresses us is that the past few months have seen the collapse of major lending institutions and the ripple which this causes. In the present economic climate there appears to be a much greater likelihood that third party financing will be necessary to complete projects once thought to be solidly financed. We are persuaded by the arguments that the preservation and completion of buildings under construction is in the public interest. The parties involved in a construction project should have the maximum flexibility in fairly resolving problems that arise from financing difficulties. It follows, therefore, that we agree with the philosophy which underlies the suggestion that the *Law and Equity Act* be amended by adding the proposed subsection set out above.

We are less enthusiastic, however, respecting the proposed amendment itself. We would prefer to see something which is less general in character, less closely tied into the law of receivership, and which applies to a wider range of persons who may have a stake in the premises or the construction project. In this regard, we believe the Ontario provisions point the way to an appropriate solution.

Under the Ontario scheme, the responsibility for completion of a project would be vested in a ‘‘trustee∗∗ rather than a ‘‘receiver”. We see this as more than merely a difference in terminology. The term trustee implies a higher order of accountability and carries with it a clear duty to carry out his responsibilities with an even hand. Unhappily, the concept of receivership has become somewhat tainted, in practice if not in theory, through a close identification of the receiver with the interest of the party that caused him to be appointed.

The conduct of the trustee would be closely regulated by the Court. While it has been argued that this is a deficiency in the Ontario scheme, we see it as a virtue.

Finally, the appointment of a trustee may be sought by any person having an interest in the project. This would include a lien claimant or the owner/ developer, neither of which would, necessarily have status to seek the appointment of a receiver under the *Law and Equity Act.*

Our recommendation is set out below. It is modeled after the Ontario scheme but with such changes as are necessary to sever it from the larger Ontario statute and to harmonize it with our other recommendations.

I. Recommendation

The Commission recommends that:

5. A new section be added to the Law and Equity Act *in terms similar to the following:*

36.1 *(1) Where the construction of an improvement on land has been commenced, any person having an interest in the improvement or the land, including a person having a claim under the* Builders Lien Act, *may apply to the court for the appointment of a trustee and the court may appoint a trustee upon such terms as the court considers appropriate.*

(2) Subject to the supervision and direction of the court a trustee appointed under subsection (1) may,

(a) act as a receiver and manager and, subject to the approval of the court, mortgage, sell or lease the land or the improvement or any part thereof;

(b) complete or partially complete the improvement;

(c) take appropriate steps for the preservation of the land or the improvement; and

(d) take such other steps as are appropriate in the circumstances.

(3) Any interest in the land or the improvement that is to be sold may be offered for sale subject to any mortgage, charge, interest or other encumbrance that the court directs.

(4) The court may make all orders necessary for the completion of any transaction by a trustee under this section.

(5) Notwithstanding any other Act, where one or more advances are made to a trustee appointed under this section as the result of the exercise of any powers conferred on him, a mortgage taken by the person making the advances has priority, to the extent of the advances, over every mortgage, judgment, lien or other encumbrance existing at the time of registration of the mortgage.

(6) A mortgage taken to secure funds advanced to a trustee for the purposes described in clauses (b) and (c) of subsection (2) is deemed to be a construction mortgage and [the provisions which implement recommendations 2 to 4] apply.

CHAPTER VI OTHER ADVANCES FOR THE PROTECTION OF THE MORTGAGEE∗S INTEREST

In the Chapter IV, it was noted that the basic reason for giving the construction lender priority for advances which enable an improvement to be completed is that the lender should be entitled to priority for money advanced for the legitimate protection of his security. Advances to enable completion of an improvement are one aspect of that policy. But there are other kinds of advances which a mortgage lender might also wish to make which can be identified for the protection of the property and the security. These expenditures are not, however, peculiar to construction mortgages and for that reason they call for separate treatment.

Almost every mortgage, whether it be for purposes of construction, securing a running account or to enable the acquisition of a residence, will contain covenants on the part of the borrower aimed at preserving and protecting the property. Typically the borrower will covenant to keep the premises insured, keep the premises in good repair, to see that local rates, taxes and levies are satisfied, and to see that any prior encumbrance is kept in good standing and money owing under it is paid. A failure to observe these covenants is usually an act of default under the mortgage. As added protection, the mortgage lender will usually reserve the right to cure any default by the borrower and to add the cost of doing so to the amounts secured. Thus, where the borrower fails, say, to insure the property as he promised to do, it is open to the mortgage lender to take out appropriate insurance and add the cost of the premium which he has paid to the principal amount secured by the mortgage.

Disbursements of this nature would probably be characterized as further advances for the purposes of the priority rules embodied in section 24 of the *Property Law Act.* Thus, if Blackacre was encumbered by a first and second mortgage, with the first mortgagee having been given notice of the second, if the first mortgagee spent money to insure the property on the borrower∗s failure to do so, he would likely be subordinated with respect to that amount to the second mortgagee.

In the Working Paper we characterized this result as one which is “manifestly unfair” and made a proposal for its correction. We proposed that section 24 of the *Property Law Act* be amended to provide, in general terms, that advances or expenses made or incurred to protect or preserve the mortgagee∗s interest in property should have priority. We proposed further that implementing legislation should set out a number of examples of such advances or expenses.

A majority of our correspondents approved of the proposal. Only one submission contained a suggestion for its improvement:

> We are also in accord with your proposal that there be priority for advances made to protect or preserve. . . property. . . ,but would prefer that such expenses fall within a carefully worded definition in paragraph 5 rather than written specific examples. We are concerned that the use of specific examples in paragraph 6 may form the basis of an argument that such expenses must be confined to those of the same nature and kind as the examples.

We are not convinced that an abandonment of the list of examples is called for. A number of other correspondents appeared to find them helpful. On the other hand, we do recognize the danger that the list may be read *ejusdem generis* and our recommendation set out below has been modified

somewhat from that contained in the Working Paper to avoid, insofar as it is possible, a narrow interpretation being placed on it.

The Commission recommends that:

6. Section 24 of the Property Law Act *be amended to provide that a mortgagee has priority over any subsequent encumbrance for advances made or expenses incurred for the purpose of protecting or preserving the mortgagee∗s interest or the property, where the mortgage provides that such advances may be made or expenses incurred.*

7. Legislation implementing the previous proposal should set out examples of advances or expenses contemplated by it including:

(a) payment of local rates and taxes;
(b) hazard insurance premiums;
(c) charges, assessments and penalties levied by a strata corporation in accordance with the Condominium Act;
(d) payments to keep prior encumbrances in good standing;
(e) charges arising from the observance of a covenant running with the land; and
(f) necessary repairs.

but the legislation should specify that use of examples does not limit the generality of the principal provision.

A. Introduction

The recommendations made so far in this Working Paper are directed at major policy issues concerning the scope and content of section 24 of the *Property Law Act.* In addition to these, there are a number of other improvements which might be made to the present contents of the Act to clarify its operation and to eliminate any anomalies which might arise. This chapter, therefore, will involve a more detailed look at some of the features of section 24 of the *Property Law Act* and will set out recommendations for its improvement.

B. The Property Law Act

The starting point in any examination of section 24 is subsection (3). It provides:

(3) Except as provided in this section, a right to tack in respect of mortgage of land is abolished.

The effect of this provision is that the whole of the common law concerning tacking in relation to mortgages of land is abolished except to the extent that it is expressly permitted by other parts of the section. This brings one to subsection (1) which sets out the statutory tacking rights:

(1) Notwithstanding the *Land Title Act,* after October 30, 1979, further advances made by a registered owner of a mortgage contemplated by and in accordance with the mortgage rank in priority to mortgages and judgments registered after his mortgage was registered where

(a) the subsequent registered mortgagees or judgment holders agree in writing to the priority of the further advances;

(b) at the time the further advance is made he has received no notice in writing of the registration of the subsequent mortgage or judgment, from its owner or holder;

(c) at the time the further advance is made the subsequent mortgage or judgment has not been registered; or

(d) the mortgage requires him to make the further advances.

This provision should be read in conjunction with subsection *(5)* which defines further advance:
(5) In this section "further advance" includes a first advance.

Paragraphs (a) to (d) of subsection (1) set out the particular circumstances in which priority for a further advance may be asserted. These circumstances are, however, qualified by the "opening flush" of subsection (1). It has several features which might be noted.

First, the section operates notwithstanding the *Land Title Act.*[2] It is not totally clear what the draftsmen intended to achieve by this. There is little doubt that when a priority result arrived at through the application of section 24 conflicts with a result arising through the application of the *Land Title Act,* the former should prevail. That position would, however, seem to be achieved by the general rule of statutory interpretation that the particular overrides the general. Moreover, the fact that the courts were prepared to give effect to priorities arising under the common law doctrine of tacking in circumstances similar to those contemplated by section 24, even though the results may, theoretically, have been in conflict with the *Land Title Act,* suggests that the draftsman inserted this provision out of an abundance of caution.

Section 24(1) confers priority only with respect to advances made by the "registered owner" of the mortgage. This would seem to preclude any priority for a further advance given by an assignee of the mortgagee∗s interest unless the assignee registered the transfer.

Another limitation is that the advances to which section 24(1) applies are only those "contemplated by and in accordance with the mortgage." Hence the mortgage itself must provide for the further advance. It does not appear to be open to the borrower and lender to agree at some subsequent time that an earlier mortgage shall provide security for a further advance.

Finally, section 24(1) provides a priority rule only where the prior mortgage is in competition with a subsequent mortgage or judgment. There are, however, numerous other interests in land which might arise after the registration of the prior mortgage and which may be registered. What is, or should be, their position?

Even where a further advance satisfies the requirements of section 24(1) it must also be made in one or more of the circumstances specified in paragraphs (a) to (d). Under paragraph (a) the further advance will have priority where "the subsequent registered mortgagees or judgment holders agree in writing to the priority of the further advances." Essentially, this permits the subsequent encumbrancer to enter into a subordination agreement. It is a straightforward manifestation of a general policy which favours freedom of contract.

Paragraph (b) gives priority to the further advance where "at the time the further advance is made he has received no notice in writing of the registration of the subsequent mortgage or judgment, from its owner or holder." This provision captures the core of the common law position that the prior mortgagee can safely make his further advances until he receives notice.

Under paragraph 24(1)(c) a further advance has priority where "at the time the further advance is made the subsequent mortgage or judgment has not been registered." On its face, this provision seems to be no more than an attempt to reinforce a policy which underlies the *Land Title Act:* before a document creating an interest in land is enforceable, other than between the parties to it, it should be registered. It may, however, serve another function. Because section 24(1) is stated to operate notwithstanding the *Land Title Act,* the draftsman may have felt that something should be said about unregistered instruments lest it be thought that section 24(1) infused them with a vigour they do not deserve.

Under section 24(1)(d) the lender has priority with respect to a further advance where "the mortgage requires him to make the further advance." This provision provides clear guidance on what many had regarded as an unsettled aspect of the common law in relation to the tacking of further advances. The problem arises where the mortgage lender has entered into a binding agreement to make one or more further advances but, before the advance or advances are made, a subsequent encumbrance is perfected and its encumbrancer gives notice to the prior mortgage lender. One line of authority suggests that the prior lender has no priority for advances made after he receives the notification but that the creation of the new encumbrance relieves him of his obligation to make the further advances. Other cases suggest that

notwithstanding the notice of the subsequent encumbrance the prior lender enjoys priority for the further advance if made pursuant to a commitment. Paragraph (d) favours the policy of the latter approach.[6]

Some of these issues are discussed in greater detail below.

C. Specific Issues

1. ADVANCES BY THE "REGISTERED OWNER"

(a) Change in the Identity of the Lender

The priority conferred by section 24(1) applies only to those advances made by the "registered owner" of the mortgage. Two circumstances come to mind in which this limitation might be relevant. The first case is where a lender (L1) holds a mortgage over land owned by his debtor (D) and a second lender (L2) seeks to advance further money to D and have it secured by L1's mortgage. (All parties, presumably, are agreeable to such an arrangement.) This might arise, for example, where L1 and L2 are related corporations whose shares are owned by the same person and there are sound business reasons for preferring that one or more further advances be channeled through L2. On the face of it, the language of section 24(1) would appear to preclude the parties from structuring the loan in this way. In order to be secured L2 must obtain his own mortgage.

The other circumstance is where the lender∗s interest has been transferred. To continue with the example above, the parties may choose to structure their arrangement by having L1 assign its debt and the mortgage to L2 thus giving L2 status to make further advances. Section 24(1), however, speaks of a priority for advances made by the "registered owner" of the mortgage. This gives rise to three possible scenarios:

(1) L1 transfers the mortgage to L2. The transfer is registered immediately. L2 then makes one or more advances before a competing lender, L3, intervenes by registering his mortgage and giving notice.

(2) L1 transfers the mortgage to L2. L2 fails to register the transfer and makes one or more advances before L3 intervenes by registering his mortgage and giving notice.

(3) L1 transfers the mortgage to L2. L2 then makes one or more advances before he registers the transfer. At a later time L3 intervenes by registering his mortgage and giving notice.

Clearly in the first scenario, L2 will have priority. Through his timely registration, he became the "registered owner" of the mortgage and his priority position seems unimpeachable. The other two scenarios, however, raise difficult questions as to what is, or should be, the law.

First, should it be a requirement that the transfer be registered? There are two arguments in favour of that view. First, our land title system is one which is based on the registration of documents and the law should be molded so as to discourage persons from holding and relying on unregistered documents. A second argument is that a person in L3∗s position will wish to inquire into the status of the first mortgage and the amount secured by it. The state of the register should enable him to make his inquiries directly and he should not be required to trace the present owner of the mortgage, possibly through multiple transfers, to find the person who can provide this information.

The contrary argument is that the land title system does, in fact, give L3 notice that a competing mortgage of higher priority exists. He is not taken unaware. It is arguably unfair to deprive L2 of priority for his further advances for a failure to register which does not seriously mislead anyone as to the state of title to the property.

The third scenario reflects an ambiguity in section 24(1). To claim priority, must the transferee have been the "registered owner" at the time the further advance in question was made, or is it sufficient that he should have been the registered owner at the time the competing interest (that of L3) arose? In this case, the only argument for depriving L2 of his priority is the general policy favouring the timely registration of documents.
In the Working Paper we stated:[7]

> In our view, the ambiguity illustrated by these scenarios should be resolved in favour of the transferee. A slight change in the wording of section 24(1) would accomplish this. As to the other aspect of this issue, described initially, our present inclination is to make no proposals for change. We do, however, invite comment on whether the "registered owner" requirement constitutes a significant impediment to mortgage financing.

The only response which we received on the latter issue indicated that the "registered owner" requirement was not creating any practical problems. Accordingly, we make no recommendation on this aspect. As to the first issue we adhere to the view expressed in the Working Paper. Our recommendation is set out at the end of this chapter.

(b) Equitable Mortgages

At common law, a mortgage involved the actual transfer of the title to land to the mortgage lender — a legal mortgage. What was left with the borrower was an interest recognized only in the courts of equity and was known as his "equity of redemption." Any purported attempt on the part of the borrower to create a further mortgage of the land created only a mortgage of his equitable interest and that, too, was recognized only in courts of equity. Therefore, all mortgages of land except a first mortgage comprise one class of a group of interests known as equitable mortgages.

It was also open to the parties, at common law, to create security interests which did not involve a transfer of title, but which were also recognized in equity as creating mortgages. This class of equitable mortgages included the physical deposit of title deeds to property by the borrower with the lender, coupled with an agreement that the lands shall stand as security for a debt. Such a mortgage would also be created by a simple written declaration by the borrower that the land would stand as security for the debt, or that the borrower would at some future time create a legal mortgage in favour of the lender.

The significance of characterizing a mortgage as either legal or equitable is in the differing rights which the mortgagees have against third parties. The holder of an equitable mortgage is liable to be defeated by a person who *bona fide* acquires a legal interest in the property without notice of the equitable mortgage. The rights of a legal mortgagee are not vulnerable in this way.

In British Columbia, our system of land registration permits all mortgages to be registered, provided they satisfy certain formal requirements, and legislation specifies the relevant rights and priorities. Where competing mortgages have been registered, therefore, the distinction between legal and equitable mortgages has little significance.

It is still possible, however, either through the pledge of a duplicate certificate of indefeasible title, or through an informal written agreement, to create equitable mortgages which are enforceable *inter partes* and are not registered. The question, therefore, arises as to the way in which section 24 of the *Property Law Act* affects the right of such equitable mortgagees, and whether their position is satisfactory.

(i) Further Advances by an Equitable Mortgagee

Where further advances are contemplated by an equitable mortgage, what is the status of such advances vis-a-vis subsequent interests?[9] The answer would appear to be that an equitable mortgagee has no priority whatever for advances made after a subsequent mortgage or judgment has been registered. Indeed, depending on the character of the intervening encumbrance, he might not even enjoy priority for money advanced before that encumbrance came into being and was registered. Section 24 requires that the mortgage under which the advances are made be registered. This precludes an equitable mortgagee from bringing himself within any of the circumstances where he might enjoy priority. Nor can the equitable mortgagee look outside the *Property Law Act* for relief. Section 24(3) abolishes tacking in respect of *all* mortgages, which would include equitable mortgages.

We believe this position to be a satisfactory one. Lending on the security of an unregistered mortgage is inherently risky. Given the fact that this risk can be diminished or eliminated through registration in our land title system, it is difficult to make out any case for enhanced rights respecting further advances by an equitable mortgagee. To do so would create an anomaly.

(ii) The Equitable Mortgage as an Intervening Encumbrance

Where further advances are made under and in conformity with a registered mortgage, it would appear that a subsequent equitable mortgagee would have no status to challenge the prior lender∗s claim to priority for his further advances.

Section 24(1)(c) states explicitly that such advances have priority over subsequent interests which have not been registered. Any attempt by the equitable mortgagee, therefore, to give notice of his interest to the prior lender would be ineffective. Again, we can see no case for enhancing the rights of the holders of unregistered interests.

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(c) Floating Charges on Land

Frequently a corporate borrower will grant security in all its assets, undertaking, and present and future property, to secure corporate indebtedness. Such security frequently takes the form of a "floating charge." A distinctive feature of the floating charge is that it leaves the borrower free to deal with its property and to sell it or encumber it in the course of business. Where

the property charged includes land, a mortgage of sorts has been created. A floating charge is generally regarded as a species of equitable mortgage.

If the analysis stopped at this point, the description, in the previous section, of the position of equitable mortgages would cover the situation and no more would need to be said. Because, however, that discussion turns on requirements that a mortgage be "registered" before it has any status under section 24, somewhat different considerations apply.

Floating charges do not fit comfortably within our system of land registration. [15] A floating charge on the assets of a property developer might charge property covered by literally thousands of certificates of title. The mechanics of seeing that the floating charge is registered against all relevant titles presents formidable difficulties. There is, however, other registration machinery available to the lender. Under the *Company Act,* a floating charge on land and other assets can be registered with the Registar of Companies. It has been held that such registration is sufficient to protect the lender*s interest from the borrower*s unsecured creditors in a bankruptcy.

In the Working Paper we stated:[15]

> A question arises, therefore, whether a floating charge covering land that has been registered under the *Company Act* is also a "registered mortgage" for the purposes of section 24 of the *Property Law Act.* We think as a matter of policy it should not be, but in practice the point is a sterile one. The fact that a floating charge normally permits the debtor to freely sell or encumber his property means that the intervening interests will invariably have priority over the floating-charge-secured-lender for all advances, both past and future. We, therefore, make no proposals on the matter.

Those observations prompted the following response:

> [The Working Paper] does not address the issue of where the mortgage must be registered in order to be a "registered mortgage." The suggested revision may exclude from section 24 security instruments such as floating charge debentures, which are not generally registered in the Land Title Office. We disagree with the conclusion on page *53* of the Working Paper that a subsequent mortgage registered in the Land Title Office would invariably have priority over a floating charge. Debentures often contain negative pledges prohibiting the granting of any security which would rank in priority to or *pan passu* with the debenture.
>
> Such a debenture would take priority over a subsequent mortgage, unless a priority agreement was granted by the debenture holder. The definition of "registered mortgage" should include a debenture secured by a floating charge where there is a prohibition in the debenture on the granting of other security. The statute should state clearly whether the debenture must be registered in the Land Title Office to qualify as a "registered mortgage."

The author of this submission seems to be suggesting that, under the present law, a floating charge debenture which *inter alia* charged land would have priority by virtue of being registered in a place other than the Land Title Office. We question whether this is the law, but it is difficult to state anything with certainty insofar as floating charges on land are concerned. For this reason, earlier this year the Law Reform Commission added to its program a project on floating charges on land. In this project we hope to examine some of the concerns raised in this submission in the more specific context. We believe that any recommendations on this point should await the outcome of the further work which will be undertaken.

2. COMPETING INTEREST OTHER THAN A SUBSEQUENT MORTGAGE OR JUDGMENT

Our land title system is sufficiently flexible that a wide range of interests are capable of being registered on the title to land as a charge. Some of these charges are devices whereby the land stands as security for a debt. These include the mortgage, the judgment registered under the *Court Order Enforcement Act*[16] and the claim under the *Builders Lien Act.* It is with respect to interests of this kind that the law of tacking has traditionally fixed priority rules.

There are, however, other types of registrable interest which do not involve the land as security for money. A sale of the property which results in a transfer of registered ownership (subject to a prior mortgage) or an agreement for such a sale is an obvious example. Lesser inter-

15 At p. 53.

ests of an "ownership" character can also be created which would be registrable as a charge. These include a lease for a term exceeding three years or interests in the nature of an easement, *profit a prendre,* or restrictive covenant. Still other kinds of registrable charges may evidence limitations on the way in which an owner can deal with his property. The owner may have given an option to purchase or a right of first refusal which might be registered. Filings might also be made under the *Land (Wife Protection) Act,*[19] the *HomesteadAct,*[20] or under section 49 of the *Family Relations Act.*[21] The effect of these is to limit the way in which an owner can deal with property without the consent of his or her spouse. Another group of registrable instruments are the
lis pendens and the *caveat* which warn of claims, the assertion or enforcement of which are pending.

Any of these non-security transactions or interests is capable of intervening in a financing arrangement which involves further advances under a mortgage. What is the result, then, when a mortgage lender continues to make further advances after a non-security charge has arisen and been registered?

Section 24 of the *Property Law Act* offers little by way of specific guidance. It sets out priority rules only where the intervening interest is a mortgage or judgment. Apart from that, it simply states that the common law right to tack is abolished. Two questions present themselves. First, at common law (prior to the enactment of section 24 of the *Property Law Act)* did the mortgage lender enjoy priority for his further advances made after an intervening non-security charge had arisen? If so, did that priority flow from the

old law of tacking or was it based on some other legal theory? If that priority was based on tacking, has it been swept away by subsection (3) that abolishes the law of tacking except as specifically provided?

There are no obvious answers to these questions. The fact is that the reported cases invariably involve intervening security interests and intervening interests of other kinds simply do not appear to have arisen in practice. In part this seems to be explicable by the general caution of the conveyancing profession and by common law practices concerning the custody of title deeds. We think little purpose would be served by attempting any exhaustive analysis of what the present position might be, particularly since it would be highly speculative in character. We think it sufficient at this stage to record only our own conclusions on the matter.

We believe this aspect of section 24 should be clarified and there are two ways one might approach this exercise. First, one might assimilate all these non-security interests to mortgages and judgments and apply similar rules. Under this approach, a person in whose favour an intervening interest (for example, an easement) has been created, would be able to give notice to the mortgage lender and thereafter he could claim priority for his interest over any subsequent advances made by the lender. This example, however, illustrates some of the difficulties of this approach. What if the borrower is in default with respect to advances made both before and after the easement was created and the lender finds it necessary to foreclose? What is the state of the title? Does the intervening party end up with one-third or one-half of an easement depending on the proportion of the advances made after the easement was created?

The other approach is to give the mortgage lender priority, according to the tenor of his mortgage, over all intervening charges for all advances made, whether before or after the charge was created unless that charge is security for money (which is already convered by section 24). It is this approach which we believe best accords with common sense and which restricts the intricacies of the law of tacking and future advances to the ambit which it has historically occu-

pied. We recommend that section 24 of the *Property Law Act* should be clarified to achieve that result.

We do confess some unease with this conclusion in its application to intervening filings made under the *Land (Wife Protection) Act* or the *Family Relations Act.* Where such a filing is made subject to an existing mortgage, which contemplates further advances, it could, in some circumstances, render the effect of a filing by a spouse nugatory. We think, however, that this is an issue which should be examined in the context of family property law and the specific role which those statutes play.

3. "NOTICE IN WRITING FROM OWNER OR HOLDER"

Paragraph (b) of section 24(1) gives the earlier mortgagee priority for advances made without notice of the intervening interest. It may be observed that the notice must be in writing and must be "received" by the prior mortgagee. This imposes on the subsequent encumbrancer a standard of conduct in relation to the notification which is virtually the same as that required for service of a writ of summons. He may not rely on the more relaxed standards attached to the word "deliver" in section 29 of the *Interpretation Act.*

We make no recommendations for change in this aspect of paragraph (b). We do observe, however, that its purposes would be equally well served by

some "middle standard" of notification more rigorous than "delivery" but more relaxed than personal service. If the *Interpretation Act* were to be amended to provide such a middle standard, its use in this context might be considered.

This notice must be received from the "owner or holder" of the subsequent encumbrance. This raises questions as to the status of a notification received from an agent (such as the solicitor) of the subsequent encumbrancer. Is it a nullity? While this is not a major issue, the position might usefully be clarified if section 24 is to be amended in any event. We suggest that paragraph (b) be amended to make it clear that the notice may be one issued by or on behalf of the owner or holder of the subsequent encumbrance.

D. Recommendations

The Commission recommends that:

8. Section 24 of the Property Law Act *be amended:*

(a) In the opening of subsection (1), the words "a registered owner of a mortgage" be deleted and replaced by "an owner of a registered mortgage ;

(b)To clarify that, except as specifically provided in section 24 [with respect to mortgages, judgments and builder∗s liens] a mortgagee has priority, according to the tenor of his mortgage, as against any subsequent encumbrancerfor any advance made under the mortgage, irrespective of when the advance was made.

(c)In subsection (J)(b) by clarifying that notice may be provided by an agent of the subsequent encumbrancer.

A. Summary

We have concluded that several aspects of the law relating to the priority of further advances should be modified. In particular, mortgages given to secure a running account and con-

struction mortgages raise special concerns. In both cases we believe that an enhanced priority position for the mortgage lender is called for and recommendations are made which embody that view. A number of minor recommendations are also made.

B. List of Recommendations

We have made the following recommendations in this Report:

1. Section 24 of the Property Law Act *be amended to provide that, notwithstanding subsection (1), where a mortgage is expressed to be made to secure a current or running account, the mortgagee shall, for all further advances made under the mortgage up to a maximum amount stated in the mortgage, have priority over any subsequent mortgagee.* (Page 21)

2. Section 24 of the Property Law Act *be amended so as to provide definitions similar to the following:*

(a) "construction mortgage" means a mortgage which is clearly expressed to be a "construction mortgage" and that secures an obligation which the mortgagor incurred for the purpose of making an improvement on the land over which the mortgage has been granted;

(b)"builder∗s lien" means a lien claim arising under the Builders Lien Act.(Page **30)**

3. Section 24 of the Property Law Act *be amended to reflect the principle that where a construction mortgage has been registered under the* Land Title Act, *the mortgagee, with respect to any advance made under the mortgage after its registration up to a maximum amount stated in the mortgage, has priority over the interest of any intervening encumbrancer, including the claimant of a builder∗s lien, ~f the advance was made* bona fide *for the purpose of enabling the completion of an improvement on the land.* (Page **30)**

4. Section 6 of the Builders Lien Act *be amended:*

(a) to provide that its operation is confined to mortgages other than construction mortgages, and

(b) to specify that the priority of a builders lien vis-a-vis *a construction mortgage shall be determined in accordance with section 24 of the* Property Law Act. (Page 30)

5. A new section be added to the Law and Equity Act *in terms similar to the following:*

36.1 *(1) Where the construction of an improvement on land has been commenced, any person having an interest in the improvement or the land, including a person having a claim under the* Builders Lien Act, *ma)∗ apply to the court for the appointment of a trustee and the court may appoint a trustee upon such terms as the court considers appropriate.*

(2) Subject to the supervision and direction of the court a trustee appointed under subsection (1) may,

(a) act as a receiver and manager and, subject to the approval of the court, mortgage, sell or lease the land or the improvement or any part thereof;

(b) complete or partially complete the improvement;

(c) take appropriate steps for the preservation of the land or the improvement; and

(d) take such other steps as are appropriate in the circumstances.

(3) Any interest in the land or the improvement that is to be sold may be offered for sale subject to any mortgage, charge, interest or other encumbrance that the court directs.

(4) The court may make all orders necessary for the completion of any transaction by a trustee under this section.

(5) Notwithstanding any other Act, where one or more advances are made to a trustee appointed under this section as the result of the exercise of any powers conferred on him, a mortgage taken by the person making the advances has priority, to the extent of the advances,

over every mortgage, judgment, lien or other encumbrance existing at the time of registration of the mortgage.

(6) A mortgage taken to secure funds advanced to a trustee for the purposes described in clauses (b) and (c) of subsection (2) is deemed to be a construction mortgage and [the provisions which implement recommendations 2 to 4] apply. (Page 38)

6. Section 24 of the Property Law Act *be amended to provide that a mortgagee has priority over any subsequent encumbrance for advances made or expenses incurred for the purpose of protecting or preserving the mortgagee∗s interest or the property, where the mortgage provides that such advances may be made or expenses incurred.* (Page **41)**

7. Legislation implementing the previous proposal should set out examples of advances or expenses contemplated by it including:

(a) payment of local rates and taxes;

(b) hazard insurance premiums;

(c) charges, assessments and penalties levied by a strata corporation in accordance with the Condominium Act;

(d) payments to keep prior encumbrances in good standing;

(e) charges arising from the observance of a covenant running with the land; and

(f) necessary repairs.

but the legislation should specify that use of examples does not limit the generality of the principal provision. (Page **41)**

8.Section 24 of the Property Law Act *be amended:*

(a) In the opening of subsection (1), the words "a registered owner of a mortgage" be deleted and replaced by "an owner of a registered mortgage";

(b) To clarify that, except as specifically provided in section 24 [with respect to mortgages, judgments and builder∗s liens] a mortgagee has priority, according to the tenor of his mortgage, as against any subsequent encumbrancer for any advance made under the mortgage, irrespective of when the advance was made.

(c) In subsection (J)(b) by clarifying that notice may be provided by an agent of the subsequent encumbrancer. (Page 50)

C. Conclusion

It is our view that the implementation of the recommendations set out above would do much to rationalize the operation of section 24 of the *Property*

Law Act. The particular priority which we recommend with respect to construction mortgages and mortgages to secure a running account should have the effect of stimulating business and construction financing.

We wish to express our great appreciation to all those who responded to the Working Paper which preceded this Report. The responses were most helpful and greatly assisted in sharpening our views on the relevant issues.

We would also like to acknowledge the contribution of the Honourable Mr. Justice Ronald I. Cheffins, the former Vice-Chairman of the Commission. He participated in the development of the Working Paper and in the deliberations on our final recommendations. He was appointed as a Justice of the British Columbia Court of Appeal only shortly before the contents of this Report were settled. Lyman R. Robinson, Q.C., who replaced Mr. Justice Cheffins on the Commission, only participated in the discussions of the Commission which led to the adoption of the final Report and he endorsed the adoption of the Report by the Commission.

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January 23, 1986

APPENDICES

APPENDIX A
Property Law Act
R.S.B.C. 1979, c. 340

Further advances by mortgagee

24. (l) Notwithstanding the *Land Title Act,* after October 30, 1979, further advances made by a registered owner of a mortgage contemplated by and in accordance with the mortgage rank in priority to mortgages and judgments registered after his mortgage was registered where

(a) the subsequent registered mortgagees or judgment holders agree in writing to the priority of the further advances;

(b) at the time the further advance is made he has received no notice in writing of the registration of the subsequent mortgage or judgment, from its owner or holder;

(c) at the time the further advance is made the subsequent mortgage orjudgment has not been registered; or

(d) the mortgage requires him to make the further advances.

(2) Where a mortgage is expressed to be made to secure a current or running account, it shall not be deemed to have been redeemed by reason only that

(a) advances made under it are repaid; or

(b) the account of the mortgagor with the mortgagee ceases to be in debit,

and the mortgage remains effective as security for further advances and retains the priority given by this section until the mortgagee has delivered a registrable discharge of the mortgage to the mortgagor; but, if the mortgagor is not indebted or in default under the mortgage, the mortgagee shall, on the mortgagor∗s request and at the mortgagor∗s expense, execute and deliver to the mortgagor a registrable discharge of the mortgage.

(3) Except as provided in this section, a right to tack in respect of mortgages of land is abolished; but priority acquired before the coming into force of this section for further advances under a mortgage is not affected~

(4) This section applies to mortgages of land made after October 30, 1979.

(5) In this section "further advance" includes a first advance.