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Backgrounder

LRC 85—Report on Mortgages of Land: The Priority of Further Advances

Date: January 1986

Creditors often seek to protect their interest in receiving repayment of their loans by taking security in the assets of debtors. 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 reimbursement out of these assets if the debtor fails to repay the loan. Although a debt may be secured in a number of different ways, large debts are frequently secured by taking some kind of security interest in the land. The most popular form of security interest in the land is the mortgage.

This report examines issues that arise with some frequency for commercial mortgages. Most people are familiar with mortgages granted to financial institutions to secure the purchase price of residential property. Less familiar to the general public are the various types of fixed charges on land created under corporate security instruments. The borrower need not look to a single lender to meet the 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 taken out by a commercial borrower 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 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. If a borrower is in default, then the holder of the mortgage that was registered first is entitled to have its debt fully satisfied out of the land before the second mortgage lender can assert rights against the property and so on. So, 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. But, in the business context, there are situations in which a prior mortgage lender is prepared to lend further money to the borrower. This sets up a conflict. The prior lender will wish to maintain priority for the 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 that the later advance was made. The holders of those intervening interest will not want this to occur.

This conflict is resolved by reference to a rather obscure body of equitable principles known as "tacking." There was a longstanding common law rule that held that a prior mortgagee could, with respect to future advances, enjoy priority over an intervening interest, if the advances were made without notice of that intervening interest. But in 1978, British Columbia enacted section 24 [now section 28] of the *Property Law Act*, which abolished the common law rules governing tacking and replaced them with a set of statutory rules. Section 24 was not intended as a radical break with the past; rather, its intention appeared to be to restate the common law position in a way that harmonizes with British Columbia's land title system. Briefly stated, the effect of abolishing the common law rules concerning tacking means that a mortgagee can claim priority for further advances only in the circumstances described in section 24 (1).

This report considers section 24, discussing a number of questions. Is the range of interests against which the priority can be asserted satisfactory? Does section 24 prevent a mortgage holder from asserting priority for further advances in circumstances where, as a matter of policy, the mortgage holder 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?

After a brief introductory chapter and a chapter discussing the history and general approach of the law to further advances, the report analyzes these questions in relation to three specific situations.

First, the report considers mortgages that secure a running account. These are arrangements (such as a line of credit) that contemplate a continuing flow of dealings between a debtor and a credit grantor, which may extend over a lengthy period of time. The report analyzes a number of practical and accounting issues that are not fully addressed by section 24 and concludes that the section should be amended to provide that, if a mortgage is expressed to be made to secure a current or running account, the mortgagee must, for all further advances made under the mortgage up to a maximum amount stated in the mortgage, have priority over any subsequent mortgagee.

Second, the report discusses construction mortgages. In most cases, the money secured by a construction mortgage is disbursed in a number of advances that are timed to coincide with various stages of completion of the building. The chapter discusses the relation of section 24 to the *Builders Lien Act* and makes recommendations aimed at clarifying the position of construction mortgages.

Finally, the report analyzes borrowings by a receiver. This chapter looks at another aspect of construction financing—the status of advances by a construction lender as characterized in the 1984 Court of Appeal decision in *Yorkshire Trust Co. v. Canusa Construction Ltd.* The decision was a controversial one and the report proposes legislative amendments to blunt its impact.

Further Developments

The report's recommendations have not been implemented by legislation.