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Get Your Priorities Straight: The Extent of Lienholders' Priority Over Mortgagees

In *KingSett Mortgage Corporation v Mapleview Developments Ltd*, the Court of Appeal for Ontario delivered a significant ruling regarding the priority of lien claimants and building mortgagees under the *Construction Act*. The decision provides clarity on how to calculate the quantum of a lien claimant's holdback where a priority dispute (a disagreement over who gets paid first from the property) arises with a mortgagee.

Balancing the Rights of Mortgagees & Lien Claimants

One of the key purposes of the *Construction Act* is to protect the rights of contractors, subcontractors, and suppliers who provide services or materials to improve properties in Ontario.

When these parties go unpaid, the Act allows them to commence a construction lien action. The lien is registered against the title of the property and serves as a "public notice to all" that there is an outstanding claim relating to the improvements to the property.

At the same time, the Act protects building mortgagees (lenders who provide capital to fund the building and improvements to the property). In this way, the Act balances two important commercial interests: protecting those who supply work and materials and protecting lenders who finance construction projects.

How to Calculate a Lien Claimant's Holdback in a Priority Dispute With a Mortgagee

The issue in *KingSett* centered on section 78(2) of the *Construction Act*, which states that where a mortgagee takes a mortgage with the intention to secure financing for an improvement to the property, any liens arising from that improvement have priority over the mortgage "to the extent of any deficiency in the holdbacks required to be retained by the owner."

Under the Act, a "holdback" is 10% of the value of the services or materials supplied by a contractor or subcontractor. The owner must retain that amount until "all liens that may be claimed against the holdback" have "expired or been satisfied"

or “discharged.”

Section 78(2) directs that, in the event of a priority dispute between a mortgagee and a lien claimant, the mortgagee will have priority in all cases, “except to the extent” of any amount of the 10% holdback required to be retained by the owner for the benefit of the contractor.

The Court had to decide how to calculate the quantum of the 10% holdback in circumstances where:

- A priority dispute arises between a mortgagee and a lien claimant.
- The lien claimant has received full payment for some, but not all, of its invoices, including the holdback amount.

On one side of the argument, the appellants argued that the 10% quantum should be calculated by taking 10% of the total contract price, regardless of how much of the holdback amount had been paid.

By contrast, the respondents took the position that the 10% quantum should be calculated using only the outstanding amounts, such that the holdback would be 10% of the outstanding amounts owed.

The Court agreed with the respondents’ position. It held that the phrase “deficiency in the required holdbacks” must be interpreted to “account for the full payments made” to the lien claimants, such that there is no “deficiency” in the holdback amounts paid in full.

Put differently, the Court held that the quantum of the 10% holdback (for which the lien claimant has priority over the mortgagee) should be calculated as 10% of the unpaid holdback amounts, not 10% of the total contract.

In simple terms, consider a contractor that issued 10 invoices of $100,000 each, for a total of $1,000,000. If the owner paid nine of those invoices in full, including the holdback amounts, and left only one $100,000 invoice unpaid, the contractor’s priority over the mortgagee would be limited to 10% of the outstanding amount ($10,000), *not* 10% of the entire contract amount ($100,000).

Key Takeaways

- **The decision reinforces balance under the *Construction Act***. The Court confirmed the *Construction Act* must be interpreted in a way that balances the rights of various parties involved in the construction process.

- **Paid holdbacks do not create further priority**. A lien claimant does not receive priority over a mortgagee for holdback amounts the owner has already paid in full.
- **The calculation focuses on unpaid amounts**. In a priority dispute with a mortgagee, the lien claimant's holdback priority is calculated as 10% of the unpaid amounts, not 10% of the total contract price.
- **The Court avoided commercial absurdity**. As part of its effort to properly balance the rights of all parties, the Court emphasized that the Act cannot be interpreted in a manner that would lead to commercial absurdity (an unfair or illogical business outcome). In this case, that meant favouring the approach of the respondents, as, under the appellants' proposed approach, contractors "would effectively be paid the same holdback amount twice": once through full payment of their invoices, and again through priority over the mortgagee for the already-paid amounts.