CONSTRUCTION LAW LETTER

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GUEST ARTICLE

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Given the "sacrosanct" findings of the trial judge regarding Celestine as "owner", the Divisional Court's otherwise legitimate concerns about the applicability of the definition of "owner" under the CLA to Celestine were considered irrelevant.

LIENHOLDERS DEFEAT OWNER'S COMPLEX ATTEMPT TO PRESERVE PRIORITY

Neither a borrower nor a lender be ...

How do these famous words of advice from Shakespeare's *Hamlet* apply where the borrower *is* the lender?

Ontario's Court of Appeal recently had the chance to consider that question in a construction lien case — *Parkland Plumbing v. Minaki Lodge Resort 2002 Inc. et al.* — and decided that it spelled trouble for "borrower/lender". Not only does the court's decision highlight the potential risk of structuring an arrangement where this relationship exists on a construction project, but it also underscores the high degree of deference the Court of Appeal will give to the original decision of the trial judge, which is the subject of the appeal.

The Background

Among the risks faced by a developer in the role of owner of a new project is the potential loss of the investment to other creditors if the project fails. Monies advanced to the project by the developer are therefore often secured by means of a mortgage registered against the property in the hope that, if things should go badly and creditors such as construction lien claimants try to sell the property, the developer's own investment will be protected and stand ahead of the claims of those other creditors.

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In other words, it is not at all unusual that you'll find a developer loaning money under the security of a mortgage through one company to a project owned by a related company. Does this scheme actually work?

In 2002, one such developer named Philip Archer set out to redevelop a resort property named Minaki Lodge in Northern Ontario. He bought the property through a newly incorporated company called Minaki Inc. for about $2 million. On closing, he registered a first mortgage against the property for $1 million in favour of Celestine Mortgage Corporation. Archer was the president and sole shareholder and director of Celestine.

Shortly after closing, other adjacent lands were purchased and added to the development. The funds for these acquisitions came from a company called Land Development Corporation, which Archer also owned. The LDC monies flowed through Celestine in exchange for LDC getting a syndicated interest in the mortgage.

As the project proceeded, other funds were advanced by LDC, the Archer Group of Companies (another corporate vehicle of Archer) and others. LDC advanced the lion's share of the $3.3M cost of the project. During the project, it appears that these funds were paid directly to third parties on behalf of Minaki (and treated as increasing the payor's interests under the syndicated security) instead of the funds first being provided to Minaki and then Minaki using them to make payments.

Part way through the project, the first Celestine mortgage was refinanced and replaced by a new $5M mortgage in Celestine's favour. To further secure the monies invested in the project, Archer also caused Minaki to issue promissory notes to Celestine, LDC, the Archer Group and Archer himself.

By the spring of 2003, the project was in financial trouble, and 14 construction liens were registered against the property, claiming a total amount owing of $875,000. Parkland Plumbing & Heating Ltd., the lead claimant, claimed to be owed over $176,000. In due course construction lien actions were commenced against Minaki, Celestine, Archer and other related companies.

Minaki had been required, under the terms of the Celestine mortgages, to place fire insurance for the Minaki Lodge property, and if Minaki didn't do so, Celestine could place the insurance at Minaki's expense. Presumably to save costs, Archer never obtained the insurance. For reasons that are unclear (but perhaps not entirely surprising), about five weeks after Minaki Lodge was closed on Labour Day weekend of 2003, the main building was destroyed by fire.

Following the fire, and in the face of the construction lien claims, Celestine commenced power of sale proceedings under the mortgage while even more funds were advanced to the project through Archer's related companies.

The Trial

The Parkland construction lien trial came before Mr. Justice Jarvis in August of 2005. The parties agreed that the preliminary questions to be determined were (a) whether the lien claimants had priority over Celestine mortgage on the basis that Celestine was in fact an "owner" within the meaning of the *Construction Lien Act* of Ontario, and (b) how the mortgagee's priorities under s. 78 applied to the circumstances.

The trial judge concluded that all of the various companies involved in the project were under the directing mind of Archer and within his complete control. Of critical importance was the finding that Celestine and Minaki were "indistinguishable", based on a host of facts which reflected a relationship structured for show rather than commercial reality. As a result, Jarvis J. held that Celestine was, like Minaki, an "owner" of the project rather than an arm's-length mortgagee. As such, Celestine's interest was therefore subject to the full amount claimed by the lien claimants.

Following the trial, the property was apparently sold by a court-appointed receiver for net proceeds of about $1.9 million.

Divisional Court Decision

Archer appealed the trial judgment to the Divisional Court.

Justices Greer and Jennings disagreed with the decision of the trial judge. They concluded that while Celestine clearly had an "interest in the premises" as mortgagee, Celestine did not meet the statutory requirements of "owner" under the *CLA*. That definition includes a requirement for the work to have been requested by the "owner", and Celestine had not requested the project to be undertaken. The two corporations were separate entities: Minaki was the "owner" and Celestine was the mortgagee.

As a result, the priority rules under s. 78 of the *CLA* governing mortgages meant that the Celestine advances of about $2.2M had priority over the liens of lien claimants except for any deficiency in the holdbacks required to be maintained.

Justice Cusinato dissented, agreeing with the trial judge that Celestine should be treated as an owner in these circumstances.

Court of Appeal Decision

On appeal to the Court of Appeal, the court reversed the Divisional Court and restored the original trial decision.

In the Court of Appeal decision, Justice Cronk, writing for the court, was critical of the failure of the majority of the Divisional Court to give sufficient deference to the trial judge's findings of fact regarding Archer and his relationship to his various companies. "Found facts" such as Archer's disregard for the interests of the lienholders and his failure to act in a commercially reasonable manner (as demonstrated by the failure to place fire insurance) — leading Jarvis J. to "pierce the corporate veil" and treat Minaki and Celestine as interchangeable — were not to be freely substituted by an appellate court's differing view of the evidence.

This point is worth underscoring. Although the Divisional Court determined that Minaki and Celestine enjoyed separate legal existences, the trial judge had found otherwise. As in the recent *Kennedy Electric v. Dana Canada* case, the Court of Appeal again chastised the Divisional Court for taking a view of the facts which differed from the trial judge's own findings.

The court reviewed the test for when the ability to pierce the corporate veil is available, and held that, in circumstances where a corporate entity is completely dominated and controlled and being used as a shield for fraudulent or improper conduct, piercing is appropriate. The latter part of the test considers whether the conduct in question is "akin to fraud that would otherwise unjustly deprive claimants of their rights". This was such a case.

Once the Court of Appeal had concluded that a sufficient basis existed for the trial judge to have found the facts as he had — treating Celestine and the "real" owner Minaki effectively as one corporate entity — Archer's remaining arguments were easily disposed of.

Given the "sacrosanct" findings of the trial judge regarding Celestine as "owner", the Divisional Court's otherwise legitimate concerns about the applicability of the definition of "owner" under the *CLA* to Celestine were considered irrelevant. Since Minaki had asked for work to be done, that fact was sufficient to stand as a request by Celestine, for purposes of satisfying the definition.

Under s. 78(1) the interest of an owner is subject to the liens in full, and since Celestine had been held to be an "owner", the lien claimants had priority over all amounts advanced by Celestine, even though Celestine held a mortgage. Other subsections, such as s. 78(3) (governing purchase-money priority for certain mortgagees) did not save Celestine's position of subordination to the lien claimants.

What can be taken from this decision?

Two lessons come to mind: First, an owner must be very careful about how funds are advanced to a project in these kinds of circumstances. Treating related companies casually, rather than distinct and separate and in a commercially reasonable way, will likely lead the court to do the same.

Second, the time to get the court decision right is clearly the first time; the appeal court may be of little help to a losing party once the findings of the lower court decision go badly. You're pretty well stuck.