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Use of Receiver Disentitles Lender to 3 Months Interest Penalty

In a recent Ontario case, the legal question was whether a lender/mortgagee was still entitled to charge for three months' interest, amounting to over $350,000, even though it used a privately-appointed receiver to realize on the secured property.

The borrower owned a Waterloo-area student residence property still under construction, for which the lender had advanced $11.7 million in financing. When the borrower defaulted, the lender appointed a private receiver-manager, as it was entitled to do under the mortgage terms. The receiver was later able to sell the property for $14.4 million.

In its accounting of the proceeds, the lender withheld three months' interest, totaling over $350,000, which was in addition to the mortgage interest calculated at closing. The lender relied on a clause in the mortgage stating that, upon default, the borrower "shall not require the Chargee [*i.e.* lender/mortgagee] to accept payment of the said principal amount without first giving three months' previous notice in writing." In the lender's view, this phrasing allowed it to keep the three months' interest charge upon default.

The borrower disagreed, claiming that this right did not apply to a forced sale of a property by a privately-appointed receiver, as was the case here. Nor was such a three-month interest charge allowed by legislation. The matter ended up in court for resolution.

The court looked at two possible bases for the lender's claim to retain the disputed funds: 1) section 17 of the *Mortgages Act*; and 2) the terms of the mortgage itself.

First, while section 17 of the *Mortgages Act* did allow for the payment of three months' interest after the borrower's default or mortgage repayment, it was a "shield" behind which the borrower could take steps to give notice of an intent to pay arrears, and thus "buy some time" equivalent to three months. Importantly, it was an option given to the *borrower* – not the lender – upon default.

Also, prior courts have established that section 17 does not apply to situations involving a receivership and forced sale, or in cases where the lender has already taken other steps to realize on its security. Because a private receiver is generally considered to be an agent of the lender (rather than the borrower), the section is simply not "activated" in these scenarios.

Next, the court examined the wording of the mortgage itself. Like section 17 of the Act, the provision stating that the borrower "shall not require" the lender to accept payment of the principal without giving either three months' notice or an equivalent interest bonus was also "borrower-centric." It granted a right and option to the *borrower*; it was not set up as a right belonging to a lender intending to realize on the security.

The court concluded that in this situation where the lender had sold the property using a privately-appointed receiver, neither the mortgage provisions nor the legislation justified the lender's attempt to impose a three-month interest penalty as part of its mortgage realization proceeding. If the lender wanted to impose such a charge as part of enforcement proceedings using a receiver, the proper approach was to draft the mortgage terms accordingly. See: *58 Cardill Inc. v. Rathcliffe Holdings Limited*, 2017 ONSC 6828.

Was Ambiguous "Right of First Refusal to Purchase" Valid?

In a recent land deal case, the court untangled the narrow distinction between a "right of first refusal" and a "right to purchase," and considered whether such rights granted as part of a redevelopment project had been affected after a drastic change to the project's scope.

As part of a plan to assemble several mid-town Toronto properties that were ripe for redevelopment, the buyer purchased a two-story building from the seller, Shunock. The property, which Shunock used as both a residence and office for his orthodontic practice, was bounded by three contiguous properties, which together would form a large swath of prime land. Negotiations were underway with those three other owners to have them partner in the project.

As part of Shunock's terms of sale, he negotiated the right to purchase up to 3,500 square feet of the main floor of the redeveloped future complex, at a set price. This was confusingly called a "right of first refusal to purchase" (the "Refusal Right") which term, the court noted, "melds, and to an extent conflates, a 'right of first refusal' with a 'right to purchase'."

The proper interpretation of Shunock's Refusal Right became the focus of a post-closing dispute between him and the buyer/new owner. The unforeseen wrinkle was that negotiations had fallen through with the owner of the largest and most desirable of the four targeted properties. This meant that only a much smaller project was now possible.

The buyer of Shunock's property claimed that the Refusal Right applied only to the envisioned project involving all four pieces of land; to allow Shunock to take as much as 3,500 square feet in a much smaller complex would change the essential character of the redevelopment. Relying on the non-cooperation by the fourth landowner as an unforeseen change, the buyer claimed that Shunock's Refusal Right had been legally frustrated, and no longer needed to be accommodated.

Shunock countered by saying that the Refusal Right was not contingent on the fourth owner's participation, and there were no conditions as to the size of the land assembly. He felt that even with the reduced scale, it was not impossible for suitable space to be allocated to him.

The court reviewed the facts. When the buyer struck a deal with Shunock, it had already reached agreements with two of the other adjacent owners, but the third one was never even discussed. Strictly speaking, the deal with Shunock was not conditional on all four properties being included. The court noted that Shunock was initially unwilling to sell, since the existing property served him well, but when he finally agreed, it was important to him that the Refusal Right was part of the agreement.

Unfortunately the Refusal Right, as drafted, actually merged two terms having different legal meanings. A right to purchase would give Shunock the ability to compel conveyance of the property to him, once certain events fully within his control had occurred. He would have full control over the decision to convey, as well as an immediate interest in land. In contrast, a right of first refusal would give Shunock the right to have the first opportunity to acquire the land, but only if the owner decided to sell. No interest in land was created.

Shunock's apparent rights did not fit neatly into either definition. The court was left to examine who was in control of the triggering event, and to take a common-sense look at what the parties must have intended.

Here, Shunock had been approached to sell his property for only one purpose: to form part of a four-property land-assembly initiative in furtherance of the larger-scale redevelopment project. Although the agreement Shunock signed did not specify the number of properties, some of its terms clearly inferred there would be four. Had the buyer wanted to restrict its obligation to Shunock, it could have added specified contingencies to the agreement.

Next, any doubts as to the parties' intentions were clarified by how they acted after the contract was signed. A later agreement executed a full five years after Shunock's deal acknowledged his Refusal Right even if the fourth piece of land was not included. This also supported the conclusion that he had a legal interest in the property, and a right to purchase, regardless of the project's actual size.

The buyer also fell short of establishing that the contract with Shunock had been legally frustrated, since it could not show that it was impossible to allocate 3,500 square feet of main floor space in the smaller plan. Frustration required an unforeseen, non-culpable supervening event that "radically changed" the contract between the parties, rendering its performance impossible. Mere inconvenience was not enough.

The court declared that Shunock's Refusal Right was a valid right to purchase, forming a contingent interest in land that applied even to the smaller-scale project. See: *2284064 Ontario Inc. v. Shunock*, 2017 ONSC 7146.

Bad Faith Precludes Party From Relying On Non-Compliance with Option Agreement

A family Estate owned a 25-acre property conceptually split into two parts: a main residential portion with four acres, and the remaining 21 acres of farmland. The property was subject to an Option Agreement, giving the option holder the right to buy parts of the 21-acre farmland on request, and obliging the option holder to pay a proportionate share of the overall property taxes, under what was called the "Realty Tax Sharing Provision" (the "Tax Clause"). Any default in paying the tax for a period of two full years or more would void the Option Agreement, and with it the right to purchase farmland.

By 2002, purchases by the existing option holder had left the Estate with about 12 acres anchored by the main residential portion. That same year the Estate bought out the option holder's rights, thus becoming: 1) the owner of the main property; 2) the new option holder; and 3) one of the parties responsible for paying a share of the property taxes. A family member named Fraser took care of paying the property taxes on the Estate's behalf.

In 2003 a couple named LaPolla bought the 12 acres of farmland that was subject to the option now in the hands of the Estate. When the Estate moved to buy back some land from them, the LaPollas resisted, claiming that the Tax Clause had been breached for failure to pay the Estate's share of taxes two years in a row.

The court rejected this argument. It heard evidence that Fraser had repeatedly tried to obtain accurate tax information from the LaPollas, but they were uncooperative. With no other choice, and mindful of the obligations under the Tax Clause and the Option Agreement, Fraser had simply estimated the Estate's share of the taxes, and had made annual lump-sum tax payments accordingly.

The court noted that any shortfalls in Fraser's tax payments over the years never triggered a breach of the Option Agreement, since they never spanned more than the requisite two years' duration. From 2004 to 2006, for example, Fraser did not actually make any tax payments, but due to his guesswork he had *overpaid* in the earlier period, so there was a credit balance on file. After 2006 he maintained a credit balance every year, so the account was technically never in arrears. In this scenario, it was simply not a reasonable modern-day commercial interpretation to conclude there had ever been a tax "default" triggering breach.

Moreover, any default or breach were contributed to by the LaPollas themselves, given their failure to cooperate with Fraser on the tax figures. This lack of good faith precluded them from turning to the court for a remedy. See: *Lapolla v. The Estate of John Bostock*, 2017 ONSC 7448.

The statements of law and comments contained in this Newsletter are of a general nature. Prior to applying the law or comments to any specific problem, please obtain appropriate legal advice.