SRLaw
Schneider Ruggiero LLP

Mortgage and Real Property Law Report

Vol. 22, No. 3 • August 2016

A Legal Newsletter for the Mortgage and Real Estate Industries

Under *Interest Act* Prohibition, is a Discount the Same as a Penalty?

In a case decided by the Supreme Court of Canada called *Krayzel Corp. v. Equitable Trust Co*., the issue was whether the provisions of the federal *Interest Act* were breached by a mortgage agreement that (unlike the usual scenario) did not impose a penalty in the event of a default, but rather allowed for a lower-interest discount if there was no default.

The Court's ruling turned on the interpretation of section 8 of the *Interest Act*, which prohibits a lender under a mortgage agreement from imposing a "fine, a penalty or a rate of interest" that has the effect of creating a higher charge on arrears than what has been imposed on principal money not in arrears.

In this case, depending on whether the mortgage was in good standing or not, it was subject to two different rates of interest, which were known as the "**interest rate**" and the "**pay rate**". The higher "interest rate" took effect only if the mortgagor defaulted, either by failing to pay out the loan upon maturity, or else by failing to make the regular set payments, which were calculated at the lower rate of interest, called the "pay rate". Essentially, the option to pay the lower "pay rate" was a discount available to the borrower only so long as it was not in default, and served as an incentive for punctual payment.

With that conceptual dichotomy in mind, the Court considered the details of the particular transaction in issue. It involved the lender taking a mortgage against the borrower's office building in exchange for a $27 million loan. The interest rate was agreed to be prime plus 2.875 percent per annum. When the borrower defaulted by failing to pay out the mortgage on maturity, the lender agreed to extend for seven months, but the amending/renewal agreement carried a higher rate of interest, namely prime plus 3.125 percent for the first six months, and 25 percent during the seventh month. Once again, on maturity the borrower went into default by failing to pay out.

The parties then entered into a second renewal/amending agreement. The second amending agreement bumped the interest rate even higher: it provided a per annum "interest rate" on the entire loan of 25 percent, and made that higher rate retroactive to a month before the first renewal agreement expired. Monthly payments were set at the "pay rate" of either 7.5 percent, or else prime plus 5.25 percent, whichever was greater. So the mortgage renewal agreement expressly provided for these two different rates, one being the much higher "interest rate", and the other being the lower "pay rate" which was in force only if there was no default.

When the borrower defaulted a final time, the lender demanded repayment of the loan balance at the 25 percent "interest rate". Naturally this prompted a dispute between the parties; after various rulings in the lower courts as to the validity of the renewal agreements in light of section 8 of the *Interest Act*, the matter came before the Supreme Court of Canada.

Against this background the Supreme Court of Canada therefore had to consider whether, for the specific purposes of interpreting section 8 of the Act, there was a difference between: (1) terms that impose a higher rate of interest after default as a penalty and (2) terms that reserve, by way of discount, a lower rate of interest if there is no default.

The Court concluded that there was no distinction; the interest rates established by the mortgage agreements' discount provisions offended section 8 and could not be insisted upon by the lender.

It was true that the express wording of the *Interest Act* set out only three different categories of charges: a "fine", a "penalty", and a "rate of interest". Also – and aside from the blanket prohibition in section 8 – the Act's other provisions allowed the parties a general right of freedom to contract for any rate of interest or discount they wished.

However, when looking at the overall goal of the Act, it was clear that section 8 must reasonably be considered to apply not only to penalties for non-performance, but also to incentives for performance in the form of "discounts."

Historically, the legislative purpose behind section 8 was to protect landowners from charges that would make it impossible for them to redeem, or to protect their equity. That overarching purpose would not justify creating a distinction between a higher interest rate being imposed as a penalty for default, and a discounted interest rate for punctual payment. Under either scenario the net result would be to make it more difficult for borrowers already in default.

The Court observed that the key to understanding and applying section 8 was to look at the effect of the contentious terminology in any mortgage agreement. Regardless of whether the parties use misleading terms like "bonus", "discount" or "benefit", the validity of the provision is determined by its substance, not by its

form. What matters is how the impugned mortgage term operates and the consequences that it produces, irrespective of the label or name that is used.

Looking merely at the second renewal agreement in this case, it purported to impose a 25 percent interest rate on arrears, as compared to the 7.5 percent interest on principal money not in arrears. This result fell within the wording of the section 8 prohibition.

That 25 percent rate was therefore void; instead, the Court set the interest as either 7.5 percent, or else prime plus 5.25 percent, whichever is higher.

See *Krayzel Corp. v. Equitable Trust Co.*, 2016 (SCC).

'Sole & Absolute Discretion' Mortgage Assumption Condition Tested

As part of the agreement to purchase the seller's property for $36 million, the buyers had agreed to assume two existing mortgages. The agreement's mortgage assumption clause required them to: (1) proceed "in good faith and with due diligence" to apply to the existing mortgage lenders for their approval of the mortgage assumption; and (2) provide those lenders with any information reasonably requested by them as part of the application process. Once the buyers had done as required, they would be entitled – at their sole discretion – to decide whether the terms that the lenders offered were acceptable, and if so, to proceed to complete the purchase or not.

As it turned out, after making initial inquiries, the buyers did take exception to the onerous conditions imposed by one of the two lenders (which required, among other things, the payment of $230,000 as a "reserve" for 10 months' interest payments and $21,000 as a lender's fee). The buyers promptly decided not to proceed with the purchase; yet the seller refused to return to them the $2 million that had been put down as a deposit. The parties asked the court to settle the dispute.

The buyers conceded that although they had contacted the second lender once in order to make initial inquiries, they never made a formal mortgage assumption application to that lender, and did not provide documents as requested. Although this technically fell short of satisfying their "good faith and due diligence" obligations, the court concluded that it was not fatal: the nature of the lender's initial reply made it obvious in the circumstances that the submission of a formal application would have been an "exercise in futility", and the lender would not be accepting their request to assume the existing mortgage in any event.

The court pointed out that in interpreting a commercial contract, it must construe the agreement as a whole, in a manner that gives meaning to all the terms, yet avoids an interpretation that renders one or more of those terms ineffective. Here, the wording of the mortgage assumption condition, being "on terms and conditions satisfactory to the Buyer, in its sole and absolute discretion" would be meaningless if the Court overrode it by finding in the seller's favour. The court therefore held for the buyers, and ordered their deposit returned.

See *International Property Group Inc. v. 2262814 Ontario Ltd.*, 2016 (ONCA) affirming *International Property Group Inc. v. 2262814 Ontario Ltd.*, 2015 (ONSC).

Can a Judge Relocate a Right-of-Way in the Interests of Justice?

In a recent Nova Scotia Court of Appeal decision, the court confirmed that a legal right-of-way cannot simply be re-located by a court, even if it appeared that it would benefit the interests of justice to do so.

The case involved two neighbouring landowners: the Sheas on one side, and the Bowsers on the other. Pursuant to a deed that had been registered years earlier, the Sheas enjoyed a right-of-way over the Bowsers' property, pursuant to an express grant.

When a dispute arose as to the precise location of that right-of-way, the parties agreed to go to court to have it settled and to have a declaration made accordingly. But, after using expert survey evidence to make a finding of fact on that narrow point, the judge took the liberty of going one step further: he declared the right-of-way to be relocated to a different spot on the Bowser property, based on his assessment of the "interests of justice". These included the fact that the deeded right-of-way was not being maintained, had become overgrown in areas, and was no longer passable by cars. Plus, a new road had been established over the Bowser property in a different location, which the judge felt the Sheas could use instead. With all of that in mind, he declared it to be of "questionable benefit" to re-establish the right-of-way in the original spot.

The Sheas appealed this decision on the basis that the judge had no legal or statutory authority to relocate the right-of-way and that his attempt to do so was a reversible error.

The Appeal Court agreed. It began by observing that in making the purported ruling, the judge failed to identify any legal principles to support a judicial authority to relocate a right-of-way; his attempt to do so flew in the face of established legal principles. For example, even if the right-of-way was found to be impassable, in law, the Sheas only unilateral recourse would be to assert their rights to have it re-opened through repair or reconstruction; they would not have the right to use other areas of the Bowsers' land instead.

Here, it was true that the existing location of the right-of-way was more invasive to the Bowsers and that there might be practical reasons to want to relocate it elsewhere, but to actually do so was beyond the judge's authority. Unless there was a mutual agreement to relocate, abandon, or extinguish the right-of-way (none of which were at play here), the Sheas had a legal right to have and enjoy the right-of-way in its original location on the Bowsers' land.

See *Shea v. Bowser Estate*, 2016 (NSCA).

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.