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Future Interest on Closed Mortgage Not a "Penalty"

In a recent ruling, the Ontario courts held that the future interest due on a closed mortgage is not considered a "penalty" for the purposes of s. 8 of the *Interest Act*.

The lender had first mortgages on two properties to secure loans of about $10.5 million. The mortgages were granted in 2007 and 2009, each with a term of 20 years. Importantly, they were closed mortgages offering no right of prepayment unless: (1) the mortgagor was not in default; and (2) there was a *bona fide* arm's-length sale of the property.

The mortgages went into default in 2017, when there was about 8 years left on their terms. In 2019 the properties were ordered sold by a court-appointed receiver. In light of that sale, the lender asked the court to declare it was entitled to be paid $1.5 million from the sale proceeds, as a pre-payment of future interest. The lender argued it was entitled to this amount – over and above the principal owing under the mortgage, plus arrears of interest – for the portion of future interest payments that would have been earned over the remaining 8 years on the charges, had they not been prematurely vested off title in the receiver's sale. The lender founded its claims on: (1) the terms of the mortgage itself; (2) the relevant commitment letters (incorporated by reference); and (3) the common law applicable to closed commercial mortgages discharged prior to their full term.

The court granted the lender's request. In light of the buyers' default, these closed commercial mortgages allowed for no prepayment privileges. They had been terminated prematurely and vested off title on the closing of the sale by the court-appointed receiver. The court found the lender's entitlement to future interest was indeed found in the mortgage documents, which called for interest to be paid over the mortgages' terms.

There were common law principles to support the lender's interest entitlement. First, the law is well-settled that a borrower cannot "open up" a closed mortgage by his or her own default, and no equity of redemption is afforded to a borrower in such circumstances. Nor were the mortgages opened up by the lender when it took steps to realize on its security.

Next, when a closed mortgage is redeemed prior to the end of its term, the borrower must pay not only the outstanding principal and accrued interest, but also the future interest to the end of the term. Such interest is payable even on a mortgage with no right of prepayment, if the lender has not resorted to enforcement of its security and has not triggered the borrower's right to redeem.

Finally, when a mortgage is vested off title, the lender will be entitled to amounts due under the mortgage – and in the case of a closed mortgage this will include future interest accrued to the end of the term. This arises from an implied contractual term, and need not be expressly set out in the mortgage terms.

In this scenario, the court concluded the future interest had not been forfeited; to the contrary, it became due. This was not a violation of public policy and it did not create an unfair preference in the lender's favour over the other creditors of the now-insolvent borrowers.

The court also rejected the argument that the payment of the future interest to the lender would offend s. 8 of the federal *Interest Act*, R.S.C. 1985, c. I-15. The lender was not seeking to add a penalty to the arrears of interest. Rather, it was seeking payment of capitalized future interest, calculated at the same rate that had been provided for in the mortgage, for the amounts not in arrears. There was no tenable general proposition that any future interest entitlement, the quantum of which exceeds arrears of interest, contravenes s. 8(1) of the *Interest Act*.

In the end, the court ordered that since the lender's mortgages were fully closed on the receivership sale date, the lender was entitled to nearly $1.5 million as a prepayment of future interest under them. The funds were paid out from those held in trust after the sale. See: *First National Financial GP Corp. v. Golden Dragon HO 10 Inc.*, 2020 ONSC 6994.

Municipality Liable for Faulty Building Inspection

In 1999, a couple purchased a 6-bedroom cottage in the Township of Bays. It had been built by the prior owner in 1991 in accordance with an issued building permit, and was duly inspected by the Township at that time.

When the couple started renovations on the cottage in 2012, they discovered it had several structural issues and defects, which rendered it unsafe and in violation of *Building Code* requirements.

The couple sued the Township for about $580,000 in damages, alleging it had fallen short of its duty of care. Specifically, they claimed the Township had been negligent during the 1991 inspection and had breached its legal duty to enforce the provisions of the then-prevailing *Building Code* and regulations.

The couple succeeded in establishing the

Township's liability. The court noted that the purpose of the building inspection scheme was to protect public health and safety by enforcing safety standards for all construction projects. That regime also afforded the Township the power to grant or reject a building permit application where it saw fit. This left the Township with a duty of care towards those who, on a reasonable conclusion, might be injured by the negligent exercise of its inspection powers. Nothing in the legislation expressly limited the scope of that duty. The applicable standard was measured by what would be expected of an ordinary, reasonable and prudent municipal inspector in the same circumstances.

Here, the Township conceded that it owed a duty of care to the prior owners at the time of the 1991 inspection. There was no public policy reason not to extend that duty to subsequent owners – including the couple. This was reasonable, since they might be injured today by the Township's negligent exercise of its authority three decades earlier, respecting the building permit and construction.

The Township clearly breached its duty to them, and was responsible in damages for failing to meet the standard of care around identifying and having *Code* violations rectified. As for the amount: the court granted the couple the costs needed to remedy structural *Code* violations the Township overlooked, but declined to award them amounts for longer-term water penetration damage purportedly flowing from the prior owner's poor construction.

In the end, the court awarded the couple damages of $360,000, together with related costs and expert opinion fees. See *Breen v. The Corporation of the Township of Lake of Bays*, 2021 ONSC 533.

Sale of Merged Lands Complied with *Planning Act*

Under separate agreements of purchase and sale, the buyers agreed in 2016 to purchase two abutting residential properties, both owned by the seller. The seller had acquired them both in 2013, also under separate agreements that culminated with a single transfer instrument. This was the same method that had been used since 1983 to convey both properties to a succession of owners, the most recent being the seller.

The seller's MLS listing for the properties indicated the properties "Merged Together. Vendor Wants Both Lots to Be Sold Together. The City Has Consent For Subdivision". The standard form agreement contained the customary clause requiring the seller to comply with the subdivision controls of the *Planning Act*, and to obtain the necessary consents respecting severance. To this end, the buyers' lawyer requisitioned satisfactory evidence of *Planning Act* compliance, together with a statutory declaration stating that the seller did *not* retain the fee or equity of redemption in any of the abutting lands. The seller's lawyer declined to provide it, noting the seller owned both properties. However the seller did provide amended statutory declarations for each property, in which she simply blacked out the word "not" to indicate and confirm that, as the seller, she did indeed retain the fee or equity of redemption in the abutting land.

The deal did not close in late 2016 as scheduled, since the buyers did not have the needed funds. After continued negotiation efforts failed, the seller sued the buyers for breach of contract. She asked the court to award her damages, and to declare that the buyers' $100,000 deposit was forfeited.

The seller succeeded in getting partial summary judgment, with damages to be assessed at trial. The buyers' appeal of the summary judgment was unsuccessful.

The Appeal Court found the motion judge was correct to find that the agreements were not rendered void merely because the seller-provided statutory declarations had been amended to confirm the seller's legal interest in the abutting parcel, notwithstanding the subdivision control provisions of the *Planning Act*.

First, the court examined the context of these transactions. The buyers clearly breached the agreement since they lacked the necessary funds to close. In contrast, the seller expressed that she was ready, willing and able to convey marketable title to the properties in compliance with the Act, in fulfilment of her obligation under both agreements. She did not breach or void the agreements by presenting the buyers with the amended statutory declarations; the changes had been made in the context of the seller's communicated intent to: (1) culminate two agreements with a simultaneous conveyance of the properties; and (2) close the transactions in compliance with the *Planning Act*.

Furthermore, the evidence showed that both parties considered the deal to be a single transaction that did not sever the lands, even though it involved two properties. This was borne out by the MLS listing; it was also evidenced by the identical execution dates, closing dates and parties on both deals. It was also supported by the buyers' offer, which reflected the intent to buy the properties together in one transaction, and to treat them as merged – as they had been since 1983. This was also in accord with s. 50(15) of the *Planning Act*, which expressly states that simultaneous conveyances of abutting properties involving the same parties merge those properties for the purposes of the Act.

Finally, the seller blacking out the word "not" on the statutory declaration, effectively acknowledging her retention of the fee or equity of redemption in the abutting land, was not an attempt to close the transactions in violation of the *Planning Act.* This was again done in the context of her communicated attempt to convey both properties simultaneously. Viewed this way, it could not be characterized as a defect in the tendered documents, or a failure to effectively answer the buyers' requisition. On the contrary, the seller at all times made it clear she was ready and able to convey marketable title in compliance with the subdivision control provisions of the Act. Furthermore, the buyers made the offer to purchase with full knowledge that the properties have merged as abutting lands. The court dismissed the buyers' appeal. See: *Malik v. Attia*, 2020 ONCA 787.