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MORTGAGE AND REAL PROPERTY LAW REPORT

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SHARI'A COMPLIANT LENDING – THE NEXT FRONTIER OF FINANCING?

One is reading and hearing the words "Shari'a compliant" increasingly in 2008 as increased attention is being paid in the Canadian and international financial industry to the growing market of Muslim financing. A 2007 British report placed the international value of such financing at greater than $500 billion per year. It should be noted that Muslims are now the fifth-largest religious group in Canada.

Shari'a (or Islamic) law is derived from the Holy Qur'an, the Islamic holy book. The Holy Qur'an's economic prescriptions emphasize effort and the due reward for work, and prohibit business transactions that involve interest or speculative investments. The paying and receiving of interest is prohibited as a form of usury.

A number of Shari'a compliant banking products have been developed that are relatively similar to traditional Canadian products and offer comparable risks. For instance, a "Murabaha" transaction will take the place of a traditional purchase financing mortgage. In this type of transaction, the "capital provider" [*viz*. Lender] agrees to purchase the property and then immediately re-sell same to the purchaser at a pre-determined mark-up calculated to cover the capital provider's costs and profits (which take the place of traditional interest). In this type of transaction, the re-sale price is often paid by fixed installments. The capital provider will also take a security interest in the property to secure the payments.

This transaction may have the same end result as a traditional mortgage transaction, but is acceptable under Shari'a law as the capital provider is not earning interest on its investment – rather it earns a share of the profits.

Canadian regulators appear not to have taken an official position on Shari'a type transactions. That being said, many investors are anxious to take advantage of what is perceived as an un-tapped market.

IN THIS ISSUE:

Legal Alerts

- **Parties to new home sale transactions should note that the Ontario government is cracking down on the requirement to include costs of all construction extras in calculation of sale price for purposes of determining Land Transfer Taxes.**

- **The new Ontario Mortgage Brokers, Lenders and Administrators Act comes into effect Jul. 1/08, and all current Mortgage Broker registrations will expire. Any person or entity carrying on business of dealing or trading in mortgages, administering mortgages or as a mortgage lender must be licensed with FSCO pursuant to the new Act unless an exemption applies. More information can be obtained from the Financial Services Commission of Ontario website at www.fsco.gov.on.ca/english/regulate/mortgagebrokers.**

- **Recent amendments to the Cdn Income Act eliminate Cdn withholding tax on most interest payments made to non-residents on arm's length debt obligations. The amendments allow foreign lenders to provide operating and revolving credit facilities to Cdn borrowers, and should provide Cdn borrowers with increased access to foreign capital.**

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DECISION BRINGS HOME THE DANGERS OF RELYING ON POWERS OF ATTORNEY, AND ADDS ELEMENT OF FAULT TO LEGAL ANALYSIS OF WHO BEARS COSTS OF MORTGAGE FRAUD

88 year old PR owned a residential property. A "fraudster" acting pursuant to a fictitious Power of Attorney and posing as PR's relative purported to sell the property to PM, who borrowed most of the purchase money from HSBC Bank on the security of a charge on the property.

Though knowing that the person purporting to sell the property was acting pursuant to a Power of Attorney, the solicitor for PR and the Bank knew nothing about its form, content or validity, and did not take any steps to learn about these issues. The Bank did receive a copy of the Power of Attorney, but the Bank did not examine it.

The underlying action was a motion to have the Bank's mortgage declared invalid. The Bank, relying on the recent Ontario Court of Appeal decision of *Lawrence v. Maple Trust Co.*, argued that it was a "deferred" owner whose title was "indefeasible".

"*Under this theory [established … in Lawrence v. Maple Trust Co.], the party acquiring an interest in land from the party responsible for the fraud (the "intermediate owner") is vulnerable to a claim from the true owner because the intermediate owner had the opportunity to avoid the fraud. However, any subsequent purchaser or encumbrancer [viz. Lender] (the "Deferred Owner") has no such opportunity … and acquires an interest in the property that is good as against all the world*".

The Court recognized that, *prima facie* under the principles set out in *Lawrence v. Maple Trust Co.*, the Bank would be a deferred owner with indefeasible title. However, the Court felt that the opportunity to avoid the loss should be a factor in determining who would bear the loss in the face of mortgage fraud.

In finding against HSBC Bank, the Court found that the Bank could have avoided this fraud by picking up on the invalidity of the Power of Attorney. "The bank had the opportunity to avoid the fraud … It dealt with the fraudster and, whether through its solicitor or otherwise, it did not take steps to scrutinize the Power of Attorney. The bank chose to put itself in proximity to the unknown fraudster in this transaction by dealing with him, yet it failed to make use of the opportunity to avoid the fraud which that proximity gave it."

"A forged Power of Attorney is an easy means of stealing a person's identity. Forged Powers of Attorney therefore are an easy means of perpetrating mortgage fraud."

The Court then held that the Bank had an opportunity to avoid the loss, which makes the Bank's interest in the property defeasible in favour of the true owner, PR. The Court concluded that its casting the test of who bears the costs of a mortgage fraud in terms of opportunity to avoid the fraud may appear to move it closer to a fault test and that such a move was not without dangers, but felt that the *Lawrence* decision implicitly supported the move.

Reviczky v. Meleknia, [2007] O.J. No. 4992, Ont. S.C.J)

COURT GRANTS BANK EQUITABLE MORTGAGE WHERE MONIES ADVANCED UNDER FRAUDULENT MORTGAGE USED TO DISCHARGE EXISTING MORTGAGE ON PROPERTY

In 1996, DO and LO purchased a condominium as joint tenants, and in 2004 transferred a 1/3 interest in the property to their daughter, P. At that time, the property was mortgaged to First National for $150,000.

Unbeknownst to DO or LO, in 2005, P retained counsel and transferred the property into her name alone. She told the lawyer that her parents had both left the country, and proffered separate powers of attorney for her parents. The power of attorney from LO was a forgery.

At the time of the transfer to P, Royal Bank advanced $211,000 under what it thought was a valid first mortgage, which monies were used to pay out the First National mortgage and pay closing costs. Upon default under the mortgage, and without knowledge of the alleged fraud, the Bank commenced realization proceedings.

LO sought a declaration that the Bank's charge against the property was void because it was obtained by fraud. Royal Bank sought a declaration that it held an equitable mortgage over LO's 1/3 interest in the condominium for: (i) amounts paid to First National, being $149,179.32, (ii) amounts paid for outstanding property taxes, and (iii) condominium fees paid.

The Court, walking a legal tightrope, held that LO was entitled to have the Bank's mortgage set aside, but then granted the Bank's application to

have an equitable charge against the property in part.

In making its decision, the Court found that there was a common intention on the part of the three owners of the property to charge it in favour of First National. The Court went on to hold that equitable subrogation [being the legal right to step into the place of another person] will arise in the circumstances where the Bank's mortgage is unenforceable due to a fraud, but the mortgage it replaced was enforceable. The owners of the property have benefitted from removal of the First National mortgage, and they would be enriched if they are not required to repay the indebtedness associated with that mortgage.

That being said, the Court went on to state that it would not be fair to permit the Bank to enforce the entirety of the First National charge against LO's 1/3 interest in the property, and then enforce the balance of its claim against the 2/3 interest of P. This would have the effect of imposing the loss occasioned by P's fraud on LO, rather than on the Bank.

The Court ordered that, upon closing of the sale of the property, proceeds shall be applied firstly to sale costs, second to the Bank in an amount equal to its payments on account of real estate taxes and condominium fees, thirdly to the Bank in an amount paid to discharge the First National mortgage, and the balance to be distributed in accordance with the findings of a Court Reference to determine the entitlement of all interested parties.

O'Brien v. Royal Bank of Canada, [2008] O.J. 653, ON S.C.J.

UNILATERAL MOVE BY BUILDER OF FURNACE TO HALL CLOSET OF CONDOMINIUM UNIT ALLOWED PURCHASER TO TERMINATE TRANSACTION

Mr. and Mrs. B agreed to purchase a condominium unit from Independence Way from plans. At the time, they were given a plan showing a sliding door separating the powder room from a room marked W/D and F.H.W. This room was to contain a stacked washer and dryer (W/D) and a hot water heater with the unit's furnace stacked on top (F.H.W.).

"Mr. Brooker testified that the front hall closet was rendered useless by the placement of the furnace in one-half of the closet and by bringing forward the rear wall of the closet to within six inches of the closet doors."

During construction of the unit, the furnace was moved into the front hall closet. The B's were not told of this change, only to discover same at the pre-delivery inspection. They spent the next seven weeks attempting to persuade the builder something had to be done about the closet, but the builder put them off and, basically, refused to discuss the matter.

The Bs tried to rescind the Agreement of Purchase and Sale, and eventually commenced an action in Small Claims Court, where the Trial Judge found against them.

On appeal, the Court determined that the question was "did the change in the location of the furnace constitute a fundamental change to the Agreement of Purchase and Sale?"

The Appeal Court reviewed the decision of *Danko v. 792207 Ontario Ltd. (c.o.b. Marbrook Homes)*, [2004] O.J. No. 1542 (C.A.) wherein the purchasers contracted to receive a cathedral ceiling over the family room, but did not. The Ontario Court of Appeal held there was evidence which subjectively and objectively supported a finding that the cathedral ceiling was a crucial feature of the home, and the purchasers were entitled to the return of their deposit.

Similarly, in *Kingsgate Homes Ltd. v. Goliszek*, [2001] O.J. No. 1258 (C.A.) the Ontario Court of Appeal found that the move of a detached garage from the side of a house to the front was a fundamental change.

At trial, Mr. B had testified that in attempting to solve his problems he obtained permission to try and sell the unit, and that two prospective purchasers immediately lost interest when they inspected the front hall closet and noted its configuration.

"[T]he acknowledgement contained in the Agreement of Purchase and Sale that the location of the furnace is to be determined by the architect, may not be located as shown on the brochure and [the Purchaser(s)] shall be deemed to accept any such change, can not be construed as unlimited and does not apply to fundamental changes." [emphasis added]

The Appellant Court went on to find that, on the subjective and objective evidence, the changed furnace location constitutes a fundamental change. The Court further found that the acknowledgement contained in the Agreement of Purchase and Sale that the location of the furnace is to be determined by the architect, may not be located as shown on the brochure and the B's shall be deemed

to accept any such change, can not be construed as unlimited and does not apply to fundamental changes.

Brooker v. Independence Way Inc., [2007] O.J. 4692, Ont. Div. Ct.

COURT FINDS THAT FAILURE TO PROVIDE TENANT WITH OCCUPANCY ON AGREED DATE DOES NOT ALLOW TENANT TO REPUDIATE LEASE, GRANTS LANDLORD JUDGMENT FOR $1.1M

Spirent Communications agreed in the fall of 2000 to lease an Ottawa office building under construction, and had agreed with Quake Technologies, a growing high technology company in Ottawa, to sublease part of the building for three years. June 1, 2001 was the specified occupancy date. Quake's then-existing lease was to expire on May 31, 2001.

At the time the sublease was entered into, there was a tremendous demand for space in Ottawa. However, in the spring of 2001, as a result of the decline of the high technology sector, the commercial leasing market in Ottawa had changed dramatically, with more space available and rental rates down significantly.

Weather and construction mistakes led to delays in the construction of the building. Upon being advised in April of 2001 that occupancy would be delayed until July 15, 2001, Quake advised Spirent that it would not proceed with the sublease. In May of 2001, Quake proceeded to sublease space elsewhere at a significantly lower cost, and Spirent in turn subleased the space to third parties, also at a much-reduced rate.

Spirent sued Quake for the difference between the amount it would have received under the sublease agreement and that which it was actually able to obtain. The lower court dismissed Spirent's claim on the basis that "Spirent was in breach of a stipulation of major importance to the contract", being meeting the occupancy date. In other words, Spirent was in fundamental breach of the sublease.

The Court of Appeal allowed Spirant's appeal, and granted judgment in favour of Spirent in the amount of $1,096,793.87.

"Did the anticipated delay in occupancy deprive Quake of substantially the whole benefit of the Agreement?"

The Appeal Court held that the anticipated delay did not constitute a fundamental breach: "[We] do not accept that the anticipated delay in occupancy had sufficiently serious consequences to Quake that it would have deprived Quake of substantially the whole benefit of the Agreement." The Court placed much emphasis on the fact that Quake made little effort to find temporary space. "By its own admission, therefore, although Quake would have incurred additional costs by maintaining its then-existing lease, it would have had space for at least three months after June 1, 2001. Had it elected to stay in its then-existing space, it would have been entitled to look to Spirent for compensation for those additional costs."

Spirent Communications Of Ottawa Limited v. Quake Technologies (Canada) Inc., [2008] O.J. No. 444, Ont. C.A.

Editor: H. Paul Beyer

FIRM ACTIVITY

BSR is pleased to announce the addition of two lawyers to the Firm:

JOHN M. SINGER has joined our Real Estate Department, and brings to the table extensive experience in a wide variety of real estate matters, including purchase and sale transactions, financing, real estate development and mortgage enforcement. John also acts for health professionals, primarily dentists and doctors, in leasing, practice purchases and sales and corporate matters. John has practiced law in Toronto since 1986, obtaining his LL.B. from Osgoode Hall Law School.

ELEE SCARLETT, joining our Litigation Department, is a senior litigator who was called to the Bar of Ontario in 1992. Elee practices in the area of commercial litigation, and has represented parties in shareholder disputes, fraudulent conveyance actions, debt enforcement and receiverships. She has appeared before all levels of Courts in the Province of Ontario, and has represented clients before numerous administrative tribunals. In addition, Elee has experience in mortgage enforcement and bankruptcies.

Baker Schneider Ruggiero LLP is engaged in various areas of law with particular emphasis on the following:

- Commercial Lending
- Subdivision and Condominium Development/Re-development
- Debt Restructuring & Mortgage Enforcement (Commercial & Residential)
- Real Property & Commercial Litigation
- Corporate/Commercial/Leasing