THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

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Via email: finlegis@fin.gc.ca

Jane Pearse
Financial Sector Policy Branch
Department of Finance
L'Esplanade Laurier
15th Floor, East Tower
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Dear Ms. Pearse:

Re: Ensuring Business Access to Long-term Mortgages

The Canadian Bar Association's National Bankruptcy and Insolvency Law and Business Law Sections (CBA Sections) appreciate the opportunity to respond to Finance Canada's Consultation Document entitled "Ensuring Business Access to Long-term Mortgages". In the document, Finance Canada proposes expanding the exemption from mandatory pre-payment provisions in section 10(1) of the *Interest Act*[1] to include:

a) partnerships; and

b) trusts that are settled in whole or in part for business or commercial purposes.

Section 10 of the *Interest Act* was initially intended to remedy the problem of farmers being locked into long-term mortgages at high interest rates and subject to large bonuses or penalties when they sought prepayment. The exemption in section 10(2) was enacted some ten years later in response to problems that section 10(1) had created for corporations, particularly railway companies, in obtaining long-term financing by way of loans secured by mortgages of real property. Lenders were apparently reluctant to provide long-term mortgages when it was open to borrowers to repay the loan after five years, even though the mortgage was closed on its terms. As a result, the application of section 10(1) is now restricted to non-corporate mortgagors.[2] Legislation in several jurisdictions, such as Ontario, Saskatchewan and Manitoba contains provisions that parallel section 10 of the federal *Interest Act*.[3]

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1 *Interest Act*, R.S.C. 1985, c. I-15.

2 *Litowitz v. Standard Life Assurance Co*. (Trustee of), 1996 CarswellOnt 4028 (C.A.).

3 *Mortgages Act*, R.S.O. 1990, c. M.40, s. 18. See also *The Limitation of Civil Rights Act*, R.S.S. 1978, c. L-16, s. 10, *The Saskatchewan Farm Security Act*, S.S. 1988-89, c. S-17.1, s. 35, *The Mortgage Act*, C.C.S.M. c. M200, s. 20 and *Family Farm Protection Act*, C.C.S.M. c. F15.

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Finance Canada proposes modernizing the *Interest Act* by expanding the list of entities exempted from the application of section 10(1). The CBA Sections understand that the goal is to allow all business entities equal opportunities to access long-term funding by permitting them to negotiate their own pre-payment terms. Section 10 of the *Interest Act* and the proposed amendments, would permit commercial borrowers to more easily negotiate their own mortgage terms and obtain less favourable pre-payment privileges in exchange for a lower interest rate, if they choose to do so.

COMMENTARY

i. Expansion Should Include Certain Individuals

The CBA Sections support expanding the exemption in section 10(2) of the *Interest Act*. Parties to commercial lending arrangements ought to be free to negotiate their own pre-payment terms to secure more favourable long-term lending arrangements. By excluding individuals, however, the proposed amendments effectively exclude entrepreneurs and other individuals who carry on business without incorporating or forming a partnership. The amendments would prevent these individuals from taking advantage of the potential benefits of being able to negotiate pre-payment terms to secure long-term financing secured by a mortgage of real property.

The CBA Sections believe that the exemption in section 10(2) of the *Interest Act* should apply to individuals borrowing money for the purpose of carrying on business where the loan is secured by a mortgage of real property used in relation to that business. The CBA Sections note that certain provisions of the *Bankruptcy and Insolvency Act* are intended to apply only to individuals carrying on business and for property acquired or used by those individuals in relation to that business. That *Act* includes similar limitations.[4]

Recommendation

The Canadian Bar Association National Bankruptcy and Insolvency Law and Business Law Sections recommend that the amendment in section 10(2) of the Interest Act be amended to apply to individuals borrowing money for the purpose of carrying on business where the loan is secured by a mortgage on real property used in relation to that business.

ii. Pre-payment Terms and Enforcement

The intention underlying section 10 is to permit a mortgagor/borrower carrying on business to secure favourable long-term financing by negotiating pre-payment terms included in long-term financing secured by a mortgage. This would allow lenders and borrowers to negotiate favourable interest rates in exchange for concessions with respect to the borrower's ability to pay the mortgage prior to maturity.

Generally, a mortgagor/borrower is not entitled to redeem the mortgage before the date specified in the mortgage.[5] Typically, mortgagee/lenders do not want mortgagor/borrowers pre-paying loans before maturity and disturbing yield. Mortgage loans are often closed or permit pre-payment by the mortgagor/borrower only on payment of yield maintenance – a pre-payment premium that allows a mortgagee/lender to attain the same yield as if the mortgagor/borrower made all scheduled mortgage payments through to maturity. Section 10 of the *Interest Act* is designed to permit this sort of provision.

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4 See *Bankruptcy and Insolvency Act*, R.S.C. 1980, section B-3, sections 50.6(2) (interim financing), 64.2(3) (charge in favour of professionals) and 65.13(2) (sale of assets out of the ordinary course).

5 See for example *Hongkong Bank of Canada v. Wheeler Holdings Ltd*., 1993 CarswellAlta 250 (S.C.C.) and *International Taoist Church of Canada v. Ching Chung Taoist Assn. of Hong Kong Ltd*., 2010 CarswellBC 2180 (S.C.C.).

While section 10 of the *Interest Act* addresses the ability of lenders and borrowers to negotiate pre-payment terms – typically the requirement to pay yield maintenance – applicable when the mortgagor/borrower wishes to voluntarily pre-pay a long-term mortgage loan, the CBA Sections are concerned that any yield maintenance payments under a mortgage are not enforceable where the mortgagor/borrower (voluntarily or involuntarily) defaults and the mortgagee/lender is then forced to exercise its mortgage remedies.

At equity, a mortgagor/borrower in default could redeem the mortgage by giving the mortgagee/lender either six months' notice or paying six months' interest in lieu of notice. However, a mortgagee/lender realizing on its security was required to accept payment from the mortgagor/borrower in redemption, without the additional interest or yield maintenance payments.[6] Ontario, Saskatchewan and Manitoba legislation provides mortgagor/borrowers with a similar right. For example, the Ontario *Mortgages Act* provides:[7]

> 17.(1) **Payment of principal upon default**. Despite any agreement to the contrary, where default has been made in the payment of any principal money secured by a mortgage of freehold or leasehold property, the mortgagor or person entitled to make such payment may at any time, upon payment of three months interest on the principal money so in arrear, pay the same, or the mortgagor or person entitled to make such payment may give the mortgagee at least three months notice, in writing, of the intention to make such payment at a time named in the notice, and in the event of making such payment on the day so named is entitled to make the same without any further payment of interest except to the date of payment.

The practical effect of a mortgagor/borrower being permitted to redeem a mortgage on payment of only three (or six) months' interest is to defeat the ability of a mortgagee/lender to recover contractually agreed yield maintenance if the mortgagor/borrower defaults and the mortgagee/lender takes enforcement steps. No exemption to the equitable rules regarding redemption or section 17(1) of the Ontario *Mortgages Act* is provided for corporations or joint stock companies.

The *Interest Act* is also generally seen as restricting a mortgagee/lender's ability to recover yield maintenance. The *Interest Act* provides:[8]

> 8. (1) **No fine, etc., allowed on payments in arrears**. No fine, penalty or rate of interest shall be stipulated for, taken, reserved or exacted on any arrears of principal or interest secured by mortgage on real property or hypothec on immovables that has the effect of increasing the charge on the arrears beyond the rate of interest payable on principal money not in arrears.

This has been interpreted as restricting a mortgagee/lender from recovering "early termination premiums"[9] and there is no exemption from section 8 for commercial mortgage loans.

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6 *See O'Shanter Development Company Ltd. v. Gentra Canada Investments Inc*., [1995] O.J. No. 2546 (Gen . Div.)

7 *Mortgages Act*, R.S.O. 1990, c. M.40, s. 17(1); *The Limitation of Civil Rights Act*, R.S.S. 1978, c. L-16, s. 40; *The Saskatchewan Farm Security Act*, S.S. 1988-89, c. S-17.1. See, *Interest Act*, R.S.C. 1985, c. I-15, s. 8(1). See also *Lynch v. Citadel Life Assurance Co.,* [1983] 149 D.L.R. (3d) 316, M*un. Savings & Loan Corp. v. Wilson* (1981), 20 R.P.R. 188, 127 D.L.R. (3d) 127 (C.A.).

8 *Interest Act*, R.S.C. 1985, c. I-15.

9 See for example *McDonald v. Royal Trust Corp. of Canada*, [1987] A.J. No. 1165 (Q.B.). See also *O'Shanter Development Company Ltd. v. Gentra Canada Investments Inc*., [1995] O.J. No. 2546 (Gen . Div.) re the interplay between section 8 of the *Interest Act* (Canada) and s. 17(1) of the *Mortgages Act* (ON) and *Mastercraft Properties Ltd. v. EL EF Investments Inc*., 1993 CarswellOnt 614 (C.A.), leave to appeal to S.C.C. refused (1994), 35 R.P.R. (2d) 219n (S.C.C.).

There is, in the CBA Sections' view, no compelling reason why a mortgagee/lender's right to recover yield maintenance when it enforces a mortgage in advance of maturity as a result of default should not parallel the mortgagee/lender's ability to recover yield maintenance where the mortgagor/borrower wishes to voluntarily terminate the lending arrangement prior to maturity. Any rationale for protecting an individual mortgagor/borrower from having to pay yield maintenance does not, in our view, apply in the case of commercial lending arrangements where the parties have, as permitted by section 10 of the *Interest Act*, negotiated pre-payment terms. The same rationale applies as that for exempting commercial loans from the application of section 10 of the *Interest Act*.

The CBA Sections believe that enhancing commercial borrowers' ability to secure favourable long-term mortgage financing will be fully realized only if the mortgagee/lender's claim against the mortgagor/borrower on default and enforcement is the same as the mortgagee/lender's claim if the mortgagor/borrower wishes to voluntarily terminate the lending relationship in the ordinary course.

The CBA Sections note that while there are common law restrictions on the ability of a mortgagee/lender to recover "penalties" from a mortgagor/borrower on termination of a lending relationship, the practical limitation on lenders and borrowers to negotiate pre-payment terms created by section 17(1) of the Ontario *Mortgages Act* and other similar legislation and the common law right to redeem do not apply to loans other than mortgage loans. For a loan secured by personal property, the borrower and the lender are free to negotiate pre-payment terms. Subject to the law with respect to penalties, the lender pay recover any claim that arises as a result of the termination of the loan before maturity. In *Pike v Bel-Tronics*,[10] for example, the Ontario Superior Court considered whether an "exit fee" payable upon the early termination of a lending agreement by lender or the borrower, whether voluntary or involuntary, or upon any acceleration of the obligations owing by the borrower to the lender, was recoverable by a lender in the context of a receivership of the borrower. The Court found that the exit fee was not a "penalty" and was recoverable by the lender. In upholding the lender's ability to recover the fee, the Court stated:

> [I]t must be remembered that [the lender] was a high risk, almost last resort, lender and that the Loan Agreement was negotiated between [the lender] and [the borrower], two sophisticated commercial entities both of which were fully advised by counsel throughout.[11]

In our view, section 8 of the *Interest Act* should be amended to provide that, in the case of commercial mortgages, any pre-payment penalties or yield maintenance payments provided on default are recoverable by the mortgagee/lender.

Recommendation

> ***The Canadian Bar Association National Bankruptcy and Insolvency Law and Business Law Sections recommend that section 8 of the Interest Act be amended to provide that, in the case of commercial mortgages, any pre-payment penalties or yield maintenance payments provided on default are recoverable by the mortgagee/lender.***

iii. Inconsistency with other Legislation

Legislation in some Canadian jurisdictions contains provisions similar to section 10 of the *Interest Act*. For example, section 18 of the Ontario *Mortgages Act* provides:

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10 2000 CarswellOnt 3540, 19 C.B.R. (4th) 262 (S.C.J.).

11 *Ibid*.

> 18.(1) **Right to redeem after 5 years**. Where any principal money or interest secured by a mortgage of freehold or leasehold property is not, under the terms of the mortgage, payable until a time more than five years after the date of the mortgage, then, if at any time after the expiration of such five years any person liable to pay or entitled to redeem tenders or pays to the person entitled to receive the money the amount due for principal money and interest to the time of such tender or payment, together with three months further interest in lieu of notice, no further interest is chargeable, payable or recoverable at any time thereafter on the principal money or interest due under the mortgage.
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> (2) **Exceptions**. This section does not apply to any mortgage given by a joint stock company or other corporation nor to any debenture issued by any such company or corporation for the payment of which security has been given on freehold or leasehold property.

Unless parallel amendments are made, expanding the exemption in section 10(2) of the *Interest Act* could lead to inconsistency between federal legislation and legislation elsewhere in Canada. The result could be additional and avoidable litigation.[12]

CONCLUSION

The CBA Sections support the proposal to expand the exemption in section 10 of the *Interest Act* to include other business entities. We believe the exemption should be further expanded to include individuals who carry on business in respect of mortgages over property used in connection with a business.

The CBA Sections also note that:

> (a) the restrictions on the ability of a mortgagee/lender to recover yield maintenance in the enforcement context prevents the objective underlying section 10 of the *Interest Act* from being fully realized and an amendment to section 8 of the *Interest Act* would remedy this situation; and
>
> (b) the proposed amendments could result in inconsistency between the *Interest Act* and legislation dealing with mortgages in certain jurisdictions, such as Ontario, Saskatchewan and Manitoba.

Yours truly,

(signed by Gaylene Schellenberg for E. Patrick Shea and Ross Swanson)

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[12] See for example *Mastercraft Properties Ltd. v. EL EF Investments Inc*., 1993 CarswellOnt 614 (C.A.) where the Ontario Court of appeal considered the constitutionality of what is now section 17(1) of the *Mortgages Act* (ON) in light of the provisions of section 8(1) of the *Interest Act* and *Tomell Investments Ltd. v. East Markstock Lands Ltd*., 1977 CarswellOnt 422 (S.C.C.) where the constitutional validity of section 8 of the *Interest Act* (Canada) was considered. The CBA Sections have not considered whether the legislation dealing with mortgages in provincial/territorial legislation might be unconstitutional to the extent of any inconsistency between that legislation and section 10 of the *Interest Act*.