LAW REFORM COMMISSION OF BRITISH COLUMBIA

REPORT ON MORTGAGES: JUDICIAL SALES AND DEFICIENCY CLAIMS

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TO THE HONOURABLE RUSSELL G. FRASER
ATTORNEY GENERAL OF THE PROVINCE OF BRITISH COLUMBIA

The Law Reform Commission of British Columbia has the honour to present the following:

REPORT ON
MORTGAGES: JUDICIAL SALES AND DEFICIENCY CLAIMS

Where a debt is secured by a mortgage, the process by which the lender recovers the debt is called foreclosure. The law governing foreclosure reflects a careful balancing of the rights of the lender to insist upon repayment of a loan, and the interests of the borrower. In this context, an issue has recently arisen for consideration by the courts: when a borrower defaults, should a lender be permitted to purchase the land that stands as security for the debt and , if so, in what circumstances? Whether there is a need for legislation to settle this point is considered in this Report. An amendment to the *Property Law Act* is recommended.

CHAPTER I INTRODUCTION

A. Mortgages

A person making a major loan frequently wants some form of security. A familiar arrangement is the mortgage against land. When the borrower fails to repay the loan the lender may pursue a number of remedies, but the final and best one usually involves looking to the mortgaged property. In most cases, the property is sold and the proceeds are applied against the debt. If the proceeds of the sale are not enough to repay the loan, the lender retains rights against the borrower.

One remedy allows the lender to take the property in satisfaction of the debt. The lender is said to "foreclose." The borrower loses all interest in the property and it becomes the lender's, to do with as the lender chooses. After a foreclosure, the borrower is no longer responsible for paying back the debt, even if the value of the property is far less than the amount that is owed.[1]

In the past few years, some lenders have explored a new way of realizing on a mortgage. The lender purchases the property when it is sold under a court order. When this occurs, the borrower remains liable to pay back any amount owed beyond the value of the property. It appears that the law dictates different results, depending on how the lender acquires title to the property.

What policies are advanced by this distinction? When technical differences of form lead to inconsistencies for no apparent reason it is appropriate to reassess the law and its policies. In this Report, we will consider whether the law governing a lender's ability to recover money secured by a mortgage should be revised. [2]

B. Consultation

A consultative document was prepared and given limited circulation. The process of consultation is described in greater detail later in this Report. Comments that were made will be addressed throughout the following discussion.

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1. *Property Law Act*, R.S.B.C. 1979, c. 340, s. 28; *Johli* v. *Toronto Dominion Bank*, [1988] B.C.D. Civ. 2764-02 (C.A.).

2. This is an area of the law that we have considered in past Reports: *see Security Interests in Real Property: Remedies on Default* (LRC 24, 1975); Calculation of Interest on Foreclosure (LRC 47, 1980); *Personal Liability Under a Mortgage or Agreement for Sale* (LRC 84, 1985); *Mortgages of Land: The Priority of Further Advances* (LRC 85, 1986). Related issues in the context of personal property were canvassed in *Report on Deficiency Claims and Repossession* (LRC 8, 1972). A policy that the Commission had endorsed in past work, and continues in this Report, is to ensure that modifications to the law governing mortgages are also made to the law governing agreements for sale, a similar security instrument that also involves the taking or retaining of an interest inland for the purpose of ensuring repayment of a debt: *Report on Security Interests in Real Property: Remedies on Default* (LRC 24, 1975), *ibid*., at 4. The law governing agreements for sale is complex, particularly with regard to rights of election between inconsistent remedies and with respect to principles of merger. For a more detailed discussion, *see* the Commission's earlier Report, *ibid*., and the authorities mentioned in it.

CHAPTER II MORTGAGES: REMEDIES ON DEFAULT

A. The Mortgage

A mortgage usually consists of two parts: it represents a promise to repay borrowed money and it also constitutes security for repayment.[1] If the borrower is unable to keep the mortgage in good standing, the lender may look to the mortgaged property to recover the loan.

The lender may also seek judgment against the borrower for breach of the promise to repay the borrowed money, just as if no mortgage were involved. The borrower's promise is referred to as the "personal covenant." Judgment on the personal covenant permits the lender to recover the debt by resorting to assets of the borrower other than the mortgaged property.

B. The Lender's Remedies

When a borrower defaults on a mortgage, the lender has a number of legal remedies available but may not immediately realize on the security.[2] An application must be made to the court.

1. PETITION FOR FORECLOSURE

The lender may commence a petition for foreclosure. This asks the court to terminate the borrower's interest in the property (together with all other interests subordinate to the mortgage). The court will make an initial, interim order called an "order nisi" that allows the borrower[3] a set time - usually six months - to redeem the property by paying back the money that is owed. If the borrower is unable to pay within the allotted time, the lender may apply for a final order, called an "order absolute of foreclosure," that will bring to an end all of the borrower's interest in the property.[4] In that case, the lender, by legislation, is required to accept the property in full satisfaction of the mortgage debt. The *Property Law Act*[5] provides:

> 28. After the making of an order absolute for foreclosure or for cancellation of an agreement for sale, a mortgagee or vendor has no right to enforce the personal covenant of the mortgagor or the purchaser to pay. He may not issue execution on a judgment taken on the covenant to pay unless by process of law the order absolute is set aside or reopened.

For this reason, if the value of the property is less than the mortgage debt, the lender may not wish to take

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1. The document will usually provide for other obligations, such as payment of the interest on the borrowed money, and also operate as security for the performance of these obligations.

2. The mortgage will usually provide that the lender may exercise certain extra-judicial remedies, in the event of default, such as a power of sale or a right to possession of the property. In some provinces, such as British Columbia, these extra-judicial remedies are rarely exercised because the lender must compensate the borrow for loss rising from their improper use: *see, e.g., Unican Development Corporation Limited* v. *Settlers Saving and Mortgage Corporation*, (1984) 30 Alta. L.R. (2d) 66 (Q.B.).

3. Or any subsequent encumbrancer.

4. Order absolute will also terminate all financial interests in the property subordinate to the mortgage.

5. R.S.B.C. 1979, c. 340.

order absolute.[6]

2. THE PERSONAL COVENANT

The lender may also sue on the personal covenant. Usually those proceedings will be brought with the petition for foreclosure and judgment for repayment of the debt will be granted with the order nisi.[7]

3. ORDER FOR SALE

Often it is in the best interests of both the lender and the borrower to sell the property and apply the proceeds to the mortgage debt. Either party may apply for an order for sale,[8] but restrictions have been placed upon when a lender may make such an application.

In *Pope* v. *Roberts*,[9] the British Columbia Court of Appeal held that a lender is usually not entitled to an order for sale until the expiry of the redemption period. Sale before that time would be inconsistent with the borrower's right to redeem the mortgage.[10] At the end of the redemption period, the lender may apply for either order absolute of foreclosure or an order for sale.[11]

The rule preventing sale during the redemption period is not without exceptions. In some cases, for example, the borrower will have little equity in the property and few prospects of paying the debt, so that an order for sale will not hurt the borrower's interests.[12] In other cases, an early order for sale will help a borrower. In *Bank of Montreal* v. *Martina Enterprises Ltd.*,[13] for example, the court allowed a lender to sell the property. The borrower would not be prejudiced by abridging the redemption period because the mortgaged land was the site of an incomplete development project. It was in everyone's best interests to sell the property to someone who could complete the project. Where the property is sold, the proceeds raised are applied to the debt, but the lender may still proceed against the borrower if there is any deficiency.[14]

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6. Liability under the personal covenant revives if the order absolute is set aside. An order absolute may be set aside on the application of a borrower who is able to redeem, or on that of either a borrower or a lender who is able to establish some defect in the order or in the manner in which it was obtained: *Bank of Montreal* v. *McAloney*, (1983) 46 B.C.L.R. 12 (S.C.).

7. *See, however, Bank of Montreal* v. *Awards-West Ventures inc.*, (1990) 50 B.C.L.R. (2d) 363 (C.A.).

8. *Law and Equity Act*, R.S.B.C. 1979, c. 224, s. 16.

9. (1979) 10 B.C.L.R. 50 (C.A.).

10. *See, e.g., Devany* v. *Brackpool*, (1981) 31 B.C.L.R. 256 (S.C.); *First Western Capital Ltd.* v. *Wardle*, (1984) 52 B.C.L.R. 242 (S.C.). It is open to subsequent mortgage lenders to apply for and obtain orders for sale during the redemption period: *Vancouver Inc.*, (1990) 50 B.C.L.R. (2d) 363 (C.A.).

11. *Citizen's Trust Company* v. *Kranley Construction ltd.*, [1982] B.C.D. Civ. 2768-09 (S.C.); *cf. Locarno Investments Ltd.* v. *Industrial Mortgage and Finance Corp. Ltd.,* (1967) 59 W.W.R. 298 (B.C.C.A.); *Law and Equity Act, supra*, n. 8; *Taylor* v. *Rudolph Holdings Ltd.*, (1983) 44 B.C.L.R. 273, 277 (S.C.), *rev'd* on appeal but not on this point, *supra*, n. 7; *F.B.D.B.* v. *F.J.H. Const. Ltd.,* [1988] 4 W.W.R. 1, 6 (B.C.C.A.). After order absolute, the mortgage lended is no longer entitled to an order for sale: *Bank of Montreal* v. *McAloney, supra*, n. 6.

12. An immediate order for sale will be appropriate, *e.g.,* where the mortgage security is inadequate and the borrower has abandoned the property: *F.J.H. Const. Ltd., ibid.*

13. [1983] B.C.D. Civ. 2768-15 (C.A.).

14. *See Martens and Martens* v. *First National Mortgage Co. Ltd.*, (1982) 38 B.C.L.R. 270 (S.C.); *Orser* v. *Colonial Investment & Loan Co.*, [1917] 3 W.W.R. 513 (Sask. S.C.); *Economic Life Assurance Society* v. *Usborne*, [1902] A.C. 147, 154 (H.L.). In these circumstances, however, the option of bankruptcy may be open to the borrower, which would make the lender's further rights illusory.

C. Agreements for Sale

Legislation over the past few years has brought the agreement for sale into step with the law governing mortgages, so that few if any real differences exist between the two methods of securing a debt against real property. Any changes in policy introduced to the law of mortgages should also be translated into the law that applies to agreements for sale. This section discusses the current law governing agreements for sale.

1. WHAT IS AN AGREEMENT FOR SALE?

An agreement for sale is a common and effective security device that may be used as an alternative to a sale of real property with a mortgage back to the vendor. It is a contract between a vendor and purchaser under which the vendor agrees to sell, and the purchaser agrees to buy, the vendor's interest in the property for a certain sum payable over a specified period of time. Under an agreement for sale, legal title remains with the vendor[15] until the full purchase price is paid. Until then, the purchaser has only the right to obtain the legal title by fulfilling the terms of the agreement.

2. THE BASIC REMEDIES

A purchaser's default under an agreement for sale leaves the vendor with two basic courses of action.[16] The vendor may either

(i) affirm the contract and call for its performance[17] (the vendor would require the purchaser to pay the money that is due under the contract); or

(ii) disaffirm the contract and apply to cancel it[18] (the vendor would take the property and retain all money paid until that time).

The current market value of the property will determine the better course of action for the vendor.

If the vendor applies to cancel the purchaser's interest in the property, the purchaser is given time to redeem the property. The parallels with foreclosure of a mortgage are clear. A vendor who chooses to cancel the purchaser's interest in the land may not enforce a judgment for money due under the agreement.[19] This is the same policy that applies on foreclosure of a mortgage.[20]

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15. The beneficial (equitable) title in the land passes to the purchaser and the vendor holds legal title as a constructive trustee for the purchaser.

16. The remedies are inconsistent and the vendor must eventually elect between them.

17. The vendor would sue for specific performance.

18. The vendor would seek an order for cancellation, which would give the vendor title to the property, free of the purchaser's interest. A familiar term of an agreement for sale gives the vendor a contractual right to do this on default, without the need for a court application: *see, e.g., Wilson* v. *Abbott*, (1914) 6 W.W.R. 1097, 1099 (Sask. S.C.); *Moore & MacDowell* v. *Stewart*, (1914) 7 (Sask. C.A.). The vendor would exercise the contractual right and then request a declaration from the court that the purchaser's interest in the land was determined.

19. *Property Law Act*, R.S.B.C. 19779, c. 340, s. 28.

20. In *Report on Security Interests in Real Property: Remedies on Default* (LRC 24, 1975) the Commission as then constituted recommended that remedies available to lenders and borrowers should also be available to parties under an agreement for sale. The Commission recommended that "foreclosure" of an agreement for sale should more closely parallel foreclosure of a mortgage. That would include changing the redemption period from three to six months, as well as permitting the courts to extend that period of time to re-open order absolute. That recommendation was enacted as s. 16.1 of the *Law and Equity Act, ibid*. Other recommendations made in the Report have also been implemented. *See miscellaneous Statutes*

In addition to the remedies listed above, it is also open to the court to order the sale of the property.[21] The proceeds from the sale would be applied to the debt owed by the purchaser, and the vendor would be allowed to recover from the purchaser any deficiency that remained.[22]

D. Summary

This Chapter has set out the general framework of remedies available to a lender who seeks to recover a debt secured against property. We have yet to consider the issue with which we are primarily concerned in this Report: the legal position that applies when a lender purchases the property at a court ordered sale. From the lender's perspective purchase is a better remedy than foreclosure because, by purchasing the property, the lender is still allowed to pursue the borrower for any deficiency. This aspect of the law will be examined in greater detail in the next Chapter.

(Court Rules) Amendment Act, S.B.C. 1976, c. 33, s. 94(a) (*see now Law and Equity Act*, R.S.B.C. 1979, c. 224, s. 16); *Supreme Court Rules,* Rule 50(11), 3(2); *Land Titles Act*, S.B.C. 1978, c. 25 (*see now Land Title Act* R.S.B.C. 1979, c. 219;) *Attorney General Statutes Amendment Act*, S.B.C. 1980, c. 1, s. 15 (*see now Law and Equity Act*, R.S.B.C. 1979, c. 224, s. 21.1).

21. *Law and Equity Act, supra*, n. 8.

22. *K.C. Johnson Construction Ltd.* v. *Wilson*, Victoria Registry No. 3206/82 [1990] B.C.J. No. 1521 (S.C.).

CHAPTER III THE CURRENT PRACTICE AND THE NEED FOR REFORM

A. Introduction

Surprisingly enough, the law of mortgages continues to generate new issues. Even after several hundred years, aspects of mortgage practice are unsettled and, as business practice evolves, the judiciary is called upon to reconsider and reformulate the legal rules that achieve a balance between the interests of lender and borrower. It is only over the past decade, for example, that the courts have settled aspects of practice relating to when a lender can apply for an order for sale,[1] when a lender should apply for judgment on the personal covenant,[2] and what costs incurred by the lender can be charged to the borrower.[3] The decade has also witnessed judicial attempts to standardize foreclosure practice. Many opportunities to do this arose in the hectic days after 1981 until the local property market began to recover in 1986-7. Perhaps a cooling economy will generate a similar experience in the years ahead.

The last Chapter compared the remedies available to a lender when a borrower defaults on a mortgage. Two remedies lead to quite dissimilar results. A lender who forecloses takes the property free of the borrower's interest in it, but by doing so, the borrower's liability to repay the debt secured by the mortgage is brought to an end. On the other hand, if the property is sold by court order, and the lender purchases it, the lender takes the property free of the borrower's interest in it, but the borrower's liability to repay the debt (less the money raised by selling the property) remains intact. Should a lender be allowed to purchase mortgaged property in a court ordered sale?

The question has come before the British Columbia Court of Appeal on two occasions in the past several years - in *Royal Trust Co.* v. *Heelo*[4] and *Bank of Montreal* v. *Butler and Canada Mortgage and Housing Corporation*[5] - and in each case the court approved the purchase by the lender.

Before considering the policy implications, it is useful to discuss the current law and its historical origins.

B. The Current British Columbia Practice

In Butler it was held that a lender may purchase property provided a fair price is paid for it:[6]

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1. *Pope* v. *Roberts*, (1979) 10 B.C.L.R. 50 (C.A.).

2. *Taylor* v. *Rudopl Holdings Ltd.*, (1985) 68 B.C.L.R. 259 (C.A.). The effect of this decision, however, has been qualified by *Bank of Montreal* v. *Awards-West Ventures Inc.*, (1990) 50 B.C.L.R. (2d) (363 (C.A.).

3. In some cases, there has been a need for legislative intervention. This was the case, *e.g.* with respect to the issue of costs: *see Law and Equity Act*, R.S.B.C. 1979, c. 224, s. 18.2. Similarly, the law governing the personal liability of a borrower who had sold the property subject to the mortgage had to be rationalized by legislation: *see Property Law Act*, R.S.B.C. 1979, c. 340, ss. 19-23.

4. (1986) 4 B.C.L.R. (2d) 40 (C.A.).

5. (1990) 44 B.C.L.R. (2d) 247 (C.A.).

6. *Ibid.*, at 256.

> The principle I take from *Sayre* v. *Security Trust Co.* is that the mortgagee may be allowed, not ordinarily or routinely, but if the circumstances justify it, to purchase the mortgaged property at a court-conducted sale. What circumstances would justify it? They must be circumstances which satisfy the judge that an adequate price will be obtained. Therefore I find no bar in equity to the mortgagee here purchasing the property in its own name ...

Does the *Butler* case signal a change in foreclosure practice? There is not much case authority on the point. It has been said that although a lender may purchase property in a court order sale, the courts are very reluctant to allow the practice.[7] Whatever the common law position, however, the actual practice is clearly revealed by the absence of cases on point. As a rule, lenders do not purchase property in a court ordered sale.

It would seem, consequently, that the Butler decision signals a change in the law, under which it might be expected that a more relaxed standard will be applied as to when it is appropriate for the lender to purchase, perhaps altering the common mortgage practice.

Currently, in the usual case, the lender must elect between selling the property to a third party (typically by court order) or taking order absolute of foreclosure. So long as these are the only options, the borrower has some protection. Property will be sold where there is a good market. Otherwise, foreclosure makes sense: the lender can wait for the market to recover.[8] To do this, however, the lender must forego any further rights against the borrower.

Purchase by the lender adds a new dimension with the potential to upset the balance of rights between borrower and lender. It allows the lender to pursue the borrower, perhaps for years (provided the judgment is regularly renewed) until the lender is paid in full. This option, from the lender's perspective, is vastly to be preferred over foreclosure. If freely available, it might become the common practice, leaving the remedy of foreclosure an historical oddity, commonly listed among the mortgagee's array of rights but never to be used. Should policy allow a lender to purchase mortgaged property and pursue the borrower for a remaining deficiency?

C. Historical Background

1. EQUITY, THE COMMON LAW AND PURCHASES BY LENDERS

Are there reasons to limit the situations in which a lender may purchase mortgaged land in a judicial sale? It may be argued that as a practical matter it doesn't really matter who buys the property, so long as a fair price is obtained. That is the position adopted by the majority decisions in both the *Heelo* and the *Butler* cases. For many years, however, courts have been reluctant to allow a lender to acquire mortgaged property.

The concern arose initially several hundred years ago when a mortgage was treated as a conveyance and a borrower who defaulted on repayment of a loan worth a fraction of the property ended up losing the estate entirely. An early concern of the Courts of Equity was to identify the principles which would make a mortgage function as a security, not a conveyance.

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7. *Bank of Montreal* v. *Butler*, (1989) 31 B.C.L.R. (2d) 31 (B.C.S.C.) *per* Paris J.; and *supra*, n. 5, (B.C.C.A.) *Per* Wood J.A. The majority decisions in *Heelo* and *Butler* put this proposition in some doubt.

8. It might seem sensible to sell the property for whatever can be got and pursue the borrower for the rest, but in most cases the borrower has nothing left. Lenders usually view the property as the principal source for satisfying the borrower's debt. Consequently, a lender would be reluctant to let the property go at low a price unless, of course, it was to the lender.

In response, lenders devised a contractual power of sale, and some used it on the borrower's default to sell the property to themselves or their agents, seeking to avoid the equitable rules. The problem was that these sales often took place at an undervalue, the reason lenders wanted to purchase the property in the first place. The courts stopped this practice. It came to be accepted that a sale from a person to himself or herself was no sale at all.

Judicially supervised sales overcome the objection that a lender is selling to himself or herself. Even so, applications by lenders to purchase a mortgaged property, until recently, were usually refused. One reason was that a lender was looked upon as a trustee and a trustee is not permitted to purchase property from his beneficiary.[9] Lawyers formerly drafted the documents creating the security in terms of a trust, lending weight to this construction. By the nineteenth century this notion was finally put to rest and it was held that a lender is not a trustee of the borrower, even if the security is drafted in such terms.[10] Even so, modern courts continue to characterize some aspects of a lender's responsibilities in terms of a trust,[11] and the prohibition on purchasing the borrower's property is one such example.[12]

It can be seen that each of the historical reasons for refusing to allow a lender to purchase rest upon factors that do not arise when property is sold at a judicial sale. Purchasing a property at a fair price does not detract from the secured nature of the transaction. The trust analysis is a false, though surprisingly pervasive, notion. And (most of) the potential for abuse in a private sale by the lender does not exist in a court ordered sale.

It would seem that the objections canvassed above to a lender purchasing the security are not sufficiently compelling to support the former rule. There really is no difference to the borrower who purchases the property, provided a fair price is paid for it. Are there other arguments that can be raised against allowing a lender to purchase property charged as security?

2. SECTION 28 OF THE PROPERTY LAW ACT

Section 28 provides that a lender who takes the land (by foreclosure) may no longer look to the borrower to pay any deficiency. Is section 28 a reflection of a general policy that a lender should look to either the property or the borrower's personal covenant, but not both? Are there parallels to be drawn here with the position that should be adopted when a lender purchases property at a court ordered sale? A review of the predecessors to the section suggests that the policy advanced by it has changed over the years and some aspects of it have been arrived at more or less accidentally. The forerunner to the section was enacted in 1917

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9. *Downes* v. *Grazebrook*, (1817) 3 Mer. 200, 36 E.R. 77 (Ch.). This construction led to some difficulties. There was little a trustee/lender could do to enforce repayment. True trustees, for example, were not permitted to foreclose: *Tenant* v. *Trenchard*, [1869] IV Ch. App. 537, 546. In such a case, provided the borrower consented (and even where consent was not forthcoming, when no one else would purchase the property) the trustee would be permitted to do so. Equity, however, never looked upon a simple lender as having all of the attributes of a trustee. This led to an interesting paradox. Lenders were allowed to foreclose, but not purchase, because they had trustee-like obligations. True trustees, however, were not allowed to foreclose so they were, in extreme situations, allowed to purchase.

10. *Cholmondeley* v. *Clinton*, (1820) 2 Jac. & W. 190. (H.L.).

11. More accurately, obligations imposed on a lender by modern courts are derived from those obligations crafted by eighteenth century courts anxious to graft a trustee status on the lender: *see, e.g., Whelpdale* v. *Cookson*, (1747) 1 Ves. Sen. 9; *Fox* v. *Mackreth*, (1788) 2 Bro. C.C. 400.

12. *Downes* v. *Grazebrook, supra*, n. 9; *Robertson* v. *Norris*, (1858) 1 Giff. 421; *Farrar* v. *Farrars, Ltd.*, (1889) 40 Ch. D. 395; *Henerson* v. *Astwood*, [1894] A.C. 150 (P.C.).

as a response to an administrative problem experienced in the land title system.[13]

In British Columbia, title to land is recorded in registers. Once recorded, the person in whose name property is registered is regarded as the owner. This is in contrast to the common law system, under which ownership is established by verifying the validity of the chain of conveyances by which the current owner acquired title. However sensible the British Columbia system of land registration may be, a problem arose when property was acquired by foreclosure. Under the equitable rules, a lender who acquired title by foreclosure might reopen the purchaser's interest - the right to redeem - by attempting to recover the unpaid debt. This was inconvenient to a system which attempted to reflect ownership accurately, since the title would not indicate rights remaining in the former owner.

The problem was dealt with by devising a new, temporary, method of registration using an interim certificate. A lender could register the interim certificate and take whatever additional steps were necessary to recover the debt. This would signify to the world that the lender's title was possibly subject to a former owner's equitable right to redeem. A final certificate would only be issued when the lender decided that further pursuing the borrower was pointless. Registration of the certificate absolved the borrower of liability for the debt.

This procedure was followed in British Columbia for over 60 years until modified, in part as a response to a recommendation of this Commission.[14] The Commission, as then constituted, was of the view that the interim certificate procedure provided for open-ended liability which left the borrower far too vulnerable:[15]

> What should be the extent of the right to proceed on the covenant? We are unhappy with the existing law which may permit the mortgagee's rights to remain alive indefinitely. There ought to be some point at which the borrower knows absolutely that he is free from personal liability on his covenant. This is in fact the current result where a mortgagee takes a certificate of indefeasible title under section 199 (1) of the *Land Registry Act*.
>
> It is our conclusion that the opportunity to execute on the personal covenant ought to cease upon the pronouncement of an order absolute, whether the action be brought on a mortgage or agreement for sale. This position has been taken with these factors in mind:
>
> (i) Interim certificates are very rarely used in practice.
>
> (ii) In practice the cut-off date established by the issue of a certificate of indefeasible title usually arrives very shortly after the granting of the order absolute.
>
> (iii) The date of the order absolute appears to be more convenient for the purpose of equating the default under the two relevant security devices.
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> ...
>
> The Commission recommends:
>
> *[U]pon the pronouncement of an order absolute in an action*

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13. *An Act to Amend the Land Registry Act*, .S.B.C. 1917, c. 33, s. 2. *See, e.g., Scottish Temperance Life-Assn.* V. *registrar of Titles, Vancouver,* (1916-7) 24 B.C.R. 232 (C.A.) decided one month after the amendment was assented to. One submission disagreed with the following description of the development of the law in this context without, apparently, reviewing the content of the former legislation. The reader may find it helpful to refer to Appendix A, where the text of the original section is set out.

14. *See Report on Security Interests in Real Property: Remedies on Default* (LRC 24, 1975).

15. *Ibid*., 27-8.

(a) for the foreclosure of a mortgagor's interest in land; or

(b) for cancellation of an agreement for sale,

the mortgagee or vendor shall thereupon be deemed to have released the mortgagor or purchaser from his personal covenant and to have irrevocably taken the property in full satisfaction of the debt secured so long as that order remains in force.

> The previous recommendation necessarily raises the question of the continued existence of the interim certificate of title now available under section 199 (2). In any view its continued existence would serve no useful purpose, and we recommend that it be dispensed with.

In accordance with the recommendation, the section was modified by eliminating the interim certificate, so that the borrower's liability ended not with registration of the lender's title in the land title system, but when the court made the order absolute of foreclosure.

The evolution of section 28 demonstrates that it did not start out as borrower protection legislation. Nor does it really perform that function now. Nothing prevents a lender from taking any number of legal steps to recover the debt before applying for order absolute of foreclosure. As a practical matter, by the time the lender applies for foreclosure, the borrower will have little property remaining.

The rationale for adopting the policy advanced by section 28 of the *Property Law Act* does not assist in determining whether a lender should be permitted to purchase mortgaged property at a court ordered sale.

D. Practical Difficulties with Lender Purchases

The discussion above suggests that many of the reasons that have been put forward to justify restricting a lender's ability to purchase the security are not persuasive. Are there other reasons that support the former practice? This section considers some of the points raised in - or as a result of - cases over the years.

These issues have not arisen in British Columbia until recently, nor do they arise frequently in other jurisdictions. It is worth emphasizing that our concern is whether a change in British Columbia foreclosure practice may open the door to unfair practices. Consequently, cases referred to are from outside British Columbia and a few of them are quite old. Some of them arise against a different legal background and, even where the law is similar to that in British Columbia, notable differences in practice exist. Even so, these cases usefully catalogue some facts courts have considered to be sufficiently weighty to deserve serious consideration.

1. CONFLICT OF INTEREST

Obviously, the interests of the lender and borrower, taken as a whole, are in conflict. Even so, on some issues, certain results may be expected to be mutually advantageous. Where property is to be sold to a third party, for example, both lender and borrower benefit if the property is sold at a good price.[16] Where a lender wishes to acquire the property, however, the interests of the lender and the borrower on the issue of

16. This may be a matter of less importance to a lender who expects to be able to recover the deficiency by other means, such as recourse to a guarantor.

price come into conflict.[17] The lender, quite prudently, will wish to acquire the property at a low price. Some who commented on an earlier draft of this Report took exception to the point, but it would appear to be self-evident.

It has been suggested that in some cases a lender wishing to acquire the property at a low price may be able to discourage or hinder others and so keep the purchase price of the property artificially low.[18]

It is not behaviour one would expect of an institutional lender, but of course not all lenders fit into that category. Objections of this kind are usually met by placing the property in the hands of a competent real estate agent. Nevertheless, the possibility exists that a lender intent on purchasing the property may be in a position to discourage the interest of others.

For example, a lender who has additional security against the borrower's personal property may be able to alter the nature of what is for sale. Seizing equipment on the premises may turn a cinema, bowling alley or brewery into a warehouse that requires a good deal of fixing up. The price difference between an empty building and a going concern is often sizable. In a residential context, the removal of appliances might have a similar result.

2. BUSINESS INFORMATION

In some cases, a lender has information that is not generally available. The lender may be better placed to estimate the value of the property, particularly if it is a business enterprise about which the lender, by virtue of the relationship with the borrower, has had access to business information not generally known.

Business information may have the effect, it is sometimes suggested, of damping the interest of others. Is a lender participating just to force the price up? If a lender is unprepared to pay more, does it make sense for anyone else to do so? It is difficult to assess how potent the psychological factor might be.

3. A FORCED SALE DOES NOT OBTAIN THE BEST PRICE

One factor, it might be argued, that may be raised in support of allowing the lender to purchase at a court ordered sale is that the court is vigilant to ensure that a fair price is obtained. Consequently, from the borrower's perspective, it does not matter who purchases the property. In many cases, however, a forced sale fails to obtain the best price.[19] The manner in which the sale is conducted often discourages other buyers.

In the *Clark*[20] case, for example, the court noted that the lender taking the property at a forced sale price would reap an additional benefit of over 25 per cent of the value of the property by selling it at its real value and giving easy terms of payment.

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17. *Crown Life Ins. Co* v. *Clark*, (1915) 9 W.W.R. 333, 25 D.L.R. 519 (Alta. C.A.).

18. *Canada Permanent Trust Co.* v. *King Art Dev. Ltd.,* [1984] 4 W.W.R. 587, 601-2 (Alta. C.A.) *per* Moir J.A. (Dissenting). This is the modern case in which the Alberta Court of Appeal endorsed the *Rice* Order - first made in *Trusts & Guar. Co.* v. *Rice*, [1924] 2 W.W.R. 691, [1924] 3 D.L.R. 352 (C.A.). A *Rice* Order allows a lender to purchase the property and pursue the borrower for any deficiency.

19. *King Art, supra*, n. 18, 602, *per* Moir J.A. (Dissenting). For this reason, in Alberta the practice now requires the lender who seeks a *Rice* order to pay fair market value for the property: *Yorkshire Trust Co.* v. *Armwest Dev. Ltd.*, (1986) 1 W.W.R. 478 (Alta C.A.); *see also Standard Trust Co.* v. *Stoelzle*, [1990] B.C.J. No. 1498 (C.A.).

20. *Supra*, n. 17, 338-9.

Court ordered sales do not always proceed smoothly and a prospective purchaser is often in doubt for some time as to whether or not an offer will be accepted. A fairly common occurrence, particularly in rising markets, is to find that another party has made a last minute bid. The court might even approve a purchaser's offer and then change its mind, if higher offers are received.[21]

Prospective purchasers are not the only source of last minute offers. The borrower sometimes tries to upset matters. In one case, the borrower offered a trifling amount more than each bid presented to the court, requiring further proceedings and delay before a final bid was approved.[22] The court need not accept a last minute bid, although two factors might convince it to do so: an obligation to obtain the best price for the property, and a concern to be scrupulously fair to the borrower.

These aspects of a court ordered sale all have the potential to discourage the enthusiasm of prospective purchasers, perhaps resulting in prices that fall short of the property's fair market value.[23] In such a case, a lender may be able to buy the property and then almost immediately resell it for a profit. Meanwhile, the borrower is responsible for the deficiency that remains after the court ordered sale.

The judicial supervision of a court ordered sale, consequently, is not in itself good reason for allowing a lender to purchase property. The question becomes, it would seem, if a bargain is to be had, why should it not be available to the lender? This question is pursued in the next section.

4. PROFITS FROM RESALE

A scenario that makes most people uncomfortable arises from the prospect that a court ordered sale may not obtain the best price: in such a case, a lender who purchases the property may be able to resell it, perhaps for a substantial profit, and still pursue the borrower on the "deficiency." This happened, for example, in a notorious case of the 1920's, *Gordon Grant & Co.* v. *Boos*.[24]

When this occurs, the borrower loses the property but is still responsible for paying the remaining debt. The lender, on the other hand, not only recoups most, if not all, of the money that has been loaned, but may enjoy a profit. The series of transactions may result in a windfall for the lender. Because of this potential for injustice, some would argue, the lender should not be allowed to purchase mortgaged property.[25]

5. CONCLUSION

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21. *FBDB* v. *Mission Creek Farm Inc.*, (1988) 25 B.C.L.R. (2d) 188 (B.C.C.A.); *see also Westcoast Savings Credit Union v. Wachal*, (1988) 32 B.C.L.R. (2d) 390 (B.C.C.A.). In each of these cases, the person making the original offer brought an action to confirm it over the highest bid made in the later proceeding, but the law is clear that the court can take these steps to obtain the highest price.

22. *Vencer Mortgage Investments Ltd.* v. *Batley*, [1987] B.C.D. Civ. 2768-05 (C.A.); *see also First Pacific Credit Union* v. *Grimwood*, [1987] B.C.D. Civ. 2771-06 (C.A.). The objectives of a borrower who follows such a course are not clear. While the tactic may effectively disrupt proceedings, a successful bid by the borrower only benefits the lender, who may pocket the proceeds from the first sale and then apply to have the property sold again, until the lender's judgment is completely satisfied.

23. *See, e.g., Bank of B.C.* v. *Singh*, (1990) 51 B.C.L.R. (2d) 273 (C.A.) where the purchaser (not the lender) in the court ordered sale almost immediately resold the property for a profit of more than $100,000.

24. [1926] A.C. 781, 786 (P.C.).

25. Alberta has legislation which forbids execution until mortgaged property is sold. If the market is depressed so that property cannot be sold, a lender is powerless unless permitted to purchase. The lender "wants" to purchase because this is the only way any further proceedings can be taken. This is the origin of the *Rice* Order. In British Columbia, however, there is no such impediment to a lender pursuing alternative remedies against a borrower.

Allowing a lender to purchase property in a court ordered sale represents a reversal of legal policy. Although historical reasons raised against the practice are not entirely convincing, a consideration of modern foreclosure practice suggests that there is good reason to anticipate that a less restrictive approach to lender purchases may result in unfairness. For one thing, the practice of allowing a lender to participate decreases the chances of attracting the best price for the property. For another, there is more than a little prospect of injustice to the borrower. Moreover, the lender who purchases may possibly profit from the arrangement, if not from insider information, then because the lender who purchases the property has time to find a willing buyer, and could arrange easier terms for its sale, in this way obtaining a better price. Even if there is no actual prejudice, there is the appearance of injustice.

It is our view, consequently, that the former judicial antipathy to a lender purchasing the security is well founded. The current law in British Columbia, which has retreated from that position, is in need of attention.

E. Consultation

The issues involved in the decision of the Court of Appeal in the *Butler* case raised concerns in a number of quarters and these concerns were communicated to the Ministry of Attorney General. Officials within the Ministry referred the subject to the Commission for examination and advice.

We accorded this matter priority primarily because it was evident that economic conditions might well lead to an increase in foreclosure proceedings. Deferring work until the implications of *Butler* became clear might conceivably result in a response too late to assist borrowers and lenders in British Columbia. Moreover, since the Butler decision has at least some potential to lead to unfair consequences involving large sums of money, an increase in litigation on the issue can be expected, just as various foreclosure issues arose to demand an undue amount of the time of the Court of Appeal in the early 1980's (some of these cases have only recently come to the attention, finally, of the Supreme Court of Canada).

Our usual practice is to circulate a Working Paper widely among all of those whose interests would be affected by legal change, but in this case it was difficult to identify organizations capable of speaking on behalf of borrowers and, moreover, the suggested amendments to the law were by and large beneficial to borrowers. Consequently, the consultative document that was prepared was given only limited circulation among the lending community and their advisors, and only a short time was made available for consultation in light of the importance we attached to a timely response. A number of submissions were received from this sector which were lengthy, detailed, thoughtful and uniform in their rejection of any amendment to the current law.

The concerns of our correspondents can be grouped into four general categories:

(i) the problem is nonexistent;

(ii) lenders do not wish to acquire mortgaged property;

(iii) lenders do not reap windfall profits from acquiring mortgaged property;

(iv) foreclosure practice must remain flexible to answer the needs of lenders and borrowers when difficult issues arise on a foreclosure.

It is useful to mention these concerns briefly, and set out some of our thoughts on the points raised for our

consideration.

We were advised at length that if one refers to past and current practice, it is evident that no problem arises from allowing a lender to purchase mortgaged property. The observation is both correct and beside the point. The issue is whether *Butler* signals the prospect of a shift in legal policy that might have the potential to lead to changes in foreclosure practice and, if so, whether anticipated changes would be beneficial or regrettable. In our view, as we have discussed at length, changes in foreclosure practice that can be reasonably anticipated could only have negative consequences for borrowers.

Another point found in several submissions was that there is no need for legislative intervention since lenders do not wish to purchase mortgaged property. This may well be true at present for institutional lenders who, for one thing, are not set up to administer an inventory of property. But not all lenders are institutions and not all lenders are scrupulously fair to borrowers. Moreover, the *Butler* case arose as a result of a practice adopted by the Canada Mortgage and Housing Corporation, who provided insurance against default under the mortgage involved in the case.[26] CMHC's actions are the best evidence that our correspondents may be mistaken on this point: it would appear that at least some lenders (or those claiming through them) are interested in purchasing mortgaged property.

It is also worth pointing out that Alberta foreclosure practice has altered dramatically in response to the use of Rice Orders (which allow the lender to purchase the property and pursue the borrower on the deficiency). It is not beyond reason to suspect that lenders which find such a practice prudent in another Canadian jurisdiction may well find it advantageous to adopt in British Columbia.

Several submissions commented on the prospect of a lender reaping windfall profits - in the sense of proceeds that exceed the amount owed the lender - from purchasing and reselling mortgaged property. Experience shows that lenders not only do not enjoy such profits, but that lenders seldom recover all of the money they are owed once a mortgage goes into foreclosure.

The prospect of windfall profits, however, is only one of a variety of problems we find with a practice allowing lenders to purchase mortgaged property routinely. If lenders do not purchase property anticipating some profit from the exercise, it is legitimate to ask: why does the lender wish to purchase the property? Even so, our concern is not with windfall profits. Our concern is that any such profits would not only benefit the lender exclusively, since they would not be credited to the borrower, but this would all take place as part of a process which prolongs the borrower's exposure to additional legal proceedings, further preventing the borrower, now stripped of property, from regaining his or her financial feet.

Each of the submissions we received argued that purchase by the lender was a non-existent practice. One correspondent, for example, wrote:

> I have been practising in the area of mortgage foreclosures for seventeen years. During that time, I have handled in excess of ten thousand foreclosure actions, mostly on behalf of petitioners but often on behalf of respondents. In all of those cases, I have never been involved in a situation where the petitioner was bidding on the property.

But this correspondent, like the others, was opposed to legislation which would prevent such a practice from becoming the standard. Our correspondents seem to wish to have it both ways: while it is a virtually non-existent practice it is important to lenders that the option remain open. It is difficult to see how judicial flexibility would be unduly diminished by removing an option which is not resorted to.

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26. Mortgage insurance is discussed in greater detail in the next Chapter.

We have carefully considered the points raised in these submissions, and are indebted to those who took the time to consider and comment on our work. Nothing in the submissions we received, however, shakes the firmness of our conviction that these issues must be addressed by legislation and they must be addressed promptly. This is a matter to which we attach high importance.

CHAPTER IV REFORM

A. Introduction

The discussion in the last Chapter arrived at the conclusion that as a general rule the law should not allow lenders to purchase mortgaged property. This Chapter considers options for revising the law. Two basic paths are available. One would attempt to fine-tune the law, to provide that, as a starting point, lenders are not permitted to purchase, but then go on to identify specific situations where an exception might be tolerable. The other approach would be to allow a lender to purchase in any situation, but to remove the distinction that currently exists between purchasing property in a court ordered sale, and acquiring it by foreclosure.

B. Allowing Exceptions to the General Rule

Over the years, the courts have in some cases allowed lenders to purchase mortgaged property. Are there categories of exceptions that legislation should recognize? That question is pursued in this section.

1. WHERE PURCHASE IS A PRECONDITION TO EXECUTION

In Alberta, lenders are often permitted to purchase mortgaged property. Courts countenance this practice because Alberta legislation provides that a lender may not take steps to recover the secured debt until the property is sold.[1] If no one is prepared to purchase the property, the lender is prevented from pursuing any remedies against the borrower. The only solution to this problem is to allow the lender to purchase the property, while retaining rights against the borrower to recover the outstanding debt.

This is not a problem that arises in British Columbia. After the borrower's redemption period ends (and even earlier, unless the court otherwise orders)[2] the lender may take execution proceedings on the personal judgment regardless of whether the property has sold. Consequently, in British Columbia the lack of a willing purchaser is not reason in itself to allow the lender to purchase the property. If the lender wants to acquire the property in such a case, the option of foreclosure is available.

2. WHERE THE BORROWER IS CREDITED WITH THE PROCEEDS RECEIVED BY THE LENDER ON RESALE OF THE PROPERTY

In *Royal Trust Co.* v. *Heelo*,[3] the lender received title to the property to assist in selling it by agreement for sale (an arrangement under which the vendor retains legal title until the purchaser has paid for

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1. *See* M.J. Trussler, "Foreclosure of Corporate Mortgages: Update 1984," (1985) 23 Alta. L. Rev. 332.

2. *See, e.g., Citadel Life Assurance Co.* v. *Abacus Cities Ltd.*, (1983) 45 B.C.L.R. 138 (S.C.); *Zonailo* v. *Cypco Holdings Ltd.*, [1983] B.C.D. Civ. 2768-16 (S.C.); *IWA and Community Credit Union* v. *Erickson*, [1983] B.C.D. Civ. 2768-24 (C.A.); *Bank of Montreal* v. *Pilling and Pilling*, (1984) B.C.L.R. 179 (C.A.). A court may stay execution until after the redemption period, and the borrower may even obtain further extensions pending, *e.g.*, appeal, unless the stay is of no practical use to the borrower: *e.g.*, where the borrower has little equity and few prospects of redeeming the property: *see I.W.A. and Community Credit Union, ibid.*; *H.A. Roberts (H.A.) Group Ltd.* v. *Dawson Lands Ltd.*, (1983) 46 B.C.L.R. 24 (S.C.); *Prospect Mortgage Corp.* v. *Bragg*, [1983] B.C.D. Civ. 2768-34 (C.A.). Where the lender is allowed to proceed, the borrower's time to redeem may be extended and, in any event, money raised by execution will be credited against the borrower's debt.

3. (1986) 4 B.C.L.R. (2d) 40 (C.A.).

the property in full). As such, the lender did not acquire the property for any reason other than to facilitate the court ordered sale in the foreclosure proceedings.

Heelo involved an unusual situation and the decision itself is largely unobjectionable because the borrower was credited with the full price received by the lender on the sale. The troubling aspect of the *Heelo* decision is that it is relied upon by lenders who wish to purchase mortgaged property in other circumstances.

The facts in *Heelo* could have been dealt with by vesting title in a third party to facilitate the transfer of the property by agreement for sale. There would appear to be no need to single these circumstances out as an exception to a general rule against allowing lenders to purchase mortgaged property. The result has been to introduce an unfortunate element of confusion into the general policy we believe the law should advance.

3. WHERE THE LENDER IS A TRUSTEE

In some, admittedly rare, cases, the lender will also be in a formal trust relationship with the borrower. A lender who is a trustee is not permitted to foreclose, a legal fact that has been regarded as sufficient justification to allow the lender to purchase the property.[4]

It is not clear to us what is gained by allowing a trustee to purchase but not foreclose. In British Columbia, under the current law, the beneficiary/borrower is better off if the trustee forecloses rather than purchases the property, since foreclosure brings personal liability to an end while purchase of the property does not. In our view, legislation should not perpetuate this oddity of the law.

4. THE "LENDER" IS A MORTGAGE INSURER

In *Bank of Montreal* v. *Butler*, the party applying for permission to purchase was the Canada Mortgage and Housing Corporation, one of whose functions is to assist people in acquiring homes. CMHC provides mortgage insurance - for a fee - to borrowers who take out mortgages securing an amount in excess of 75 per cent of the property's value. The lender is paid by the insurer in the event the borrower defaults under the mortgage.

In the face of an economic slowdown, where more defaults are to be expected and fewer purchasers are to be found, it may make sense for a mortgage insurer to acquire the property. In this way, the insurer can manage inventory and perhaps reduce losses by awaiting the property market's recovery.

Even so, inventory management does not require that the borrower remain liable on the personal covenant. A lender wishing to defer sale of mortgaged property until a later date can elect to take the property by foreclosure.

Saskatchewan has adopted just such a policy when mortgage insurance is involved. Under the Saskatchewan *Limitation of Civil Rights Act*, a borrower is not liable on the personal covenant, unless the mortgage involved is made available under the *National Housing Act*.[5] But a recent amendment provides that even when an NHA mortgage is involved, if it is insured by CMHC, the protection from personal liability continues. *HFC Trust Ltd.* v. *Gettle* involved an NHA lender who wished to sell the mortgaged property and

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4. *Tenant* v. *Trenchard*, [1869] IV Ch. App. 53.

5. *See* S.S. 1982-83, c. 16, s. 24; *CMHC* v. *Hagblom*, [1983] 6 W.W.R. 413 (Sask. Q.B.).

pursue the borrower for the deficiency. It was held that under the Saskatchewan legislation, because of the mortgage insurance, the borrower was not personally liable.[6]

5. CONCLUSION

None of the situations where courts have allowed lenders both to purchase mortgaged property and continue to look to the borrower for repayment of the debt should be protected. It is our view that legislation should provide that whatever the means by which a lender acquires ownership of mortgaged property, upon doing so the borrower's personal liability to repay the debt secured by the mortgage should come to an end.[7] An appropriate revision of the law could be achieved by an amendment to section 28 of the *Property Law Act*, which currently provides for such a result when a lender forecloses on a mortgage.[8]

While we believe the general outlines of the policy that should be adopted are clear, there are questions of detail which must be further considered.

C. Acquisition by a Lender's Agent

In some cases, instead of directly acquiring property a lender may arrange for a nominee to purchase the property in a court ordered sale. A recent example of this subterfuge is to be found in *Parklane Enterprises Ltd.* v. *Bennett*.[9] The sale had been approved by the court and, presumably, was for a fair price, but even so, on discovering the relationship between the purchaser and the lender the court set the conveyance aside.

The *Parklane* decision sits uncomfortably with the policy adopted in the *Butler* case. Under the current law, a lender can purchase mortgaged property with the court's permission. If permission is not obtained, however, a third party may not purchase mortgaged property on behalf of a lender, even if the price is a fair one. If there is nothing wrong with the lender purchasing the property, what is the objection to allowing an agent to do so? It would seem that the fatal defect was not the subterfuge, but the failure to apply for permission before purchasing. But if that is the case, why could the transaction not be ratified by the court after the event? Aspects of the *Parklane* decision appear to conflict with the *Butler* case.

In our view, legislation clarifying the policy that should govern in these circumstances should apply not only to lenders but agents acting on their behalf.[10] The *Parklane* case suggests that courts are vigilant on

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6. [1990] 5 W.W.R. 727 (Sask. Q.B.).

7. An alternative would be to extend rights of redemption - allow such a right to extend past sale - and to provide that a lender account to the borrower for any profit made on resale of the property. In that way, the borrower's liability would be reduced. Some reflection, however, suggests that it is not satisfactory solution. Several problems might be anticipated: *e.g.*, the lender may not sell for several years. It might be unfair to credit the borrower with any portion of the profit, since the lender will have incurred costs in maintaining the property. Moreover, the lender who purchases the property also assumes the risk that values will decline.

8. Manitoba has adopted similar legislation: *The Mortgagee Act*, R.S.M. 1979, c. M200, s. 16; *see man. Dev. Corp.* v. *Berkowitz*, [1979] 5 W.W.R. 138, 144 (Man. C.A.). The legislation was adopted in 1934, probably in response to *Gordon Grant & Co.* v. *Boos*, [1926] A.C. 781 (P.C.).

9. [1990] B.C.D. Civ. 2771-06 (S.C.).

10. During our consultation, comment on this issue took two different directions. One submission suggested that an approach based on agency might sweep in persons who are unrelated to the lender, such as real estate agent handling the sale of the property who decides to purchase it. Another submission suggested that care must be taken not to frame the legislation too narrowly. In some cases, a lender might conduct business through as series of corporate entities (*e.g.*, one company handles lending while another acquires property or makes other kinds of investments). These companies may not be in a direct relationship, but neither are they necessarily dealing at arms length. The concern is to include those who purchase the property

this issue.[11] Nevertheless, it would be useful if legislation were to address the point explicitly.[12]

D. Residential Mortgages

In recent years, the law governing mortgages and foreclosure practice has evolved and functional distinctions have been drawn based on the kind of mortgage involved. A mortgage arranged for commercial reasons will have one set of consequences. A mortgage arranged to purchase a residence is treated slightly differently. These kinds of distinctions are most evident in recent amendments to the *Property Law Act* which revised the law relating to the personal liability of a borrower after mortgaged property had been sold. These amendments, for the most part, operate to protect the consumer borrower.

A similar distinction can be drawn on the issues addressed in this Report, and the amendments to the *Property Law Act* are an example of how to distinguish between commercial borrowers and those who have arranged mortgage financing to purchase a residence. Section 19.1 of the *Property Law Act* provides a useful model for drawing such a distinction:

> 19.1 (1) In this section and sections 20 to 20.3, "agreement for sale" means an agreement for sale as defined in section 16.1(1) of the *Law and Equity Act*.
>
> (2) In sections 20.2 and 20.3 "residential mortgage" or "residential agreement for sale" means a mortgage or agreement for sale registered against the residence where the borrower resides that was granted, entered into or assumed for the purpose of permitting the borrower
>
> (a) to acquire the residence,
>
> (b) to make improvements to the residence,
>
> (c) to make expenditures for family or household purposes, or
>
> (d) to re-finance for any of the purposes in paragraphs (a) to (c).
>
> (3) In subsection (2) reference to the borrower is reference to
>
> (a) the mortgagor or purchaser under the agreement for sale, or
>
> (b) where the mortgage has been assumed or the purchaser's interest in the agreement for sale transferred, the person who assumed the mortgage or the person to whom the purchaser's interest was transferred, as the case may be.
>
> (4) A reference in sections 20.2 and 20.3 to the "personal covenant" or "covenants" is deemed to be a reference to all covenants, terms and conditions in the mortgage or agreement for sale, and where those sections provide that liability in respect of the personal covenant or covenants ceases, liability ceases with respect to all those covenants, terms and conditions in the mortgage or agreement for sale.

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on behalf of the lender - incorporating a kind of arms length requirement between lender and purchaser to avoid the consequences of the section - or who have taken an assignment of the personal covenant: *see, e.g., Financial Corp.* v. *Timber Rock Enterprises Ltd.*, (1982) 40 B.C.L.R. 85 (S.C.). We have attended to this point in the draft legislation set out in the next Chapter.

11. *See also Lam* v. *Sen*, [1983] 1 W.L.R. 1349 (P.C. on appeal from Hong Kong).

12. A similar conclusion was reached by the Law Reform Commission of Victoria (Report No. 8, *Mortgagee Sales and Judgment Debts*, June 1987) with respect to sales under the lender's power of sale to a subsidiary company in which the lender is a director or shareholder.

It is our conclusion that legislation ending personal liability on the covenant when a lender acquires legal title to property should only apply to "residential mortgages" and "residential agreements for sale" within the meaning of section 19.1 of the *Property Law Act*.[13]

E. Collateral Security

Two submissions were critical of the recommended changes on the basis that they did not address the status of a guarantor of the borrower's personal covenant, or of an indemnitor who shared liability to repay the debt. These are classes of collateral security which a lender will commonly arrange to ensure repayment of the principal loan.

Our inquiry has focused on the existing section 28 of the *Property Law Act*, and the policy advanced by it. In our view, the amendments we recommend do not require a reconsideration of the position already adopted by the legislature with respect to a lender's rights under collateral security. Our analysis is set out in Appendix B to this Report.

13. Two submissions said that not only was it bad policy to distinguish between residential and other kinds of mortgages, but the current method adopted in the *Property Law Act* does so inadequately. Interestingly, the policy rationale in the context of Saskatchewan legislation has recently been considered - and described with approval - by the Supreme Court of Canada in *National Trust Co.* v. *Mead*, (1990) 71 D.L.R. (4th) 488. As to the effectiveness of s. 19.1, it has only been in operating for a few years, so that any substantive amendment of it would be premature, although experience to this point has not revealed defects. As a test for determining legal consequences, "residence" is not entirely satisfactory. If it becomes necessary to amend the legislation, one option suggested to us is to revise the test to provide expressly that the definition encompasses situations where the borrower resides *or has resided*, so that a borrower who moves away from the property before foreclosure may still claim the benefit of the legislation.

CHAPTER V RECOMMENDATIONS

A. Recommendations

This Report has considered the ways in which a lender may acquire title to mortgaged property, and the distinctions drawn by the law depending on the method used to do so. It is our conclusion that the current law should be revised so that when a borrower defaults on a mortgage and a lender eventually acquires title to the mortgaged property in circumstances where a deficiency remains, the borrower's liability on the personal covenant is brought to an end. The revised law should only apply when the mortgage is arranged to acquire residential property, as that concept is defined in section 19.1 of the *Property Law Act*.

To implement the policy of our conclusions, it is our recommendation that section 28 of the *Property Law Act* be revised along the following lines:

> 28. (1) The personal covenant of the mortgagor or the purchaser to pay is no longer enforceable where
>
> (a) an order absolute for foreclosure or for cancellation of the agreement for sale is made, or
>
> (b) the property is subject to a residential mortgage or residential agreement for sale and the mortgagee or vendor becomes owner of the property free of the interest of the borrower or purchaser.
>
> (2) For the purposes of subsection (1), a mortgagee or vendor includes any person who
>
> (a) purchases the property on behalf of the mortgagee or vendor,
>
> (b) takes an assignment of the personal covenant from the mortgagee or vendor, or
>
> (c) the court considers to be so affiliated with the mortgagee or vendor that purchase by the person will in substance be a purchase by the mortgagee or vendor.
>
> (3) Nothing in this section affects the jurisdiction of the court to set aside or reopen an order absolute for foreclosure or for cancellation of an agreement for sale.
>
> (4) Where an order absolute for foreclosure or for cancellation of an agreement for sale is set aside or reopened, the liability of the mortgagor or the purchaser under the personal covenant revives.
>
> (5) The benefit of this section cannot be waived by the borrower or purchaser.

Subsections (1)(a) and (3) are based on the existing section 28. They carry forward current policy.

Subsection (1)(b) achieves the policy amendment we recommend relating to a lender's rights after acquiring the mortgaged land.

In keeping with the current policy of section 28, the legislation applies to both mortgages and agreements for sale.

Subsection (5) clarifies that the protection offered by section 28 is not subject to variation by the agreement of the lender and borrower. That, in fact, is the current policy of section 28 as it applies to the vesting of ownership by court order in foreclosure or cancellation proceedings. To ensure that such a point is not raised with respect to the amended legislation, subsection (5) places the issue beyond doubt.

It will be necessary to amend section 19.1 of the *Property Law Act* to provide that section 19.1 applies to the amended section 28. (Section 19.1 provides a series of definitions - such as the definitions of "residential mortgage" and "residential agreement for sale" - which will define the ambit of section 28 as revised.)

It is also our conclusion that the amendments should only apply to mortgages or agreements for sale where the lender or vendor acquires title after the amendments come into force.

B. Acknowledgments

We are indebted to those who commented on the Working Paper. The submissions received provided useful information on not only current practice and experience in commercial lending, but the perspective of lawyers involved in the complexities of security placement and realization on default. The detailed analysis of the policy set out in the consultative document that preceded this Report helped us refine our thinking on these issues, as reflected in the form of our final recommendations set out above.

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APPENDIX A

EXCERPT FROM
AN ACT TO AMEND THE "LAND REGISTRY ACT"

S.B.C. 1917, C. 33, S. 2

Registration of mortgagee in indefeasible fee extinguishes covenant

14A. (1.) The registration of a mortgagee or any person claiming under him in the register of indefeasible fees as owner of the fee by virtue of a final order of foreclosure shall operate to extinguish all rights of the mortgagee or those claiming under him under any personal covenant for payment contained in said mortgage, and any judgment obtained by him or them thereon, and any rights under any bond or collateral security or obligation for the payment of the mortgage debt.

Mortgagee may obtain interim certificate

(2.) The mortgagee shall be at liberty at any time after securing such final order to apply for registration and to endorse thereon 'Interim certificate only required,' and the Registrar shall, if satisfied that a good safe-holding and marketable title has been made out by the applicant, issue to him a certificate in the Form C (1) in the First Schedule hereto, and note the fact of such issuance against the title in the register.

Reopening foreclosure

(3.) Notwithstanding any rule of law or equity to the contrary, no such final order of foreclosure shall be or be deemed to be or to have been reopened by the mortgagee proceeding to execution against the goods or lands of the mortgagor, or any person liable for the mortgage debt or any part thereof, unless he shall have recovered a portion of his debt through such proceedings.

How mortgagee may obtain indefeasible certificate

(4.) The mortgagee may at any time surrender the interim certificate, and upon such surrender and upon furnishing evidence satisfactory to the Registrar that he has not since the date of the final order for foreclosure done any act to reopen the foreclosure or recovered or been paid any portion whatever of the mortgage debt, shall be entitled to completion of registration in accordance with his application and to the issuance of a certificate of indefeasible title to the mortgaged lands.

Proof of title in applications under foreclosure order

(5.) In all applications founded upon a final order of foreclosure, the Registrar shall, upon production of the order nisi and final order, and of proof that the writ of summons was duly served upon all parties appearing upon his records as the owners of any interest in or charge upon the lands, priority to the regularity of all intervening proceedings, and no person foreclosed by any such order who, having been served with the writ, is deprived of any lands or interest therein by the issuance of a certificate of indefeasible title shall have any action or claim against the Assurance Fund based on any alleged defect in the foreclosure proceedings.

APPENDIX B

COLLATERAL SECURITY AND SECTION 28 OF THE *PROPERTY LAW ACT*

A. Introduction

Some correspondents suggested that amendments to section 28 of the *Property Law Act* revising the law governing a lender's rights after purchasing mortgaged property must also address the position of guarantors and indemnitors. As set out in the main body of this Report, we have concluded that legislation should not amend the current law on this point. For one reason, the object of section 28 is not to prevent lenders from being repaid, nor is the policy simply to confine remedies to the property. Primarily, it would seem, the section serves to mark the time when the lender should stop pursuing the borrower. Little would be achieved by legislation that restricted rights against guarantors or indemnitors after foreclosure, since the natural result would be to find lenders more zealous in pursuing those remedies beforehand.

This Appendix reviews the ability of a lender to enforce collateral security in foreclosure proceedings, and sets out our reasons for not modifying the current law in this area.

B. Classes of Collateral Security

The forerunner of section 28 expressly provided that a lender could not enforce rights under collateral security after foreclosure.[1] It is not clear why section 28 is silent on the point, but a good guess is that it was felt that a lender should be allowed recourse against certain kinds of collateral security. What kinds? Case law under section 28 gives some idea. Trends can be discerned, although the judicial mind is not completely made up. It is convenient to categorize decided cases into four groups to demonstrate the distinctions that are (implicitly) being drawn:

(a) collateral security against personal property owned by the borrower;

(b) assignment of an obligation owed the debtor by a third party;

(c) assumption of responsibility for the debt by a third party as a guarantor; and

(d) assumption of responsibility for the debt by a third party as a co-debtor.

1. COLLATERAL SECURITY AGAINST PERSONAL PROPERTY OWNED BY THE BORROWER

Before the enactment of the *Personal Property Security Act*[2] "seize or sue" provisions dealt with the overlap of rights a lender enjoyed under security arrangements involving both personal and real property.[3] Those provisions have now been modified. The degree to which it is necessary to harmonize the operation of personal property legislation with rights relating to real property will become apparent as expertise is developed under the new regime of personal property security.

2. ASSIGNMENT OF AN OBLIGATION OWED THE DEBTOR BY A THIRD PARTY

The courts seem to have little trouble allowing a lender to pursue collateral security falling into this category. Even after

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1. *See* Appendix A. The section remained unchanged until its replacement by section 28. *See Land Registry Act*, R.S.B.C. 1960, c. 208, s. 199(1).

2. S.B.C. 1989, c. 36.

3. *Harbour Way Motel Ltd.* v. *Westcoast Savings Credit Union*, (1986) 3 B.C.L.R. 161 (C.A.) (land mortgages and chattel mortgages).

receiving an order absolute of foreclosure, lenders have been permitted to enforce rights under, for example, an assignment of rents[4] and an assignment of insurance proceeds.[5] Protecting the borrower does not require preventing the lender from looking to this kind of security. The amendments to section 28 we recommend do not call for legislative revision on this point.

3. ASSUMPTION OF RESPONSIBILITY FOR THE DEBT BY A THIRD PARTY AS A GUARANTOR

The lender may have required the borrower to find a third party to vouch for his or her creditworthiness and, perhaps, accept responsibility for all or part of the debt. A third party could assume responsibility to pay when the borrower defaults, as a guarantor, or the third party could assume equal responsibility for the debt as a co-debtor or indemnitor.[6] In this section, we will examine the law relating to guarantors and, in the next, that which governs indemnity agreements.

Cases in this category differ markedly from those in the first and second groups. In the first group, the lender is empowered to look to other property owned by the borrower. In the second group, the lender is authorized to collect debts or enforce rights owed the borrower. The first two groups differ only in the kind of property or right in favour of the debtor against which the lender may assert rights.

With respect to a guarantor, however, the lender enjoys rights against a party who has pledged his or her creditworthiness without necessarily owing any obligation to the borrower nor obtaining any advantage from the transaction. Some may find it unfair, in such a case, to allow the lender to recover against a third party while the borrower is immune from liability. This perspective seems, as a general matter, to have informed many cases dealing with guarantees, and those in the foreclosure context are no exception.

The initial judicial reaction was to find that after foreclosure section 28 prevents a lender from proceeding on a guarantee, because taking order absolute of foreclosure impairs the guarantor's rights against the debtor.[7] But two cases suggest that the issue is not so neatly resolved. In *Victoria Mortgage Corp*. v. *Elexir Development Corp.*[8] it is said that a guarantor's rights are not impaired by foreclosure where the guarantor retains rights of contribution against the borrower (rights of contribution are not affected by section 28). *Western & Pacific Bank of Canada* v. *Axiom Management Ltd.*[9] suggests that foreclosure will not affect rights against a guarantor where the guarantee provides, as they commonly do, that impairment of the guarantor's rights does not alter the guarantor's liability.[10]

The direction of the case law would appear to be discernible: it seems that the courts are heading toward a position where, provided the guarantee is properly drawn, the guarantor remains liable even after the borrower is released from liability under the mortgage by operation of section 28 of the *Property Law Act*. In any event, there is no need to amend section 28 on this point.

4. ASSUMPTION OF RESPONSIBILITY FOR THE DEBT BY A THIRD PARTY AS A CO-DEBTOR

One correspondent suggested that the obligations of a third party under an indemnity agreement - which, essentially characterizes the indemnitor as a co-debtor - survives the operation of section 28. We see no reason why the courts should adopt an approach which differs markedly from that taken with respect to guarantees, although it does not appear that there is case law to

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4. *See, e.g., Vancouver City Savings Credit Union* v. *Miller Electronics Ltd. and Gendis Inc*., (1987) 13 B.C.L.R. 205 (C.A.).

5. *Canim Lake Farms (1969) Ltd.* v. *Toronto-Dominion Bank*, [1987] B.C.J. No. 1728 (S.C.).

6. The distinction is explained in *Walter E. Heller Financial Corp*. v. *Timber Rock Enterprises ltd*., (1982) 40 B.C.L.R. 85 (S.C.). citing with approval *Sarbit* v. *Hanson and Booth Fisheries (Can.) Co.*, 58 Man. R. 377, 1 W.W.R. 115, [1952] 2 D.L.R. 108 (C.A.).

7. *Timber Rock, supra*, n. 6; *Johl* v. *Toronto-Dominion Bank*, [1988] B.C.D. Civ. 2764-02 (C.A.); *Westcoast Savings Credit Union* v. *Andrews*, (1987) 19 B.C.L.R. (Sd) 45 (C.A.); *F.B.D.B.* v. *F.J.H. Const. Ltd.*, (1988) 4 W.W.R. 1 (S.C.).

8. [1990] B.C.J. No. 710 (S.C.).

9. (1989) 36 B.C.L.R. 67 (S.C.) (The case dealt with co-covenantors).

10. *But see Schnurch* v. *Ploeger*, [1991] B.C.J. No. 596 (C.A.), which involved a claim for contribution between guarantors, not a claim by a lender against a guarantor. The court assumed that the lender's rights against the guarantors were ended by order absolute of foreclosure, but the case gives no indication of the terms of the guarantee. The decision may turn on the particular facts of the case.

support the proposition.[11]

C. Conclusion

The enactment of legislation regarding the effect of section 28 of the *Property Law Act* on collateral security is unnecessary at this time. It would appear that when section 28 was enacted, a decision was taken to leave the courts with sufficient flexibility to define when a lender can, and when a lender cannot, recover on collateral security. There is no evidence from the existing case law that the courts require assistance on this point, although future developments may invite a reconsideration of the issue.

11. *Timber Rock, supra*, n. 6, suggests that in some cases an indemnitor may be liable where a guarantor would be released from liability, but that case characterized the agreement in question as a guarantee, not an indemnity.