

THE THREE MONTH MORTGAGE PENALTY

- Understanding the Principles -

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Can a mortgagee charge a three month penalty when it is attempting to enforce repayment of its mortgage loan on default?

Mortgagees have been raising this issue for some time but it has become more pressing in recent years now that mortgagees have, in many cases, been adding a three months interest penalty to their claim when issuing Notice of Sale proceedings upon default in their mortgage.

Prepayment Penalties Per Se

The first point to make and one clearly supported by the case law, is that any additional monies sought by the mortgagee which are characterized as penalties, bonuses or interest at a higher rate after default than before default, may not be imposed by a mortgagee and will not be enforced by a court. These additional charges are restricted by Section 8 of the federal *Interest Act*,¹ which states:

8. (1) 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 which has the effect of increasing the interest on the arrears beyond the rate of interest payable on the principal money not in arrears.

Both the constitutionality of Section 8 of the *Interest Act* and its application to invalidate bonus or additional payments charged on default under a mortgage were determined in the affirmative by the Supreme Court of Canada in *Tomell Investments Ltd. v. East Marstock Lands Ltd.*²

¹ R.S.C. 1985, c. I-15.

² (1977) 77 D.L.R. (3d) 145 (S.C.C.) ("*Tomell*").

The Ontario Court of Appeal has also held that Section 8 of the *Interest Act* will invalidate the additional payment even where such payment is limited to three months interest if the payment is framed as a bonus payable on default in addition to the accrued interest and costs under the mortgage.³

However, where the court was satisfied that the additional monies payable on default were designed to compensate the lender for its damages resulting from the early repayment of its loan and did not exceed the equivalent of three months interest, the Divisional Court was prepared to permit the lender to charge such additional monies.⁴ In relying on this case, care must be taken because the Divisional Court did not consider the prior decisions of the Supreme Court of Canada or the Court of Appeal and this case may be distinguished on that basis.

It would appear that the prohibition also applies to any requirement for the mortgagor to compensate the Lender for its lost income yield for the balance of the term of the mortgage to maturity where such lost yield exceeds three months interest.⁵ Although some lawyers have indicated that they find this unfair to the lenders,⁶ it would appear that the rationale for this result is that the mortgagee is not bound to accelerate the debt and call for repayment in full of the entire principal balance and accordingly it is a result of the Lender's own doing that it has lost the remaining yield to maturity. As an alternative, the lender could choose remedies which do not result in accelerating repayment of the entire principal indebtedness, such as operating the mortgaged property by taking possession or through a Receiver, and collecting income on a monthly basis to service the lender's debt for the remainder of the original mortgage term and avoid losing any yield to maturity. Even though this may not be an attractive or practical alternative for most lenders, the courts appear to be reluctant to impose the cost of the lost yield onto borrowers except where the borrower is expressly asking the lender to accept early repayment of the debt and the loan documents expressly provide for such compensation.

³ See *Gullett v. Income Trust Company*, [1985] O.J. No. 200 (C.A.) ("*Gullett*").

⁴ *O'Shanter Development Company Ltd. v. Gentra Canada Investments Inc.*, 47 R.P.R. (2d) 24, 25 O.R. (3d) 188 (Ont. Div. Ct.) ("*O'Shanter*").

⁵ *Mastercraft Properties Ltd. v. EL EF Investments Inc.*, 32 R. P. R. (2d) 312, 103 D.L.R. (4th) 759, 14 O.R. (3d) 519, (leave to the Supreme Court of Canada denied) (Ont. C.A.) ("*Mastercraft*").

⁶ See Walter M. Traub, "The Sanctity of a Closed Mortgage – Does it Still Exist?" (2006) The 3rd Annual Real Estate Law Summit, Law Society of Upper Canada.

The Three Month Interest Issue

If no penalty or bonuses are permitted, how is it then that some courts have allowed the mortgagee to recover three months' interest on default?

The answer lies in Section 17 of the *Mortgages Act*,⁷ which reads as follows:

17. (1) Despite agreement to the contrary, where default has been made in the payment of any principal monies 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.

This Section does not deal with payment of a bonus or penalty under a mortgage. Rather, it is an attempt to codify, or set out in statute, the long standing common-law restriction on the ability of a mortgagee to charge a mortgagor for compensation for the mortgagee unexpectedly receiving repayment of its principal amount on a day other than as agreed by the mortgagee.

At common-law, the mortgagor historically was called upon to give either 6 months notice to the mortgagee that it would receive repayment of its loan on a particular day other than the day specified in the loan documents or to pay 6 months interest in lieu of such notice. Section 17 of the *Mortgages Act* was enacted to reduce this 6 month period to three months notice to the lender or three months interest in lieu of such notice.⁸

⁷ R.S.O. 1990, c. M.40.

⁸ For an excellent review of the historical basis for this concept and a review of the applicable cases please refer to Richard Horodyski, "Understanding the Mortgagee's Right to Three Months Interest After Default and Enforcement – Statutory Right or Unenforceable Penalty?" (2005) The 2nd Annual Real Estate Law Summit, Law Society of Upper Canada.

The Mastercraft Case

Prior to 1993, the implications of Section 17 of the *Mortgages Act* was not very well known and few lenders attempted to collect additional compensation for receiving monies not on a day specified in the loan documents.

However, in 1993, the Ontario Court of Appeal released its decision in *Mastercraft Properties Ltd. v. EL EF Investments Inc.*,⁹ in which Madame Justice McKinlay confirmed on behalf of the Court that the mortgagee may claim this form of compensation without violating Section 8 of the *Interest Act* where the claim was not for a bonus or penalty but for compensation by way of three months' notice of the day of payment or three months' interest in lieu of such notice.

The court in the *Mastercraft* case stated:

Had the covenant in question required the payment of interest during the notice period *plus* an additional amount equivalent to three months' interest, then the provision, and its attempted enforcement, would clearly have been contrary to Section 8. However, if three months' notice of payment were given by the mortgagor, he would merely pay interest at the mortgage rate during the three month period, and at the end of the period he would be entitled to a discharge upon payment of all arrears. If you wish to discharge at any time after default without giving notice, he would have to pay all arrears of principal and interest plus a charge equal to three months' interest, for the privilege of being allowed to pay the arrears without giving the agreed three months' notice.

The court went on to say:

By its terms, the provisions of Section 17 are incorporated into every mortgage in Ontario and override any contrary provision in the mortgage. Section 17 gives a mortgagor a right, when in default of payment of principal, to repay that principal on giving three months' notice to the mortgagee of his intention to pay, and protects him

⁹ *Supra* note 5.

from *any further payment of interest except to the date of payment*. Such interest would merely constitute payment for the use of the principal during the notice period.

The provision protects the mortgagor by permitting payment of arrears without penalty, or by permitting early redemption at a price. It protects the mortgagee by giving him a three month period during which to arrange for a reinvestment of his principal, or monies to compensate for lack of that notice. The option is that of the mortgagor.

It is critical to note that the court has determined that "the option is that of the mortgagor" to either give the three months notice and have the regular interest rate set out in the mortgage run on principal until the end of the three month period, or whether the mortgagor wishes to shorten that period and pay the three months interest in advance. By corollary, it is not up to the mortgagee to decide that the three months interest is due in addition to the principal, interest and costs under the mortgage and impose this decision unilaterally on the mortgagor.

The *O'Shanter* Decision

If that had been as far as it went, it is unlikely that we would have as much controversy as we do now. However, in 1995, the Ontario Divisional Court issued its decision in *O'Shanter Development Company Ltd. v. Gentra Canada Investments Inc.*,¹⁰ which in the writer's respectful opinion is the root cause of the uncertainty and has been misinterpreted by many of the lower courts and lawyers in its application to Notices of Sale.

In the *O'Shanter* case, a first mortgagee had issued Notice of Sale under its mortgage without requesting three months interest as a bonus. *O'Shanter* was a second mortgagee and issued its own Notice of Sale. The first mortgage was not redeemed within the period of time set out in its Notice of Sale. Rather, the second mortgagee ultimately sold the property under its Notice of Sale and after the sale attempted to repay to the first mortgagee its outstanding principal and interest to the date of payment as set out in the Notice of Sale previously issued by the first mortgagee. At the time of attempted repayment by the second mortgagee, the first mortgagee refused to discharge its mortgage unless it also received, in addition to the principal, interest and costs to the date of

¹⁰ *Supra* note 4.

repayment, a three month interest payment in lieu of notice of the date on which prepayment would be made.

Ultimately, the Divisional Court held that the first mortgagee could require such three month payment under Section 17 of the *Mortgages Act* and was not in contravention of Section 8 of the *Interest Act*.

In addition, the court specifically held that although the issuance of the Notice of Sale triggered the right of the mortgagor to redeem the mortgage and repay the loan in full and that this right extended beyond the 35 day period set out in the Notice of Sale, the mortgagee was only required to accept the amount of monies set out in the Notice of Sale up to and including the date set out in the Notice of Sale as required by Section 43 (1) of the *Mortgages Act* which reads as follows:

43(1) Where such demand or notice requires payment of all money secured by or under a mortgage, the person making such demand or giving such notice is bound to accept and receive payment of the same if made as required by the terms of such demand or notice.

The Court held that based on the wording of that Section of the *Mortgages Act* once the 35 day period has passed the lender was no longer bound to accept only the amount set out in the Notice of Sale. Accordingly, the mortgagee was entitled to ask for three months notice or a three months' interest payment in lieu thereof, when it was asked to accept repayment of its loan on a date later than that mentioned in the Notice of Sale in order to give such lender time to find an alternate use for the repaid monies.

So far it would appear that this decision is consistent with the *Mastercraft* decision of the Court of Appeal, however the Divisional Court went on to make the following statement in regard to the Prepayment Amount set out in the mortgage which was defined to be three months interest:

On the basis of the wording of the mortgage contract itself and subject to the other issues, the first mortgagee, Gentra, was entitled to claim the Prepayment Amount in its notice of sale.

It is important to remember that the Notice of Sale actually issued in the *O'Shanter* case did not contain the three months interest amount and the Court decided that the three months interest was payable as a result of the mortgagee receiving payment after the 35 day notice set out in the Notice of Sale and thereby the date when it would otherwise have expected to receive the money. As a result, this statement in the *O'Shanter* decision is Obiter at best and should not be treated as anything other than that.

Moreover, that statement, in this writer's respectful opinion, flies directly in the face of the decision of the Court of Appeal in the *Mastercraft* case for at least two reasons.

Firstly, in that decision the Court of Appeal expressly stated that: "had the covenant in question required the payment of interest during the notice period *plus* an additional amount equivalent to three months' interest, then the provision, and its attempted enforcement, would clearly have been contrary to Section 8 [of the *Interest Act*]".

Secondly, the Court of Appeal in the *Mastercraft* decision stated that the determination of whether the mortgagee was to receive three months notice of the prepayment during which interest would run under its loan or to receive three months interest in lieu thereof was "the option of the mortgagor" and if the mortgagee is permitted to include a requirement for three months' interest as part of the monies set out in the Notice of Sale to redeem the mortgage then the option is no longer that of the mortgagor but that of the mortgagee.

Since the court in the *O'Shanter* case was the Divisional Court and this is a lower court than the Court of Appeal, the Divisional Court could not have made law which is inconsistent with that of the Court of Appeal in the *Mastercraft* case and the statement in the *O'Shanter* decision could not be authority for a mortgagee adding three months interest to the amount due under its Notice of Sale.

One plausible explanation of the meaning of the statement referred to in the *O'Shanter* decision is that the court was simply referring to the express words of the mortgage without sanctioning their

validity and noting that "on the basis of the wording of the mortgage contract itself" the first mortgagee was entitled to claim the Prepayment Amount in its Notice of Sale. Or perhaps the court was simply saying that "subject to the other issues" set out in its judgment, the first mortgagee was entitled to claim the Prepayment Amount in its Notice of Sale. After all in the same decision the Court states "as Section 17 overrides the mortgage contract, *O'Shanter*, upon default, could have given notice or made the payment provided for in Section 17 and thus avoided the Prepayment Amount, provided Genra had not realized on its security". However, these are unsubstantiated speculations of this writer and it clearly remains to be sorted out by a decision of another court at another time.

The result is that the statement referred to in the *O'Shanter* decision has been relied on by many parties to justify issuing a Notice of Sale with the three months interest claimed in it in addition to all other principal, interest and costs due under the mortgage.

Another answer may be found in Section 32 of the *Mortgages Act* which states that:

32. Where a mortgage by its terms confers a power of sale upon a certain default, notice of exercising the power of sale shall not be given until the default has continued for at least fifteen days, and the sale shall not be made for at least thirty-five days after the notice has been given.

This section provides a minimum of days but does not set out a maximum number of days. Accordingly, if a mortgagee wants to issue a Notice of Sale and still receive either three months notice in order to find an opportunity to reinvest its money or three months interest in lieu thereof, the mortgagee would issue its Notice of Sale and instead of giving 35 days notice would give three months notice. That would permit the mortgagee to have an extended period of time in order to find an opportunity to reinvest its money and if the mortgagor wanted to redeem the mortgage earlier than the three month period set out in the Notice of Sale then the mortgagee would be justified, at that time, in indicating that it required the additional three months interest in lieu of the notice period. All of this would be in accordance with Section 17 of the *Mortgages Act*. This would also be consistent with the *Mastercraft* decision of the Court of Appeal where the court

indicated that “the option was that of the mortgagor” and accordingly the mortgagor could decide to wait the three months notice period set out in the Notice of Sale or redeem the mortgage at an earlier date upon making the additional three months interest payment.

Recent Lower Court Decisions

The uncertainty in this area has been heightened by the fact that there are various Superior Court (or its predecessor) decisions either striking down or upholding Notices of Sale that contain three months interest payments claimed by the mortgagee. A review of the two most recent decisions of the Superior Court which were issued one day apart, will act as a highlight of this uncertainty.

The first of these decisions is *Re: Caroline Luce Ialongo et al v. Serm Investments Limited*,¹¹ a decision of the Ontario Superior Court of Justice issued on March 5, 2007 which in the writer's opinion is a well reasoned analysis of the law in this area and correctly applies the principles set out in the higher court decisions.

The court held in that case that a mortgagee/lender was not permitted to include the three months interest in its Notice of Sale issued on default in the mortgage notwithstanding that the lender had earlier properly included that same three month interest amount in a discharge statement which the lender had issued at the request of the mortgagor. The Court made the following statements:

In my view, the reasoning in O'Shanter is consistent with the view expressed by the Court of Appeal in Mastercraft, that the rights afforded by Section 17 are options made available to the mortgagor on default: it can give notice or pay the bonus prior to the expiry of the notice period. Once, however, the mortgagee takes steps to realize on its security, such as by issuing a notice of sale (see: Re Shankman and Mutual Life Assurance Company of Canada, (1985) 52 O.R. (2d) 65 (C.A.)), it cannot convert the rights of the mortgagor into obligations of the mortgagor upon realization of the security. ... In the present case, once the respondent mortgagee issues its Notice of Sale, it was not entitled to demand payment of three months' interest under Section 17 of the

¹¹ [2007] O.J. No. 789 (“*Ialongo*”).

Mortgages Act. It stood in a fundamentally different position than it did when it provided the applicants with a discharge statement at their request.

The second case that was recently decided by the Superior Court is *1259121 Ontario Inc. v. The Canada Trust Company*,¹² which was issued by the court on March 6, 2007 and in which the Court citing the *O'Shanter* decision as authority upholds the mortgagee's right to claim an additional three months' interest in advance within its Notice of Sale which it issued on default under the mortgage. The wording of the clause in the mortgage in this case states that the three months' interest payment is to be made on default and in addition to the interest that otherwise accrues under the mortgage,

In my respectful opinion, this decision is clearly wrong. It misstates the holding of the Court in the *O'Shanter* case, does not make reference to the *Mastercraft* case or the reasoning contained therein and flies directly in the face of the decision of the Court of Appeal in the *Gullett* case and the Supreme Court of Canada in the *Tomell Investments* case which are referred to earlier in this paper.

It is this writer's suggestion that as this area of the law evolves there will be lower court decisions on each side of the issue. Some of these lower court decisions are well reasoned and founded on solid legal principles and some are not, and may have to be distinguished and ignored with respect. This simply demonstrates how the common-law in the Province of Ontario develops over many years. However, notwithstanding that there may be inconsistent lower court decisions during this period of development, we should look to the higher court decisions to assist us in determining a common thread which will delineate the applicable principle of law that will become apparent over time.

Conclusion

In conclusion, what is a practioner to do in the face of this uncertainty and these conflicting court decisions?

¹² 30 B.L.R. (4th) 193, 58 R.P.R. (4th) 58 ("*Canada Trust*").

This writer would suggest that when advising a lender you should discuss the option of including a three month interest amount in the notice of sale. Point out that there is the statement set out in the *O'Shanter* case and subsequent lower case decisions which seem to indicate that there may be an ability to make such a claim. However, there is also the Court of Appeal decision and other lower court decisions that determine that the lender is not entitled to make such a claim in its notice of sale and may in fact invalidate the notice of sale if this line of reasoning is upheld. If the lender client is comfortable with taking the risk and the lawyer obtains a written acknowledgement as to the advice given, then it may well be that a notice of sale can be issued with a claim for the three months interest amount at this point in the development of the law. However, if the lender wishes to be completely safe and follow the reasoning of the author as stated earlier in this paper, the power of sale will be issued without the three months interest claimed.

When acting for a borrower/mortgagor who has received a Notice of Sale containing a claim for three months interest payment, once again, a discussion of the various court cases should be made and a decision taken as to the various options which the borrower/mortgagor has at this point. For example, the borrower/mortgagor should decide whether to request that the mortgagee wait the three months notice period in lieu of requiring the payment of the three months interest amount or whether to take the position that the notice of sale is invalid entirely by including the three months interest amount and that this prejudices the mortgagor by depriving the mortgagor of its equity of redemption. Finally a decision must be made whether the legal expenses and uncertainty of challenging the lender should be avoided and the mortgagor should simply pay the amount required by the notice of sale. In every case a written acknowledgement should be obtained from the client once a course of action has been determined.

In summary it may be helpful to remember what a number of esteemed lawyers have said: "If you are looking for certainty, don't practice law".

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