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REAL ESTATE LAW

Properties in default

When can second mortgagee take control?

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For Law Times

When can a second mortgagee take control of the sale of a property that has gone into default?

"The only way to do that is to put the first one in good standing" and comply with all of the covenants, says Lisa Laredo, who works in commercial and residential real estate.

The role of the second mortgagee arose recently in *Business Development Bank of Canada v. Pine Tree Resorts Inc.* after both the first and second mortgages had gone into default.

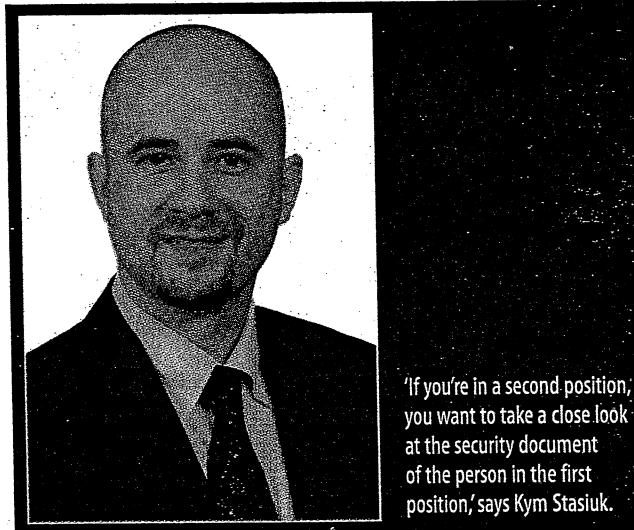
In April, the Superior Court of Justice appointed the Business Development Bank of Canada as receiver over the assets, undertakings, and properties of the company owning the Delawana Inn in Honey Harbour, Ont.

The bank held the first mortgage on the property and was the secured creditor owed about \$2.6 million. The company also owed about \$4.3 million to Romspen Investment Corp., which held the second mortgage. There was also a \$250,000 harmonized sales tax bill outstanding.

But the Delawana Inn and its second mortgagee, Romspen, wanted to sell the property as a going concern and on their own terms. Romspen intended to initiate power-of-sale proceedings. They sought leave to appeal under s. 193 of the Bankruptcy and Insolvency Act as they moved for a stay pending the outcome.

Romspen argued it had the right as a subsequent mortgagee to put the bank in good standing and could then take over the sale of the property through the power-of-sale proceedings. But it had no intention to pay the outstanding \$250,000 bill.

"As a result of the decision in *Pine Tree*, second mortgagees generally find themselves facing more significant costs before they are in a position to enforce their second position mortgage, at which point they may be more reluctant to



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enforce their security ahead of a first mortgage," says Laredo.

"In this case, the second mortgagee did pay the principal and arrears in default and all expenses incurred by the first mortgagee. However, there was still \$250,000 owing for HST. The mortgage contained a covenant requiring the owner to pay his HST. Consequently, the court concluded that the mortgage was still in arrears."

In seeking to appeal the order, Romspen questioned the rights of subsequent mortgagees under s. 22 of Ontario's *Mortgages Act*. The court was to decide which secured creditor would have control over the sale to determine how it would proceed.

In hearing the application, Justice Robert Blair of the Ontario Court of Appeal found there's no automatic right to appeal from an order appointing a receiver. In his decision, he acknowledged there has been recent movement toward a more flexible approach.

There was some concern over the timing given that the property functions as a seasonal business and the interest in resolving the issues in time for it to take

advantage of the upcoming summer.

"There has been a movement towards a more expansive and flexible approach more recently," wrote Blair, adding that there have been two approaches in the jurisprudence.

"The jurisprudence has evolved to a point where the test for leave to appeal is not simply merit-based. The problem is that Romspen has not offered to put the BDC mortgage in good standing, but has only offered to do so partially. It proposes to leave unperformed a \$250,000 covenant — payment of the outstanding HST arrears."

Blair looked at whether the proposed appeal raises an issue that's of general importance to bankruptcy and insolvency matters or the administration of justice, is *prima facie* meritorious or unduly hinders the progress of the proceedings.

He found the "discretionary considerations" presented by Romspen to be factual and case specific and suggested they didn't give rise to general issues of significance to the practice of bankruptcy and insolvency matters or to the administration of justice as a whole. He also had serious reservations given that the HST remained unpaid.

As a result, he found Romspen and Pine Tree didn't meet the test for leave.

Kym Stasiuk, a corporate lawyer working in secured lending transactions at Blaney McMurtry LLP, notes that a partial cure of a default isn't enough to bring the mortgage into good standing.

"There are certain rights for mortgagees who are in subsequent priority position," says Stasiuk. "If you're in a second position, you want to take a close look at the security documents of the person in the first position."

A successful appeal, he says, would have required a very creative interpretation of s. 22, one that would potentially create an undesirable element of uncertainty in the field of mortgage enforcement because no one would know which covenants could remain unperformed and which could not without litigating each case. **LT**