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## **Mortgages and Related Security: How Are You Liable?**

### **A. Background**

Way back in the day, a “mortgage” involved securing a loan by transferring legal title to land from the “mortgagor” (the borrower) to the “mortgagee” (the lender). If the debt was repaid on time, title to the land was transferred back to the borrower. If not, the lender kept the title and the borrower was thrown off the land.

“Mortgage” comes from the French words “mort” (dead) and “gage” (to pledge or promise); so the literal translation is a ‘dead pledge’ meaning that if the debt was not paid, the land so pledged was ‘dead’ to the borrower.

Enough history! Today, a mortgage is simply a loan contract secured by a charge against land. Even if the loan goes into default, title to the land remains in the name of the borrower and the borrower remains in physical possession of the land until the very end of the legal process involved in enforcing a mortgage, commonly known as ‘a foreclosure’ or ‘foreclosure proceedings’.

Remember that your lender is a kind of silent partner. As long as payments are made in full and on time and there is no other ongoing default, you will never hear from your lender. But miss a payment or two and your lender quickly becomes your adversary. Your lender will take action on any default under the mortgage by a series of legal steps as outlined in Appendix A.

Under our constitution, mortgage law is a provincial responsibility. So although the concept is similar across the country, and indeed throughout the western world, each province has its own set of rules. To further complicate the picture, banking law is a federal responsibility, so federal legislation comes into the picture in relation to banking issues such as high ratio lending.

The message is, for any specific mortgage or foreclosure question, YOU MUST CONSULT experienced legal counsel in the province where the land is located.

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*Plain English: We are not your lawyer and this is not legal advice!*

## **B. Basic Principles**

Some general legal principles of foreclosure law are as follows:

### **i) Conventional Mortgages**

A conventional mortgage is described as one where the loan to value ratio (LTV) is 80% or less. The lender takes at least two forms of security. The first is a charge against the land. The second is the borrower's personal covenant (personal promise) to repay the loan. If the mortgage goes into default, the lender can enforce the mortgage by way of a foreclosure action which may result in the sale of the land. If proceeds of sale are not sufficient to pay off the mortgage loan, the borrower and all of his assets are at risk to repay any deficiency. For example, if the mortgage balance is \$300,000.00 at the date of default and the property is sold through the foreclosure process but brings only \$280,000, the deficiency is the difference of \$20,000.00 (plus costs and accrued interest to the date of sale).

### **ii) High Ratio Mortgages**

The federal *Bank Act* provides that when a bank provides a mortgage loan, the LTV ratio shall not exceed 80% of the value of the property. An exception to this rule is a high ratio mortgage loan made under the federal *National Housing Act* (NHA). If a lending institution makes a mortgage loan under the NHA, the loan will be insured by either the Canada Mortgage and Housing Corporation (CMHC) or by a private insurer (to date, Genworth Financial Canada is the sole private insurer of high ratio mortgages), with the borrower paying the insurance premium. In all other respects high ratio mortgages are the same as conventional mortgages.

### **iii) Personal Guarantees**

Personal guarantees from third parties are sometimes required by lenders as additional security. If a default occurs in a mortgage, and if the lender cannot repay a mortgage loan from the sale of the land or from realizing on the borrower's personal covenant, then the lender can call on the guarantor.

## **C. Alberta**

Some principles of mortgage law specific to Alberta include the following:

### **i) No Action on the Covenant**

In Alberta, a critical divergence from the general principles is that in the event of default on a conventional mortgage, the lender's remedy is restricted to foreclosure against the land and the lender is unable to enforce any covenant in the mortgage against the borrower personally in the event of a deficiency. What a huge difference! In other

words, the borrower is not liable to the lender for any deficiency that may exist after foreclosure.

ii) High Ratio Mortgages

If the mortgage is an NHA high-ratio mortgage, the borrower remains personally liable to the lender for any deficiency. This personal liability continues even if the borrower sells the property to a third party who assumes the mortgage and also attaches to the new purchaser and so on down the chain of title no matter how many times the property is subsequently resold so long as the mortgage is assumed by each new purchaser.

iii) Mortgages Granted by Corporations

If the mortgage is granted by a corporation as opposed to an individual, the mortgage lender is not restricted to recovery of the land but can sue the corporation for the deficiency.

iv) Assumptions of Mortgages Granted by Corporations

If an individual purchases property and assumes a mortgage granted by a corporation, then the individual inherits the liability of the corporation and becomes personally liable for any deficiency unless that individual or a member of his family uses the property as their *bona fide* personal residence. If, however, the individual subsequently enters into an amending agreement with the lender where the terms of the mortgage are altered, then the protection against an action on the covenant will arise. If the mortgage was granted jointly by an individual and a corporation then the prohibition applies from the outset and therefore neither the individual nor the corporation can be sued for any deficiency.

v) Personal Guarantees

Individuals may also become liable to mortgage lenders by providing a personal guarantee for a mortgage. Commercial mortgages are usually granted by corporations and the lender will usually require the personal guarantee of the individuals controlling the corporation. Legislation unique to Alberta requires that any individual guarantor must appear before a Notary Public to acknowledge that he executed the guarantee, that he is aware of its contents and understands them. The Notary Public must attach a certificate of this acknowledgement to the Guarantee. In the absence of the Certificate, the personal guarantee is not enforceable.

**True or False**

With this brief summary of mortgage law, let's have some fun with true and false questions:

**Question # 1:** I bought at the height of the boom with a 25% downpayment in my own name. Turns out, I overpaid. My 'area in transition' has not transitioned. Prices have

dropped like a rock. I can't rent the property for enough to make my payments and nobody wants to buy the property from me. Some dude told me I can walk away from the property and the lender can't come after me personally.

**Answer:** True. In Alberta, there is no personal liability by individuals on conventional mortgages whether it was your brand-new mortgage or whether you assumed the mortgage from another individual.

**Question # 2:** Instead of a 25% downpayment I actually only put up a 5% downpayment. The good news is that I've got an offer to buy the house, even if it's for less than I paid. The catch is that my buyer wants to assume my mortgage. I'm worried that the buyer might default but I've been told that my liability ends once the buyer keeps the mortgage payments up for one year.

**Answer:** False. This is a common misconception. While CMHC (and possibly Genworth) may have a policy of not pursuing previous borrowers if the current borrower maintains the mortgage for a year, there is nothing preventing them from doing so. Policies are great, but policies are not law and policies can change. The only true protection that can be provided to the seller is a formal release or at the very least, a release letter issued by the lender. If you want to sell a property and allow the buyer to assume your mortgage, you can make the release a condition of the sale. In today's non-assumption environment, do not think that lender approval to assume the mortgage means you get an automatic release. You don't!

You have to ask for it. If the lender approves the assumption, but won't give you the release, you should mark your calendar for 12 months after the sale. At that time, if there has been no default, you should follow up with the lender and CMHC and try to obtain from them formal recognition that you are no longer liable. To avoid privacy issues you would have to have a condition in your sale contract that survived closing allowing the lender to advise you whether or not the borrower continued to be in good standing 12 months after closing. This is all a little tricky and the best protection for you is not to let anyone assume your mortgage.

Because of amendments made to the *Law of Property Act*, and in effect August 1, 2004, all insured mortgages funded after that date create personal liability for any individual registered as the owner of the property *at any point in time during* the life of the mortgage.

**Question # 3:** I bought a property through my real estate holding corporation, and paid a 20% downpayment. Now things have gone south and I need to bail out. I've heard that there might be a problem if I just walk away from the property.

**Answer:** True. For a corporation, as for any individual with a high-ratio mortgage, the covenant to pay is always enforceable meaning that the corporation will be on the hook for any deficiency.

**Question # 4:** I have a conventional mortgage in my personal name on a non-performing property. I intend to walk away from the property because I know that I won't be liable for any deficiency. I think this is a good solution to my financial difficulties.

**Answer:** False. Just because the lender can't pursue you doesn't mean there aren't other consequences. At the very least your default will be reported to the credit bureaus, likely resulting in the worst credit score possible and severely limiting any future borrowing.

**Question # 5:** My corporation took out a new mortgage to purchase an investment property. I then personally assumed that mortgage with the lender's permission and continue to rent it out. Times are tough and I can't sell the property for enough to pay off the mortgage. Any sale will be at a big loss. Dude says not to worry because the property is now in my personal name and a lender cannot enforce the personal covenant.

**Answer:** False. Remember we said that Alberta law was complicated! Amendments to the *Law of Property Act* created "an exception to the exception" in section 43 that a lawsuit on the personal covenant was possible where the original borrower was a corporation. When you assume a mortgage from a Corporation, the lender can still enforce the personal covenant unless the property is your personal residence or that of a member of your family.

**Question # 6:** I lent money from my RRSP on a second mortgage and now the borrower is in default and not paying the mortgage. I'm concerned because I'm not sure if my trustee will start a foreclosure action on my behalf and protect my interests.

**Answer:** True. Your trustee probably won't do anything for you. They may not even advise you that the mortgage is in default. You need to supervise your RRSP mortgages carefully. If the loan goes into default you will have to hire a lawyer and start a foreclosure action. If the first mortgage is also in default the first lender can foreclose the property and wipe out your position unless you take action.

**Question # 7:** I carefully monitor my RRSP second mortgages just like you told me to and I see that one of them is in default. I know the borrowers and they are good people. They've missed a couple of payments but say they can catch up in three months. I don't think there is anything to worry about.

**Answer:** False. You should be worried! It's an almost 100% rule; things always get worse, they never get better. Consult legal counsel immediately and take action. If your borrower pays you out, you can always stop your lawsuit.

**Question # 8:** I sold a property last year but had to accept a vendor-take back second mortgage to finance the deal. Now the buyer has defaulted on the payments. I don't think I should do anything because I'm sure that the first mortgage lender will sort it out.

**Answer:** False. The first mortgage lender doesn't care about you or your mortgage because they are first in line. Their foreclosure costs could eat your equity position

alive. You need to take action to protect your position by consulting a foreclosure lawyer.

**Question # 9:** My mom and dad and all my relatives are getting crappy results from their mutual funds in their RRSPs. Some of those relatives have lots of money in cash accounts. I've got lots of equity in my properties. They will give me second mortgages either in their RRSPs or out of it, doesn't matter. We don't want to be too adventurous so the LTV will never go higher than 95% and I'll pay them 6% which will be a lot more than they were making in their mutual funds. We all think this is a good investment.

**Answer:** False. This is not a safe investment. If you have positioned yourself as a real estate expert and are giving this kind of advice, you are inviting a lawsuit. Prices can drop and equity can be eroded. Normal second mortgage lenders rarely go higher than 85% LTV and only to 85% if the borrower pays a 'high sweat' interest rate of 12 to 24%. Of course, if this kind of loan ever goes bad your family relationships will be ruined.

**Question # 10:** My husband took out a commercial loan for his business. Our house is in my name alone. The bank asked me to grant a mortgage on the home to secure the loan. My husband has defaulted on the business loan and the bank has commenced foreclosure on our house. I'm worried that we will lose our home.

**Answer:** False. Your mortgage of your own property was in fact a guarantee of your husband's liability. Since the bank did not obtain a proper guarantee with a notarial certificate the mortgage given as collateral to the guarantee was also invalid. Guarantees, like all other parts of mortgage/foreclosure law are very tricky. If a guarantee is ever involved and been called on by the lender, don't give up without having a foreclosure expert review the facts.

**Question # 11:** I just finished buying my first investment property. Very exciting! However, two weeks after closing, a very official looking document on pink legal size paper was delivered to my mailing address. That document was a "caveat" and it said that my lender was forbidding the registration of anything else against the title. My know-it-all brother says this is normal, but I don't believe him.

**Answer:** True. Most lenders take both a mortgage and an assignment of rents as security for the loan. The assignment of rents can only be registered against your title by way of caveat. Whenever any caveat is registered for any reason, the Land Titles Office sends a copy to the owner at their address on title. The assignment of rents says that if you are collecting rent and not making your mortgage payment the lender can use the assignment of rents to have your tenant pay the rent directly to the lender and not to you. The assignment of rents is standard lender security and does not prevent you from dealing with your property.

**Question # 12:** I lost my job and the lender has started to foreclose on my two investment properties. Fortunately there is lots of equity in both properties, but the legal

paperwork says that they are trying to take over the properties immediately. Also I've heard that the legal costs could be \$20,000.

**Answer:** False and probably false. Courts do not like taking properties away from owners. Any equity in your property is known as the 'equity of redemption'. You will receive a reasonable amount of time from the court to bring your properties back into good standing. This amount of time is known as the 'redemption period'. As long as the equity in your property is sufficient so that giving you time doesn't hurt the lender, you will get a reasonable amount of time to bring the mortgage is back in the good standing or to sell the property.

On the legal fees side of things you have to pay all of the lender's fees and costs. Yes, there are scenarios where the legal bill could be \$20,000. However, if it is a simple, undefended foreclosure action your legal fees and costs are more likely to be in the range of \$1500-\$5000.

## **Appendix 'A'** **Court Process Of A Foreclosure**

Note: In this outline, the word "Mortgagor" can be replaced with the word "Borrower", and "Mortgagee" with "Lender", for clarity purposes.

### **Demand Letter**

Generally when a borrower misses two payments the lender will have a demand letter or default notice sent out to the borrower to “encourage” the borrower to catch up on the missed payments.

### **Statement Of Claim**

If the demand letter is unsuccessful in getting the mortgage payments caught up, a formal action for foreclosure is commenced by way of a Statement of Claim issued by the lender.

The Defendants to be named in the Statement of Claim are the registered owners of the property, any person in possession of the mortgaged property, and any persons having rights under the *Dower Act* (i.e. spouses residing on the property but not named on title). Those who hold a registered interest in the lands by way of another mortgage, a caveat, a builder's lien or other encumbrance are not named as parties in the lawsuit, although those holders of encumbrances registered after the mortgage in foreclosure must be given notice of the lawsuit.

The relief requested in the Statement of Claim is generally as follows:

- A declaration as to the amount owing under the said mortgage with interest according to the terms of the said mortgage and, in default of payment, sale or foreclosure and possession of the said lands.
- An order for possession
- An appointment of a receiver
- Such other relief as to the Court may seem just
- Costs of the action
- A shortening of the period of redemption

In addition, it is important to note that a mortgage action may be commenced in a judicial district other than where the land is situated.

### **Application For Order Nisi**

It is rare that a mortgagor in default will file a Statement of Defense. The normal course is for the mortgagor to do nothing, and then at the expiration of 15 days after service of the Statement of Claim the mortgagee will be in a position to note the mortgagor and other defendants in default.

The next step in the action will therefore be a Court application before the Master in Chambers for an *Order Nisi*. This Order confirms the mortgage debt and determines the

length of the redemption period (the period during which the borrower can catch up the mortgage or sell the property without further interference from the lender) and the method of sale of the property if the mortgage is not redeemed. This application is brought on notice to the borrower and all subsequent encumbrance holders. Supporting documentation for that application will be:

- A Notice of Motion setting out the relief sought in the application as referenced in the Statement of Claim
- An Affidavit of Default which provides evidence to the Court as to the balance presently due and owing to the mortgagee under the terms of the mortgage;
- An Affidavit of Value, which is normally prepared by a qualified real estate appraiser, and which provides the Court with evidence as to the value of the land which is under foreclosure;
- A Certified Copy of Title showing the encumbrances registered against title

Section 42 of the *Law of Property Act* provides that in the case of urban lands the period of redemption shall be six months from the date of the granting of the *Order Nisi*. The Court however does have the authority to shorten this period of redemption if there is insufficient equity in the property to secure the mortgage indebtedness, including legal costs. Therefore, and applicant must provide evidence as to the amount of the arrears under the mortgage together with the total value of encumbrances registered against the property, and the value of the property in order that the Court may determine the equity held by the mortgagor in default and set the redemption period. If there is little or no equity in the property relative to the amount owing on the mortgage, then the Court will likely shorten the redemption period to one day and also truncate the sale process.

### **Advertising and Sale**

Once the redemption period has expired, the property is advertised in accordance with the terms of the *Order Nisi*. This can involve advertising with a realtor, a tender process, or advertising in the office of the Clerk of the Court. If satisfactory offers are received through the advertising process, then an application is made to have the property sold to the successful bidder. If there are no satisfactory offers, the application by the mortgagee is for a final order vesting title in the name of the lender.

Where the mortgage is a high ratio mortgage issued by a bank and there is no equity in the property, the bank can take title the property directly by way of a *Rice Order* without any advertising.

### **Application For Final Order**

The application for the final order in the foreclosure process is made again by way of Notice of Motion served on all Defendants and all subsequent encumbrancers, and is supported by a final Affidavit of Default updating the Affidavit of Default which was filed in support of the application for the *Order Nisi*.

The application is also supported by an Affidavit Proving Publication in accordance with the terms of the directions for advertising granted by the Clerk of the Court, together with an Affidavit either setting forth the offer which the lender wants to have accepted or deposing that no offers sufficient to pay off the mortgage have been received. In the event that no satisfactory offers are received, the lender will apply for a final order vesting title in the name of the lender.

Whether the final order is to effect the sale of the lands to an offeror or to transfer title to the lender where there are no sufficient offers, the terms of the Order will provide that the borrower has to vacate the lands by a certain date, failing which the Court will allow the lender to have the borrower forcibly removed after obtaining an Order for Possession from the Clerk of the Court.