PRIMARY SECURITY
PREPARED BY WALTER M. TRAUB
AND
MICHAEL S. MYERS
OF
GORDON, TRAUB & ROTENBERG

REAL ESTATE DEVELOPMENT
AND
CONSTRUCTION FINANCING
MAY 28-29/'87

SUMMARY OF CONTENTS

INTRODUCTION

TYPES OF SECURITY DOCUMENTS 4

MORTGAGES 5

- i) Basic Concepts 5
- ii) Subsequent Advances 7
- iii) Revolving Lines of Credit 10

DEBENTURES 11

- i) Basic Concepts 11
- ii) The Pledge Agreement 15
- iii) Applicability of The Mortgages Act 19
- iv) Conclusion 22

REAL ESTATE MORTGAGE BONDS 22

GENERAL SECURITY AGREEMENT 23

KEY WARRANTIES, REPRESENTATIONS, COVENANTS AND EVENTS OF DEFAULT 26

- i) Representations and Warranties 27
- ii) Covenants 33
- iii) Events of Default 40

RECEIVER CLAUSES 47

WRAP-AROUND MORTGAGES 54

- i) What Are They? 54
- ii) When Might They Be Used? 59
- iii) Why They Are Not Used 60
- iv) Is There an Alternative 62

PRIMARY SECURITY

A. INTRODUCTION

Before attempting to deal with "Primary Security" and its various forms, it is important to ascertain what "Primary Security" is. The term has been used loosely in a legal and commercial context with reference to security documents. "Primary" is defined in the Canadian Law Dictionary at Page 293 to mean "first; principal; chief, or best.", and in Black's Law Dictionary Revised Fourth Edition at Page 1354 as "first in order of time or development, or first in intention". It can be seen that these definitions in themselves do not lend any assistance to interpreting the words "Primary Security" in a legal context.

In my view "Primary Security" only has significance when contrasted with "Collateral Security". "Collateral Security" has been defined by the aforesaid dictionary sources as "separate obligation attached to another contract to guarantee its performance;...security for the performance of covenants or the payment of money besides the principal security." (Canadian Law Dictionary at Page 77).

According to Black's Law Dictionary at Page 327 it means "security given in addition to the direct security and subordinate to it...; so that if the direct security fails the creditor may fall back upon the collateral security." In its literal sense "Collateral" means situate at the side of or parallel or additional. It is common for lenders to obtain as many different security documents securing the assets of the borrower as possible. Frequently, several mortgages are taken on different parcels of land or a combination of mortgages, debentures, security agreements, and other security documents are taken to secure the indebtedness owing. In a commercial context "collateral" or "additional" security taken by the lender is in many instances not intended to be secondary, discounted or of less importance. It is therefore a question of construction and intention in each case with reference to the dealings between parties, the form of the transaction, and the nature of the security given, whether a distinction should be drawn between primary security and secondary or collateral security or whether all security should be treated as equal.

Caution should be exercised in structuring of transactions involving "Collateral Security", due to certain specific legal implications arising in foreclosure proceedings. If a mortgagee enforces part of his security by foreclosure proceedings and then sells the property following a Final Order of Foreclosure, he is deemed to have accepted the property in lieu of the debt and to release all his rights and claims against the debtor. This is based on the theory that once the security taken by the mortgagee is put beyond reconveyance to the mortgagor, thus precluding redemption by the mortgagor, no further steps can be taken by the mortgagee. This theory only applies in a situation where the primary security for the debt is dealt with. As long as the primary security is not put beyond reconveyance, the mortgagee's rights as against the mortgagor will not be barred.

It is for this reason that lenders must clearly distinguish between primary and collateral security and make sure that they proceed with the realization of all collateral security first, so as not to preclude their remedies against the primary security or the borrower. Alternatively, a lender would be well advised to proceed against all securities at the same time in one

action, so as to avoid the issue as to which if any of the securities were primary or collateral. The simple guideline to follow is that where a mortgagee forecloses on some but not all of the property held as security he cannot seek his money out of the remaining properties, without being able and ready to offer all of the secured properties back to the mortgagor from whom the debt is sought. (Rushton v. Industrial Development Bank 34 D.L.R (3rd) 582).

B. TYPES OF SECURITY DOCUMENTS

Security documents most frequently used in the financing of a real estate development or construction are; debenture, mortgage, or real-estate mortgage bond. In addition, lenders secure either present or future personal property not otherwise secured under a mortgage, debenture or mortgage bond by way of either a general security agreement or chattel security agreement under The Personal Property Security Act of Ontario (R.S.O. 1980 c. 375) as amended ("the P.P.S.A").

Since the most frequently used security documents are either a mortgage or a debenture, I will first

distinguish between these two documents, their significance and their proper application.

C. MORTGAGES

i) Basic Concepts

A mortgage at common law was a conveyance of title to real property to the creditor as security for the debt. What distinguished a mortgage from a charge or a lien was that it transferred legal or equitable title (depending whether it was a first or subsequent mortgage) to the mortgagee. A mortgage therefore, at common law, required a reconveyance of title to the mortgagor upon payment of the debt. For that reason, mortgages were not allowed to be made irredeemable because the transfer of title was given by the mortgagor as security only, and equity protected the mortgagor. The Land Titles Act (R.S.O. 1980 c.230) as amended, and more recently The Land Registration Reform Act (S.O. 1984 c.32) as amended, have now eliminated the use of a mortgage in the traditional common law sense in the Province of Ontario. Since the enactment of The Land Registration Reform Act, all land in Ontario is secured to lenders by way of a

Charge. Similarly the repeal of the Short Form of Mortgages Act eliminated the traditional ingredients of common law mortgages (ie, provisos for defeasances and redemption etc.) However, it is still the intention of present legislation as well as lenders and lender's solicitors to create a document by which all of the common law ingredients of mortgage law are preserved. Furthermore, since the remedies of the mortgagee have not changed in any substantial manner since the enactment of The Land Registration Reform Act or The Land Titles Act, it is only in form rather than substance that the said legislation has changed mortgage law in Ontario. This proposition is supported by the provisions of Section 97 of The Land Titles Act which allows the registered owner of a registered charge to enforce it by foreclosure or sale <u>in the same manner and under the same circumstances that he might enforce it if the land had been transferred to him by way of a mortgage subject to proviso for redemption.</u> The Land Registration Reform Act contains a similar provision in Section 6(3) which provides that the chargor and chargee <u>are entitled to all the legal and equitable rights and remedies that would be available</u>

to them if the chargor had transferred the land to the chargee by way of a mortgage, subject to a proviso for redemption.

In addition to concepts derived from common law, mortgages are subject to the provisions of The Mortgages Act (R.S.O. 1980 c.296) which governs the enforcement thereof.

ii) **Subsequent Advances**

Pursuant to Section 68 of The Registry Act (R.S.O. 1980 C.445) as amended "a registered mortgage is, as against the mortgagor, his heirs, executors, administrators, assigns and every other person claiming by, through or under him, a security upon the land comprised therein to the extent of the money or moneys worth actually advanced or supplied under the mortgage, not exceeding the amount for which the mortgage is expressed to be as security, notwithstanding that the money or moneys worth or some part thereof was advanced or supplied after the registration of a conveyance, mortgage or other instrument affecting the mortgaged land..., and registered subsequently... unless before advancing or supplying the money or moneys worth, the mortgagee in the first mentioned mortgage had actual

notice of the execution and registration of such conveyance, mortgage or other instrument, and the registration of such conveyance, mortgage or other instrument after the registration of the first mentioned mortgage, does not constitute actual notice.".

In simple terms once a mortgage is registered for a specific amount, advances can be made under such mortgage without any further subsearches of title and such mortgage will have priority over any subsequent encumbrance unless actual notice of such subsequent encumbrance is communicated to the mortgagee. This is subject to the provisions of The Construction Lien Act (S.O. 1983 c.6) as amended, which give a construction lien claimant certain priorities over a mortgage as set out in S.80 thereof. Practically speaking therefore, in development or construction financing, notwithstanding that the mortgagee may have absolute priority as against any subsequent encumbrancers (other than construction lien claimants) it is prudent for such mortgagee to conduct title subsearches at the time of each advance, so as to ascertain that there are no construction liens

registered against title which could claim priority to the mortgage advances. In addition subsequent advances will not gain priority if notice of any claim for lien has been communicated to the lender.

Please note that the provisions of Section 68 of the Registry Act clearly provide that the mortgage is "security upon the land... to the extent of the money... actually advanced..., not exceeding the amount for which the mortgage is expressed to be a security,...". On strict interpretation, the mortgagee, in making subsequent advances pursuant to its mortgage, is entitled to act on the supposition that no subsequent mortgage has been made on the property. If there is a subsequent mortgage, such mortgage will not have priority over any advances subsequently made under the prior mortgage without actual notice of such subsequent mortgage being communicated to the prior mortgagee, up to the full amount for which the prior mortgage is expressed to be security. The prior mortgagee will not be entitled to priority with respect to any advance made after he receives actual notice of the subsequent mortgage, unless such advance was made in settlement of a

contingent liability which the mortgagor contracted before the making of the subsequent mortgage.

It must be clearly noted that a registered mortgage is only security for the money or moneys worth actually advanced under it. Such advances cannot exceed the amount for which the mortgage is expressed to be security. As a result, if a mortgage is stated to be security for the sum of $10,000,000.00 and the sum of of $8,000,000.00 has been advanced and subsequently $5,000,000.00 was repaid, only a further $2,000,000.00 can be advanced on the security of such mortgage. (Section 68 Registry Act, Falconbridge on Mortgages 4th Edition Page 163) This concern has frequently been alleviated where the mortgagor is a corporation, by the use of a pledge of a debenture instead of mortgage security. This proceedure is not without doubt as will be discussed later.

iii) **Revolving Lines of Credit**

It is therefore evident that mortgage security does not lend itself to revolving lines of credit. In addition, much more far reaching concerns are created by revolving loans.

We have already seen that Section 6(3) of The Land Registration Reform Act and Section 110 of The Land Titles Act have preserved all legal and equitable rights and remedies of the chargor and chargee. At common law and under The Short Form of Mortgages Act (now repealed) payment of the mortgage debt extinguished and nullified the mortgage security and automatically re-transferred the title to the mortgagor. Similarly reduction of the mortgage secured debt pursuant to a revolving line to a nil balance may extinguish the mortgage security. Furthermore, under Section 6(2) of The Land Registration Reform Act "A charge ceases to operate when the money and interest secured by the charge are paid, or the obligations whose performance is secured by the charge are performed, in the manner provided by the charge." The lender is therefore at risk of losing its security if a revolving line of credit secured by a mortgage is reduced to a nil balance at any time.

C. DEBENTURES

i) Basic Concepts

There appears to be no precise definition of a debenture at common law. The Canadian Law Dictionary

at Page 110 defines debenture as:

> "a certificate or acknowledgement of indebtedness usually by a corporation. But where it is not secured by the assets of the corporation, it is merely a promise to pay and has the character of a promissory note rather than of a mortgage."

Black's Law Dictionary at Page 489 defines a debenture as:

> "A security for a loan of money issued by a public company, usually creating a charge on the whole or part of the company stock and property though not necessarily in the form of a mortgage. In simple terms a debenture is a promise to pay evidencing indebtedness which may or may not be secured by the assets of the issuer."

In the case of Acmetrack Ltd. v. Bank Canadian National et al, (1985) 48 O.R. (2nd) 49 the Court held that a security document acknowledging and covenanting to repay a debt could be classified as a debenture if so

called. Furthermore, in the case of V.K. Mason Construction Ltd. v. The Bank of Nova Scotia (1985) 1 S.C.R. 271 it was held that a debenture is a broad enough document that it may include a real estate mortgage. The Court left a distinct impression that in certain instances a debenture may not be any more than a real estate mortgage.

In its practical application in Ontario a debenture may follow two basic forms. It may either be secured by a separate instrument such as a trust deed or it may stand on its own. A debenture secured by a trust deed is more applicable to a situation where financing is done by pooling various individual lending sources (syndication) and issuing to such sources debenture security under a trust deed for ease of enforcement and administration. The trust deed will generally contain issuer's covenants for performance and set out restrictions on the issuer's activities. This type of instrument is most frequently used in securing public debt issues and is not commonly applicable to real estate financing. It is in broad use in Quebec because of technical requirements of Quebec's Civil Code.

The form of debenture most frequently used in Ontario with respect to real estate financing is a debenture not secured by a separate instrument. Debentures generally contain fixed charges on specific assets and floating charges on all of the other assets and undertaking of the issuer. In its application to real estate financing, the debenture primarily secures by way of a fixed charge the real property under development and by way of a floating charge any and all other assets of the borrower.

It is traditionally accepted that debentures can only be issued by a corporation. There is nothing, however, in the definition of a debenture nor in law which would lead to such conclusion. In fact a debenture being a promise to pay secured by the assets of the issuer can probably be issued by any entity including individuals, limited partnerships and partnerships. The reason why in practice only corporations have issued debentures is because prior to enactment of the P.P.S.A. lenders were unable to register their security by way of a debenture from any other entity. The Corporation Securities Registration Act (R.S.O. 1980 c. 94 the "CSRA") was the only

statute governing registration of debenture security and only applied to security issued by corporations. Since the enactment of The P.P.S.A. this is no longer the case. Accordingly there is no reason why entities other than corporations cannot now issue debenture security.

Although it is now open to any entity including individuals to issue debentures as well as mortgages in Ontario, in other jurisdictions which do not have personal property security legislation only corporations can enter into such security arrangements.

ii) **The Pledge Agreement**

It is common for the issuer of a debenture to pledge the debenture with a lender as security for the payment of the indebtedness specified in the pledge agreement.

It is the writer's view that the concept of a pledge of a debenture is an antiquated concept which no longer has practical application and is only of historical significance. Prior to the modern Bank Act, Bank's were not allowed to invest in mortgages but were allowed to invest in corporate securities which could

be pledged as security for the debt. Thus a pledge was necessary.

Another reason for the use of a pledge agreement in Ontario is to assist with the requirements under the CSRA. Section 3(2) of the C.S.R.A. requires an affidavit setting out the total amount secured by the debenture in the case of a debenture not secured by a separate instrument. Since under the pledge agreement the debenture constitutes an absolute obligation, the affidavit can refer to the face amount of the debenture as the amount secured, notwithstanding the amount owing from time to time under the loan secured by the debenture. This may have been obviated by recent developments including the decision in the Acmetrack case (supra).

The pledge agreement has been retained for two other purposes which may or may not have real significance.

I have already indicated the risk to the lender in securing a revolving line of credit under mortgage security. It is the view of some practitioners that debenture security is not subject to the same concerns. Since the concept of the debenture is that it secures

an absolute indebtedness, the pledge of such indebtedness which is specifically secured against the land to the lender as security for a revolving credit facility avoids the implications of Section 68 of The Mortgages Act, Section 6(2) of The Land Registration Reform Act and the common law concerns with respect to priority of subsequent advances under a mortgage. It can be argued that the debenture in itself always secures the total obligation being the face amount thereof. This indebtedness never changes. Advances and repayments pursuant to the revolving loan facility do not effect the amount stated to be the absolute indebtedness secured by the debenture. This almost puts a debenture document in the same position as a mortgage which has been assigned to secure a revolving line of credit. If you examine the comparison, you will note that the mortgage document secures the total amount advanced thereunder notwithstanding the fluctuations of the revolving debt between the borrower and the lender for which the mortgage is assigned as security. This comparison however breaks down on two basic levels. The mortgage assigned to the lender represents a separate and distinguishable debt (presumably between the debtor and third parties) and secures money already advanced, whereas the debenture

pledged represents the identical debt to that secured and revolved under the revolving line of credit.

In most instances debentures securing revolving lines of credit secured on real estate are nothing more than mortgages. The lender therefore runs the risk that such debenture might be held to be a disguised mortgage intended to avoid the provisions of Section 68 of The Registry Act or Section 6(2) of The Land Registration Reform Act, and therefore, subject to the validity and priority concerns raised by the said Sections.

The concept of a debenture has some times been utilized by regulated companies such as banks and trust companies to obtain technical compliance with their enabling legislation. Traditionally regulated companies can only lend on the security of real estate up to 75% of the value thereof. Until now, value has been defined and interpreted as "market value". With the new amendments, the new concept of "lending value" will add yet further complications to the determination of permissible limits.

In order to qualify certain loans under their enabling legislation, institutional lenders have tried to resort to debentures as security for a loan. In many instances, debentures pledged as security from certain corporate entities have been used to secure financing in excess of the restrictions which govern real estate security.

I caution against the indiscriminate use of debentures in lieu of mortgages in order to obtain the aforenoted results. As we have already seen in the case of V.K. Mason Construction Ltd. v. The Bank of Nova Scotia the Courts are recognizing that in certain instances a debenture is nothing other than a mortgage of real estate, notwithstanding its form.

iii) Applicability of The Mortgages Act

One further reason why debentures are sometimes used in real estate development financing is the interpretation placed on Section 39 of Part III of The Mortgages Act. This section states as follows: "This Part does not apply to a mortgage given by a corporation to secure bonds or debentures."

This is of great significance since Part III of The Mortgages Act requires, inter alia, that a mortgagee must give 35 days notice of any sale of real property following 15 days of default. If the Mortgages Act does not apply to debentures, the debentures would be enforceable solely in accordance with their contractual terms and statutory notice to the debenture issuer or any subsequent encumbrancers would not be required.

There is no doubt in the writer's mind that the intent of Section 39 of The Mortgages Act was to exempt corporate debentures or bonds secured by trust deeds and not simple debentures in favour of one or several holders whose interests are directly registered. To allow for any other interpretation would nullify completely the intent of the provisions of The Mortgages Act. By calling a mortgage a debenture a lender could contract out of the provisions of The Mortgages Act, an instance clearly prohibited by the provisions of the said legislation (The Mortgages Act Section 37). The cases of Diegel Feick v. Donia Consulting Corporation (1980) 35 C.B.R. 134 and the case of Ramardo Mines Limited v. Canadian Imperial Bank of Commerce (1980) 2ACWS (2nd) 302 have created great

confusion with respect to Section 39 of The Mortgages Act. In the former case Eberly J. appears to accept the argument that a debenture (other than debentures secured under a trust deed) falls within the meaning and intent of Section 39 and that no compliance with The Mortgages Act is necessary. In the latter case (although as an aside) Mr. Justice Eberly appears to question himself as to the proper interpretation of the said section by considering whether or not the reference to bonds and debentures in Section 39 limited that section to those situations only where the debentures were issued under a trust deed.

To further add to the confusion, conflicting bulletins have been issued by the Ministry of Consumer and Commercial Relations in Ontario to the Land Registrars as to the necessity for compliance with Part III of The Mortgages Act. The first one issued on May 1st, 1983, (Bulletin No. 83003) indicates that if the land is registered under The Land Titles System a power of sale will only be exempt from Part III if it is being exercised pursuant to a mortgage which secures bonds or debentures issued under a trust deed. If the power of sale is exercised pursuant to a simple debenture which by its terms creates a mortgage on land the

Registrar must insist on full compliance with Part III before registration of a transfer from the debenture holder.

In a bulletin issued on August 6th, 1985, (Bulletin No. 85006) the Ministry of Consumer and Commercial Relations instructed the Land Titles Registrar not to insist on compliance with Part III of The Mortgages Act in dealing with sales under debentures on the basis that "the debenture itself will determine the criteria upon which the sale must take place". The latter bulletin does not distinguish between bonds and debentures secured by a trust deed and simple debentures.

iv) **Conclusion**

Although it is a simple matter to call a document a debenture even though it contains all characteristics of a mortgage or charge and although doing so does not create any risks nor detract from the security of the lender, it is cautioned that the use of a debenture which is nothing more than a mortgage may not avoid the ramifications of The Mortgages Act, The

Registry Act, The Land Registration Reform Act or the statutes governing regulated financial Institutions.

E. REAL ESTATE MORTGAGE BONDS

Another form of debt financing which can be utilized for the purpose of financing real estate development are real estate mortgage bonds.

"Bonds" are debt instruments of a corporation secured by the property of the corporation and are usually issued in units to various lenders to raise a collective sum of money. In most instances bonds have a long redemption period and usually do not call for any payments of principal until the term expires. Bonds are most often issued through a trustee which is usually one of the major trust companies. In practice, we rarely see bonds in a form which is registrable under either The Registry Act or the Land Titles Act. That is not to say that bonds cannot be registered as secured instruments on title but rather that a bond document itself does not fall within the contemplated security documents permitted by the said legislation. A trust indenture securing either bonds or debentures and creating a specific charge on real

property can be registered on title but that type of document is cumbersome and only applicable to major public financings. Accordingly, lenders have resorted to such fictitious documents as a "Mortgage Bond" or "Bond Mortgages" to effect the desired result. As a document a mortgage securing bonds or a bond mortgage is nothing more than a real estate charge under an assumed name which contains various additional provisions common to corporate bonds. From this perspective it almost mirrors the real estate debenture discussed above and is subject to the same comments and concerns as alluded to on the previous pages.

F. GENERAL SECURITY AGREEMENT

The enactment of The P.P.S.A. in Ontario has given rise to yet a further security document, namely the general security agreement. Since in its nature the general security agreement very much resembles the floating charge aspect of a debenture, the need for a non corporate debenture has to a large degree been obviated by this document.

In Ontario the advent of the general security agreement has allowed lenders to take as security a specific charge or mortgage on land and a general security

agreement, which in conjunction with one another offer basically the same form of security as a debenture. In fact, the use of a mortgage coupled with a general security agreement may be the desired security in real estate development instead of a debenture since it can readily be tailored not to generally restrict and encumber the borrower's assets other than those specifically applicable to the particular development. The use of a mortgage and a general security agreement therefore can give more flexibility to the mortgagor by freeing up some of his other assets. In general terms the general security agreement should provide the same covenants, remedies and restrictions as that contained in a debenture. A general security agreement being a security document governed by The P.P.S.A. creates fixed security under The P.P.S.A. on present and future acquired assets, establishes priorities, allows specific remedies, and avoids confusion surrounding crystallization of floating charges and enforcement thereof. The use of a general security agreement rather than a floating charge debenture is recommended with respect to security on non-specific assets. The general security

agreement puts the lender in a different position with respect to security and enforcement thereof for the following reasons:

1. The C.S.R.A. is not a priority oriented statute (registration does not guarantee priority but only gives notice);
2. Perfection of security under The P.P.S.A. establishes priority;
3. There is no necessity for crystallization in order to establish priority as is required under a floating charge debenture. (confusion as to when crystallization actually takes place; default, enforcement, notice, demand etc.); and
4. There are no specific or statutory requirements as to enforcement of a debenture and accordingly enforcement is governed only by common law principles and the provisions of the actual document. The P.P.S.A. sets out specific time requirements and procedures for enforcement of security.

G. KEY WARRANTIES, REPRESENTATIONS, COVENANTS AND EVENTS OF DEFAULT

I do not intend to review the common law distinction between a condition, the breach of which would give an innocent party the right to terminate or rescind a contract, and a warranty, the breach of which would only give an innocent party a right of action for damages. Nor do I intend to review the common law distinction between a representation, being an inducement to contract, and a warranty, being a term of the contract itself.

Rather, in this section, I shall review what I consider to be the important functions served by the inclusion of representations, warranties, covenants and events of default in the security documents. I shall also review some of the factors to be considered when negotiating these clauses. At the end of each topic I have endeavoured to list some of the essential warranties, representations, covenants and events of default which should be included in a security document. None of these lists are intended to be exhaustive. For the sake of brevity, I have intentionally omitted many of the "boiler plate" representations, warranties and

covenants that one would expect to be included in a financing transaction.

i) **Representations and Warranties**

It has become more and more common for lenders to require its borrowers to make statements of fact on which the lender relies when establishing and advancing credit facilities in favour of a borrower. These statements of fact are often described, in the security documents, as "representations and warranties".

In their simplest form, representations and warranties are statements of fact regarding the borrower and the development forming the basis of the loan. The purpose of these representations and warranties is to provide the lender with data pertaining to the borrower and the development, including the borrower's financial position and condition. Since representations and warranties are statements of fact, they should be drafted in the present tense. The maker of the representations and warranties should certify to the lender that certain statements of fact are true as of the date on which such certification is made. If it is also important to have the representations and warranties continue to be true while the loan remains

outstanding, inclusion of a specific covenant to that effect is recommended. Doing so will give the lender an opportunity to monitor, on an ongoing basis, the continued accuracy of the representations and warranties. To compliment this ongoing covenant, I find it useful to include in the security document, as an a condition precedent to each advance, the requirement that the representations and warranties be true and accurate on the date of each advance.

If a breach of a representation and warranty is stated to be a precondition to funding and a failure of the representations and warranties to remain true results in an event of default, the lender will have the options of terminating its commitment, accelerating repayment of any amounts advanced or suing for damages in the event that any one or more representation or warranty is not true. In support of a cause of action for damages, it is becoming quite usual to see a statement included in the security document that the borrower acknowledges that the lender's reliance upon the accuracy and truth of the representations and warranties, both at the time of the first advance of the loan and at the time of each subsequent advance.

When the representations and warranties are found in a security document, the cause of action arising upon a breach of these provisions will be enforceable by the lender against the borrower. As the borrower is usually obligated to the lender on the covenant in any event, the additional value to the lender of this cause of action is questionable. For this reason, many lenders take the position that a principal of the borrower or a senior officer having first hand knowledge of the business and affairs of the borrower, or both, should also be liable to the lender for breach of any of the representations or warranties. This can be accomplished by means of a separate certificate executed by the individual principal or senior officer re-stating, in his personal capacity, the representations and warranties of the borrower. Such certificate can be required contemporaneously with the delivery of the security documents and as a precondition to each subsequent advance.

When negotiating representations and warranties, the solicitor for the lender may be requested to allow the borrower to qualify the representations and warranties in a number of ways. Certain specific qualifications

may be necessary, but generalizations should be avoided. Frequently, the qualifications relate to the materiality of one or more representations or warranties. Although it may make sense to exclude immaterial inaccuracies, the lender should ensure that the concept of materiality is defined as clearly as possible. Lastly, borrowers often request that representations and warranties be qualified by the knowledge, information and belief of the maker. When representations and warranties are to be found in the security document, it is the borrower itself who is making the representations and warranties (rather than its officers or principals) and, accordingly, this kind of qualification should not be permitted. Either the statement of facts upon which the representation and warranty is made is true, or it is not true. The borrower must be required to determine which is the case. If the borrower itself does not know, then who does and who should bare the risk?

The following is a list of some representations and warranties that should be expected to be given by the borrower in construction financing.

As to Ownership and Status of Borrower and Guarantors

- as to ownership of assets (including the development)
- as to prior encumbrances (affecting the development and other property)
- as to no defaults (with lender and with third parties)
- as to no actions or proceedings instituted against or affecting the borrower, guarantors, the development or other property and assets of the borrower and guarantor

As to Financial Position or Condition

- as to financial statements
- as to taxes paid
- as to no adverse changes (since last financial statements) of the borrower, the guarantors or to the development

Status of Development

- as to all approvals, authorizations, consents and permits applied for and received from all governmental authorities having jurisdiction
- as to the existence of requisite services and utilities
- as to the existence of vehicular ingress and egress

- as to the requirement for and status of subdivision/development/site plan agreements
- as to the construction agreements and their status
- as to all other "material" agreements
- as to surveys, appraisals, soil test reports (if in existence)
- as to construction budgets and cash flow projections
- as to plans and specifications
- as to zoning/committee of adjustment applications/site specific by-laws

ii) **Covenants**

While representations and warranties are statements of fact on which the lender relies when establishing a credit facility and when making periodic advances thereunder, it is the covenants which obligate the borrower to perform the contemplated obligations. These covenants are sometimes expressed in the positive sense (imposing upon the borrower an obligation to do something) and are sometimes expressed in the negative sense (imposing upon the borrower an obligation to refrain from doing something).

The extent of the positive and negative covenants included in a security document is only a function of the degree of control required to be maintained by the lender over the borrower and the development.

Positive covenants can be loosely placed in one of three categories. Firstly, there are those positive covenants which require the borrower to maintain the status quo. Secondly, there are those which obligate the borrower to provide to the lender access to the development and information regarding the development. Thirdly, there are those which require the borrower to proceed with the development in a specific manner either with or without requiring the consent of the lender at various stages.

When drafting covenants, one should always keep in mind the contemplated degree of control that the lender desires to maintain over the borrower and its affairs, whether related directly to the development in question or to other assets as well. Covenants which are too restrictive can be just as unsatisfactory as covenants which are not restrictive enough.

Great care must be taken to avoid the situation in which a lender, as a result of the degree of involvement and control over the development, might be held to be an "owner" under the Construction Lien legislation, thereby increasing such lender's exposure.

The ability of the lender to monitor the activities of the borrower and the ability of the lender to respond promptly to requests of the borrower for consents and approvals (if so required by the covenants) must also be considered when drafting the covenants.

If the covenants are drafted in a fashion requiring the continued involvement of the lender in the operation of the business of the borrower beyond the Lender's contemplated or possible control, non-enforcement may result and the lender, through its course of conduct, may be held to have waived its rights to require further fulfillment of such covenants. Avoiding unnecessary restrictions and limiting the lender's involvement to areas of primary concern is by far the better route to take.

As was the case with representations and warranties, covenants may be qualified by specifically listed

exceptions. Qualifications as to "materiality" may also be applicable in certain circumstances. Lastly, where discretion is afforded to the lender, borrowers may require an express statement that the lender shall act "reasonably" in the exercise of any discretion given to it. Query whether the lender would be obligated in any event to exercise its discretion in a reasonable fashion in the absence of a contractual provision to that effect?

From a lender's point of view, provisions deeming consent to have been given if the lender fails to respond to a request for consent within a specified period of time should be avoided, especially where the lender does not have the capability to respond quickly to such requests.

The following is a list of some of the covenants utilized by lenders to maintain the status quo:

- all of the representations and warranties shall continue to be true until the loan is repaid in full
- pay all debts when due (to lender and to third parties)

- perform all obligations (to lender whether in the primary security document or otherwise)
- perform all third party obligations
- ensure that title to the development remains good and marketable, free and clear of all encumbrances (including claims for lien)
- ensure that all permitted encumbrances continue to be in good standing
- pay all costs and expenses incurred by the lender in connection with the loan transaction
- pay all taxes and utilities
- preserve its other assets and businesses
- comply with all laws affecting the borrower, the development and its other properties and assets
- insure the development, property and assets of the borrower secured to the lender
- not to allow the ownership, whether legal or beneficial, of the development to be changed
- not to allow the ownership or control of the borrower to be changed (whether by way of issue, redemption or purchase of shares, or by way of amalgamation, arrangement or otherwise)
- not to encumber its assets (including the development) other than to the lender

- not to borrow money except from the lender
- not to give guarantees
- not to change the nature of the businesses of the borrower
- not to pay any debt before it is due
- not to enter into any non-arm's-length transactions with respect to the development
- not to enter into any lease of personal property to be used in connection with the operation of the development
- not to alter the construction contract, the insurance policies or any other third party agreements or arrangements that have been reviewed and/or approved by the lender
- not to alter the plans and specifications or budgets for the development without the prior approval of the lender

The following is a list of some of the covenants that provide information and access to the lender:

- delivery of most recent financial statements
- delivery of future financial statements following each prescribed fiscal period
- allow lender access to the development

- allow lender access to the books and accounts of the borrower relating to the development
- provide notice to the lender of any material changes in the property or assets of the borrower
- provide copies to the lender of any notices received or given by the borrower with respect to the development or any contracts relating thereto
- provide notice to the lender of any defaults by the borrower

The following is a list of some of the covenants relating to the development of the project:

- to commence construction by a certain date
- to use a contractor (and other professionals approved by the lender)
- to continue construction without interruption or delay
- to complete construction by a certain date (whether in phases or substantial completion)
- to use the proceeds of the loan only for authorized purposes
- to obtain the lenders approval of all contracts, plans and specifications, bonds, budgets, insurance policies, surveys,

appraisals, soil test reports, etc., relating to the development

- to ensure that the construction conforms with all applicable laws and permits and the approved plans and specifications and the approved budget therefor
- to ensure that certain rental or sales tests are met and that all agreements of purchase and sale and/or agreements to lease are satisfactory to the lender
- to provide periodic cash flow reports and architect certificates relating to costs in place and costs to complete
- to provide invoices evidencing soft costs
- to correct any defect required by any governmental authority, the borrower's architect or any cost consultant or quantity engineer retained by the lender
- to retain professionals and other experts at the expense of the borrower
- to provide a survey showing footings and foundations
- to permit the lender to advertise its participation in the development and to erect a sign at the project site

- not to alter the plans and specifications, bonds, budgets, constructions contracts, policies of insurance and other matters that have been reviewed and/or approved by the lender

iii) **Events of Default**

Events of default are usually drafted so as to allow the lender the option of accelerating the indebtedness and enforcing and realizing upon its security in the event that one or more of such events occurs. Automatic acceleration of the indebtedness upon the occurrence of a default is not recommended for it may not be in the lender's best interests to accelerate the loan if a minor or technical breach occurs. In addition, acceleration may result in other debts of the borrower going into default, thus causing an unwanted "domino" effect.

It is useful to include in the security document, as an event of default, the failure of the borrower to fulfil and satisfy any obligation to be found in such security document and in addition in any other security document, agreement or other writing delivered or assigned by the borrower to the lender in connection with the loan. This will allow any default by the

borrower under any of the documents entered into with the lender in connection with the loan to be a default under the primary security document.

Lenders sometimes require "cross default" provisions to be included in the security documents so that a default by the borrower in any other indebtedness secured on the lands in question triggers a default by the borrower in the loan with the lender. It is also not unusual for a lender to provide that default by the borrower in any of the material contracts relating to the development constitutes a default under the security document as well.

Very often borrowers request a period of grace that provides that a default has not occurred until the expiry of a certain period of time, sometimes predicated by the lender giving notice of such default to the borrower. There are some practical difficulties with the lender agreeing to such request. Firstly, the 15 day default period provided for in section 31 of the Mortgages Act would be delayed. This section states that "notice of exercising the power of sale shall not be given until the default has continued for at least 15 days". It is therefore better to ensure that the default is not delayed by any

grace period given by the lender, so that the 15 day statutory period commences when the actual default occurs. In addition, if the grace period is said to run from the date of service of notice of default on the borrower, it is almost certain that at least one or more days will elapse before the lender is aware of the default and instructs its solicitors to give notice of default.

I recommend that any period of grace to be afforded to a borrower not relate to the commencement of the default, but only to the period during which the lender agrees not to enforce its rights or remedies under the security document. In that way, the existence of the default will not have been delayed so as to prevent the running of the 15 day period under section 31 of the Mortgages Act. Furthermore, evidentiary problems with respect to the giving and/or receipt of notice can be overcome by not tying the grace period into receipt by the borrower of notice of same.

No grace period should be given with respect to defaults that cannot be cured by the borrower, for example, insolvency or bankruptcy related defaults. Although often requested, I do not believe that grace periods are appropriate with respect to "monetary"

defaults, since the due date of payments is known to the borrower well in advance.

Finally, as applicable to mortgage situations, the provisions of sections 21, 22, 23, 25 and 31 of the Mortgages Act give sufficient time and opportunity to the borrower, i.e., 15 days and 35 days (or 45 days, if a statutory power of sale) to avoid the adverse ramifications resulting from a default.

Materiality tests relating to representations, warranties and covenants become more important, from the viewpoint of the borrower, in the event that any failure of a representation or warranty to be true or the failure to fulfill a covenant results in an event of default. Certainly the borrower will want to ensure that only material breaches result in events of default. When negotiating materiality provisions, extreme caution must be taken by the solicitor representing the lender to ensure that ambiguity is avoided. Where possible, objective tests (for example, not enter into any leases having a gross floor area of more than 5,000 feet, or not default in any loan having a principal amount exceeding $25,000.00) take much of the guess work out of materiality qualifications.

Insolvency and bankruptcy related defaults should include the following:

- committing an act of bankruptcy
- becoming insolvent
- making a bulk sale of assets
- ceasing to carry on business
- proposing a compromise or arrangement
- commencement of any proceedings to have the corporation declared bankrupt or wound-up or to have a receiver or receive and manager appointed for any property or assets of the borrower
- an encumbrancer or any receiver or receiver and manager taking possession of any assets of the borrower
- any execution, writ or other process of the court becoming enforceable against the borrower
- distress or an analogous process is levied upon the property of the borrower
- a claim for lien being registered against the subject property or notice thereof being given to the lender

An act of bankruptcy is defined in section 24(1) of the Bankruptcy Act (R.S. c. 14) as amended and includes

a debtor ceasing to meet its liabilities generally as they become due. When acting for a borrower, therefore, one must ensure that this section and the related case law is reviewed in detail in order to appreciate the full extent of the phrase commit an "act of bankruptcy".

A lender's solicitor must be aware of the inherent ambiguity of the phrase "becomes insolvent". Aside from an accounting definition of "insolvent" under generally accepted accounting principles, the Business Corporations Act, 1982, the Canada Business Corporations Act and the Bankruptcy Act each contain insolvency tests. It is therefore incumbent upon a lender's solicitor to ensure that insolvency is clearly defined so as to make this event of default meaningful and properly enforceable.

The following is a list of some of the additional events of default that should be included in a security document;

- if the development is condemned, destroyed or rendered substantially unfit for the purposes for which it was intended
- if all or any part of the real property on which the development is constructed (and that

is necessary for the efficient or lawful use of the development) is expropriated

- if any material adverse change occurs to either the property or the financial positions of the borrower or any guarantor
- if the lender believes that the ability of the borrower to repay its debts has been diminished or impaired
- if any insurance proceeds in excess of $* become payable

H. RECEIVERS' CLAUSES

Receivers may be appointed by a court pursuant to the Courts of Justice Act (S.O. 1984 c. 11) as amended or by a lender pursuant to the powers set out in a security document held by such lender. In this section I shall deal with the latter, who is frequently referred to as a "private receiver".

I do not intend to provide you with a summary of the law of receivers or receiverships. Rather, I shall review the essential features to be included in

security documents which give the lender the contractual authority to appoint a receiver.

Historically, a "receiver" had the power to collect debts and sell assets. It was the "manager" who had the power to manage and carry on the business of the debtor. Therefore the term "receiver" as defined in any security documents should include a receiver, a receiver and manager and a receiver/manager.

As indicated above, the power to appoint a receiver must be expressly provided for in the security document. Very often, this power is expressed to be exercisable whether or not the lender is in possession of the charged property. As a receiver is appointed with respect to specific assets, it is important to include, in the security document, a provision giving authority to the lender, at any time that a default exists, to appoint a receiver of the "charged property" and of the "rents and profits" therefrom. This has the effect of ensuring that the receiver is appointed with respect to the real property charged by the security document as well as any personal property (rents and other choses in action) that arise out of or from the use and occupation of such lands. In a non-debenture situation a receiver may have to be appointed pursuant

to more than one security documents. (ie. mortgage and general security agreement)

In addition to the power to appoint a receiver and to fix and pay the remuneration of the receiver, the lender should be given the ability to remove and replace such receiver and to fix and pay the remuneration of any new receiver.

Generally, the privately appointed receiver can only act in accordance with the contractual provisions pursuant to which he was appointed. It is therefore necessary for all of the powers of the receiver to be expressly provided for in the security document.

The receiver provisions must ensure that the receiver is given broad powers and authority so that once appointed, he will be free to do whatever is necessary in order to realize sufficient revenue from the assets charged by the security document to repay to the lender all of the indebtedness owing by the borrower.

In addition, it is usual to find the following powers included in so-called "standard form" receiver's clauses:

1. take possession of all or any part of the charged property;
2. manage, operate and carry on all or any part of the business and undertaking of the borrower;
3. sell, lease or otherwise dispose of all or any part of the charged property, whether by private tender or public sale or public auction and either for cash or credit or a combination of both;
4. to borrow money (whether in priority to the charge constituted by the security document or otherwise) in order to maintain, preserve or protect all or any part of the charged property or in order to manage, operate or carry on the business and undertaking of the debtor or any part thereof;
5. to settle or compromise indebtedness of the borrower or make any arrangement with creditors of the borrower;
6. to maintain, preserve and protect the charged property or any part thereof including the right to pay any debts

relating thereto or any charges or liens having priority to the security constituted by the security document;

7. complete any unfinished construction including the power to retain experts, contract for the supply of services and materials, enforce and take the benefit of contracts entered into by the borrower and amend and terminate any of such contracts;
8. institute, and prosecute actions and other proceedings; and
9. apply for, negotiate and execute applications for re-zoning and severance, agreements for the supply and maintenance of utilities and other services, subdivision agreements, development agreements, site plan agreements, grant easements and rights-of-way and prepare and file applications for first registration or create one or more condominium corporations.

In addition the following additional provisions should also be included in the security document:

1. a statement to the effect that a statutory declaration or certificate of an officer

of the lender as to the existence of a default under the security document shall be conclusive evidence of the existence of such default;

2. that the receiver shall irrevocably be deemed to be the agent or attorney of the borrower and, accordingly, it shall be the borrower, and not the lender, who is liable and responsible for the acts and omissions of such receiver;
3. that the appointment of the receiver shall not incur or create any liability on the part of the lender to the receiver, either in respect of such appointment, any removal and replacement of such receiver or with respect to anything done or omitted to be done by any such receiver or replacement receiver;
4. that neither the appointment nor replacement of the receiver nor anything done or omitted to be done by the receiver shall constitute the lender a mortgagee in possession in respect of the charged property or any part thereof; and
5. that the receiver shall only be liable to account to the borrower for moneys

actually received by it in respect of the charged property or any part thereof and that such receiver shall be entitled to pay, out of such moneys received, in any order deemed advisable:

(a) the remuneration of the receiver as fixed by the lender;

(b) all indebtedness and liability incurred by the receiver;

(c) all indebtedness and liability that is or becomes a charge upon the charged property or any part thereof in priority to the charge constituted by the security document including, without limitation, taxes, utilities and insurance premiums; and

(d) all amounts owing to the lender by the borrower.

In connection with the appointment of the receiver as agent of the borrower, I wish to make two observations. Firstly, as an added safeguard for the lender and to avoid responsibility for the indebtedness and other obligations incurred by the receiver, the receiver should be instructed and empowered, whenever dealing with third parties, to do so expressly as agent of the borrower. Secondly, if any of the property charged in

the security document constitutes personal property which, pursuant to the PPSA, can only be perfected by possession or, can be perfected by possession or registration (but which was not perfected by registration), deeming the receiver to be the agent of the borrower may result in such personal property remaining unperfected, even though the receiver has possession of it. This is due to the application of s. 24 of the PPSA which provides that "possession of collateral by the secured party or on behalf of the secured party (other than the debtor or the debtor's agent) perfects a security interest in...goods, instruments, securities...only during its actual holding as collateral". This result was obtained in the case Sperry Inc. v. Canadian Imperial Bank of Commerce et al (Ontario Court of Appeal) 4 P.P.S.A.C. 314, in which the Ontario Court of Appeal held that because the security agreement constituted the receiver as the agent of the debtor, the receiver's possession of collateral (not otherwise perfected by registration) did not constitute possession of such collateral by or on behalf of the secured party. Accordingly, the security interest was unperfected.

I WRAP-AROUND MORTGAGES

i) What Are They?

To quote from the Canadian Mortgage Practice Reporter (Volume I at page 44-32), "Wrap-around mortgages are an obscure financing instrument which [are] not well understood by developers or lenders.". No doubt, the reason for this obscurity can be traced directly to the obiter statements of District Court Judge Little in the 1979 decision of Wagner et al v. Argosy Investments Limited, 7 R.P.R. 305 at pages 324 and 325:

> "On the whole, I must reach the conclusion that even if I accepted the philosophy of [wrap-around mortgages] as constituting a desirable practice, which I do not, it is clearly not, on the facts of this case 'demonstrably beneficial' to the plaintiffs. The plaintiffs received no benefit here that could not have been contained in a normal third mortgage...".

This decision will be discussed in more detail later in this paper. Before doing so, let me review with you the concept of and the theory behind wrap-around mortgages.

Simply stated, a wrap-around mortgage is a variation of a conventional second (or subsequent) mortgage containing the following additional features;

1. the principal amount of the wrap-around mortgage will be the aggregate of:

(a) the outstanding principal balances of all previous mortgages that will not be discharged; and

(b) the amount of any new funds to be advanced by the wrap-around mortgagee;

2. the mortgagor is obligated to pay interest to the wrap-around mortgagee on the full principal amount of the wrap-around mortgage (even though the wrap-around mortgagee has not advanced all of these sums to the mortgagor); and

3. the wrap-around mortgagee assumes the obligation of the mortgagor to pay principal and interest to the prior encumbrancers (subject to the wrap-around mortgagee's receipt of principal and interest on the wrap-around mortgage from the mortgagor).

In theory, the wrap-around mortgage provides the following benefits to the mortgagor:

1. the mortgagor is not required to prepay existing encumbrances. Obviously, the extent of this benefit increases if the existing mortgages have rates

substantially lower than the then current first or second mortgage interest rates;

2. although the interest payable on the wrap-around mortgage is higher than the rate payable on the existing mortgages, it is lower than the average rate of the existing mortgages and any new mortgage. The effect of this benefit is to provide the mortgagor with additional funds secured by his property with lower over-all interest costs than he would have had to pay if he took out a new conventional second mortgage or a new conventional first mortgage and repaid the existing low interest first mortgage; and

3. the Borrower will only be required to make one payment of interest to the wraparound mortgagee (rather than two monthly payments, one to the existing low interest first mortgagee and one to a conventional mortgagee).

By way of example, assume a mortgagor has an existing first mortgage in the amount of $100,000.00 at 6% per annum. His yearly interest payments would aggregate $6,000.00. If this mortgagor required an additional $100,000.00 and the current first mortgage rate was 10%

and current second mortgage rate was 13%, the following examples show the costs to the mortgagor if he takes out a new second mortgage for $100,000.00, if he takes out a new first mortgage in the amount of $200,000.00 and repays the existing low interest rate first mortgage (assuming it is prepayable) and, lastly, if the wrap-around mortgage technique is utilized.

<u>Example 1 - New Second Mortgage</u>

Principal amount of Second Mortgage	$100,000.00
Amount of funds advanced	$100,000.00
Rate of Interest	13.00%
Yearly interest payments on Second Mortgage	$ 13,000.00
Yearly interest payments on First Mortgage	$ 6,000.00
TOTAL INTEREST PAYMENTS	$ 19,000.00

<u>Example 2 - New First Mortgage</u>

Principal Amount of new First Mortgage		$ 200,000.00
Amount of Funds Advanced	$200,000.00	
Less amount paid to original first mortgagee	$100,000.00	
Net Advance to mortgagor		$ 100,000.00
Rate of Interest		10.00%
Yearly Interest Payments		$ 20,000.00
TOTAL INTEREST PAYMENTS (low interest first mortgage discharged)		$ 20,000.00

Example 3 - Wrap-Around Mortgage

Principal Amount	$ 200,000.00
Amount of Funds Advanced	$ 100,000.00
Rate of Interest	8.50%
Yearly Interest Payments	$ 17,000.00
TOTAL INTEREST PAYMENTS (wrap-around mortgage pays $6,000 interest to low interest first mortgagee)	$17,000.00

N.B. Wrap-around mortgagee receives	$17,000.00
Pays to first mortgagee	$ 6,000.00
Net Interest received	$ 11,000.00
Yielding to wrap-around mortgage on amount actually advanced	11.00%

The wrap-around mortgage in theory provides the following benefits to the mortgagee;

1. As indicated in Example 3, the yield on advanced funds to the wrap-around mortgagee can be higher than the first mortgage rates then existing;

2. As the wrap-around mortgagee is obligated to make payments under the first mortgage (provided it receives payment from the mortgagor), the wrap-around mortgagee will be in a position to better monitor the status of the first mortgage and perhaps

and over a longer term and with a longer amortization may reduce the debt service for the owner; and

4. when an owner requires new financing but cannot raise sufficient funds on a new first mortgage so that additional financing is necessary but would be too expensive if secured by a conventional second mortgage. In this situation, a "simultaneous wrap-around mortgage" for additional funds may be obtained contemporaneously with a conventional first mortgage.

iii) **Why They Are Not Used**

Wrap-around mortgages are no longer considered a viable financing technique in this province as a result of the judicial disapproval expressed by District Court Judge Little in the Wagner v. Argosy case quoted above. From a lender's perspective, the key to a wrap-around mortgage is the borrower's covenant to pay interest on the full principal amount of the wrap-around mortgage (which includes the outstanding principal balances of all prior encumbrances) notwithstanding that the wrap-around mortgagee does not advance all of such funds. Canadian courts (Manley v. London Loan Co. (1896), 23 O.A.R. 139 affirmed 26 S.C.R. 443) have adjudicated, that where a mortgagee advances part of the principal

amount expressed in its mortgage to the mortgagor, with intent to advance the balance to a prior mortgagee in order to discharge such prior mortgage, he cannot charge the mortgagor with interest at the increased rate specified in the subsequent mortgage on the amount thereof that it intends to pay to the prior mortgagee, unless the subsequent mortgagee has set apart the amount owing under the prior encumbrance and notified the mortgagor to that effect. The subsequent mortgagee may, until the prior mortgage is fully paid, only charge interest at the increased subsequent mortgage rate on the amount actually advanced, (Edmonds V. Hamilton Provident & Loan Society (1891) 18 O.A.R. 347.)

In the Wagner case at Page 327 Judge Little stated:

> "...interest is payable only upon moneys actually advanced or held and specifically earmarked by the mortgagee in a trust portion where it is accountable for offset revenue."

Judge Little reached this conclusion based, in part, on the fact that Argosy Investments Limited, the wrap-around mortgagee, did not set aside moneys (equal to the principal amount of the prior mortgages on title) into a separate account to cover unadvanced payments. Of course, doing so would have all but eliminated the benefit to the wrap-around mortgagee of the wrap-around

mortgage (for the wrap-around mortgagee would have to account to the mortgagor for profits received from its use of the funds set aside in such separate account).

The Wagner case was followed in the 1984 British Columbia Supreme Court Decision Re La Pointe et al and Robinson Holdings Ltd. et al 8 D.L.R. (4th) 750. As a result of these decisions, wrap-around mortgages have become a defunct vehicle for the following reasons. Firstly, the wrap-around mortgagee can only collect interest from the mortgagor on funds actually advanced to the mortgagor. Secondly, if a sum certain is set aside for the mortgagor in a specific identifiable account, so that interest can be properly charged, the wrap-around mortgagee must credit the mortgagor with any profits obtained by the wrap-around mortgagee from the use of any such unadvanced funds.

iv) Is There an Alternative?

J. Gerald O'Grady suggests in his article entitled "The Wrap-Around Mortgage", (1982 Annual Institute on Continuing Legal Education; Real Property Current Trends in Financing and Structuring Real Estate

Interest) that a wrap-around mortgage technique can still be utilized with the following variations:

1. the wrap-around mortgagee advances to the mortgagor the full principal amount of the wrap-around mortgage (including the outstanding principal amounts of the prior encumbrances);
2. the mortgagor uses the portion of the advance representing the outstanding principal amounts of the prior encumbrances to make an unsecured loan in that same amount to the wrap-around mortgagee at the rate and on terms and conditions as are set out in the prior encumbrances;
3. the wrap-around mortgagee does not agree to assume the principal and interest payments owing on the prior encumbrances;
4. interest payments owing by the wrap-around mortgagee to the mortgagor (pursuant to the loan made by the mortgagor to the wrap-around mortgagee equal in amount and on same terms and conditions as are set out in the prior mortgages) are directed by the mortgagor to be paid directly by the wrap-around mortgagee to the holders of the prior encumbrances; and

5. The wrap-around mortgagee must be permitted to set off from the interest payments it owes to the mortgagor (which have been directed to the holders of the prior encumbrances) any amounts that the mortgagor fails to pay to the wrap-around mortgagee pursuant to the wrap-around mortgage.

Since the full amount of the wrap-around mortgage is advanced to the mortgagor, the Wagner decision should be distinguishable on its facts, and interest at the rate set out in the wrap-around mortgage on the full principal amount of the wrap-around mortgage may be enforceable against the mortgagor. In addition, as the full amount of the wrap-around mortgage has been advanced, there is no need for the wrap-around mortgagee to set aside a fund as contemplated in the Wagner decision. If no fund need be set aside, the wrap-around mortgagee need not account to the mortgagor for profits received as a result of its use of these funds.

Needless to say, this wrap-around mortgage technique with a twist has not been tested in the courts of this province. I can only guess that this is so due to the

conservative nature of most lenders and their solicitors who, wary of the beating taken by the lender in the Wagner decision and in the Re La Pointe decision, have decided to turn to alternate financing techniques in circumstances where a wrap-around mortgage would have been beneficial.

As to whether or not such technique is subject to attack by the Courts as doing indirectly what cannot be done directly, no one can guarantee. In view of a definite lack of business purpose of the mortgagor's unsecured loan to the wrap-around mortgagee and the position of the Courts in other instances I recommend extreme caution.