

Subsequent Mortgagee's Rights: Curing a Default and the Importance of Breached Covenants

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A recent decision of the Ontario Court of Appeal serves as a reminder to subordinate lenders looking to take control over the sale of a property in a mortgage enforcement scenario that a partial cure of a default will not be enough to bring a mortgage into good standing.

In the case of *Business Development Bank of Canada v. Pine Tree Resorts Inc.*, Pine Tree and 1212360 Ontario Limited, the owners and operators of the Delawana Inn in the Georgian Bay community of Honey Harbour, Ontario, defaulted on their loan obligations to both the Business Development Bank of Canada (BDC) and Romspen Investment Corporation.

BDC's security had first position with respect to Pine Tree's indebtedness. BDC applied for a court-appointed receiver, which Pine Tree and Romspen opposed. All parties agreed that the property had to be sold immediately. But, while Romspen wanted to re-open the inn for the upcoming summer season and try to sell it on a going-concern basis, BDC did not.

BDC was successful in its application for a receiver. Pine Tree and Romspen then appealed. At issue was whether an appeal was Pine Tree's and Romspen's right under section 193 of the *Bankruptcy and Insolvency Act* (BIA) and, if it was their right, whether the order should be stayed pending the appeal.

Before the application judge and on this motion, Romspen's central argument was that it was entitled to exercise its rights as a subsequent mortgagee under section 22 of Ontario's *Mortgages Act* to put BDC's mortgage in good standing and take over the sale of the property.

Romspen proposed to do so by paying all arrears and outstanding costs -- except approximately \$250,000 in HST arrears.

These arrears constituted a breach of a covenant under the BDC security and therefore was a default.

Romspen argued, however, that the arrears did not jeopardize BDC's security because they were a subsequent encumbrance.

Therefore, Romspen asserted, it was not necessary for Romspen to comply with that covenant in order to be able to take advantage of a subsequent mortgagee's rights under section 22.

The legal issue to be decided by the Court, therefore, was whether the application judge erred by relying on a covenant default that could not prejudice BDC or erode its first-ranking security as the basis for her conclusion that Romspen had not complied with the requirements for the exercise of a subsequent mortgagee's rights under section 22. In other words, was Romspen required to cure the default by performing the breached covenant involving the tax arrears in order to be able to exercise its section 22 rights?

The Court of Appeal concluded that an appeal was not as of right in this case and that leave to appeal was required.

The court then examined whether leave to appeal should be granted pursuant to section 193(e) of the BIA.

In deciding this, the court first consolidated and clarified two articulations of the test for granting leave to appeal under section 193(e) that have emerged in the jurisprudence and brought the criteria in line with the criteria used to grant leave in restructuring proceedings under the *Companies' Creditors Arrangement Act* of Canada.

Beginning with the overriding proposition that the exercise of granting leave to appeal is discretionary and must be exercised in a flexible and contextual way, the court will look to whether the proposed appeal:

- a. raises an issue that is of general importance to the practice of bankruptcy/insolvency matters or to the administration of justice as a whole, and is one that the court should therefore consider and address;
- b. is *prima facie* meritorious, and
- c. would unduly hinder the progress of the bankruptcy/insolvency proceedings.

Applying those tests, the court concluded that the facts in this case did not meet the *prima facie* meritorious threshold. Romspen's offer to bring BDC's mortgage into good standing would have left a \$250,000 covenant unperformed.

The court said that for Romspen to succeed on appeal would require a very creative interpretation of section 22 and one that would potentially create an undesirable element of

uncertainty in the field of mortgage enforcement because no one would know which covenants could be left unperformed and which could not, without litigating the issue in each case.

The conclusion is that, if a subsequent mortgagee wishes to enforce its rights under section 22 in bringing a mortgage into good standing, it will have to not only tender the arrears but will also have to perform any covenant in default.

Subordinate lenders should therefore be mindful of the covenants contained in the security documents of any prior-ranking lender and know the impact that a breach of any of those covenants will have on its rights in a mortgage enforcement situation.