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CRA Loses Priority Fight Against Holder of Unregistered Interest

A recent court decision provides important clarification as to the nature and priority ranking of registered liens filed by the Canada Revenue Agency against debtor-taxpayers.

Quoc Dung Tran ("Tran") owed about $350,000 to his sister Rosaline Trang ("Rosaline"). He also owed about $1.5 million to the Canada Revenue Agency ("CRA"). The main issue before the court was to determine how Rosaline's security interests ranked as compared to those of the CRA.

Rosaline's security consisted of an unwritten 2003 agreement giving her an equitable mortgage for $250,000 against property owned jointly by Tran and his wife. She also held an equitable mortgage for $100,000 over certain other land owned by Tran alone. The CRA, on the other hand, had filed registered liens against both of Tran's properties. Rosaline's equitable interests arose prior to the registration of the CRA's liens, but the CRA had no knowledge of her interest at that time.

A dispute arose as to the priority of these competing securities, and the matter was brought to court, with Rosaline claiming that her unregistered, equitable mortgages took priority over the CRA's certificates of lien.

In examining this scenario, the court observed that under the federal *Income Tax Act*, the CRA was entitled to issue a certificate setting out any amounts unpaid by a debtor such as Tran. Once registered, such a certificate was equivalent to a court judgment against Tran for the amount he owed, pursuant to the Act's express language. In other words, the CRA had essentially filed the equivalent of a judgment of the Ontario Superior Court; this being the case, the CRA was merely a judgment creditor, and its registered lien had essentially been transformed into a writ of execution. As such, any writ that the CRA filed would simply cover the *proceeds of sale* of Tran's equitable interests in the lands. The court also rejected the argument that the CRA's liens had priority because they had been converted into "charges" upon the land within the meaning of the Ontario *Land Titles Act*, or that they were akin to registered "mortgages". Nor was the CRA considered to be either a *bona fide* purchaser for value or a mortgagee for value.

In contrast to the CRA, Rosaline was a lender who had "bargained for priority." Her interest in Tran's properties therefore had priority over the subsequent legal interests of the CRA. See: *Trang v. Nguyen*, 2011 (ONSCJ).

New *Interest Act* Regulations Clarify Mortgage Pre-Payment Rights

The federal government has recently passed new Regulations under the *Interest Act* to clarify the law relating to commercial mortgage lending pre-payment rights. The change is an important one, because it expands upon the categories of those business and commercial entities which are excluded from legislated ramifications related to the exercise of mortgage pre-payment options.

As background, the *Interest Act* is relatively succinct federal legislation establishing general principles relating to the charging of interest on loans, including loans secured by mortgages. Section 10 of that legislation states that, in circumstances where the principal or interest under a mortgage is payable more than five years after the date of the mortgage, the borrower has a right of pre-payment; specifically, the borrower can pay off the principal, accrued interest, plus a pre-payment penalty equivalent to three months' interest. After that, no further payments or penalties can be charged by the mortgagee. [Note: This is very similar to s. 18 of the Ontario *Mortgages Act*.]

However, this provision does not apply to all mortgages, nor to all borrowers. Instead, s. 10(2) specifically exempts: 1) mortgages given by a joint stock company or "any other corporation"; and 2) a "prescribed mortgage" given by a "prescribed entity." These "prescribed" classes are defined by regulation.

Over time, certain issues have arisen from the operation of these provisions. First of all, there was some legal uncertainty surrounding their application to mortgage renewal situations where the original term *plus* the renewed term exceeded five years after the original mortgage date. (It was subsequently clarified by the Supreme Court of Canada in *Royal Trust Co. v. Potash* that, with a proper renewal letter, the mortgage can be closed for a further five-year period, without the pre-payment right arising in the borrower's favour.)

Secondly, in the modern commercial context the *Interest Act*'s s. 10(2) exclusion of joint stock corporations and "any other corporations" had resulted in an impractical differentiation between types of business entities. Practically speaking, the pre-payment option in s. 10(1) generally applied to non-corporate organizations such as business trusts, partnerships and unlimited liability corporations. However, some had argued that these entities are similar to the "joint stock company" and "other corporation" categories specifically exempted by s. 10(2). (Indeed, in a case before the Ontario Court of Appeal called *Litowitz v. Standard Life Assurance Co*., the issue was whether the narrow distinction could be circumvented. There, borrowers in a partnership – *i.e.* a non-corporate structure normally eligible to pre-pay under s. 10(1) – had chosen to use a nominee corporation to hold title to real property, since they were unable to do so in their own names. The court held that this precluded the partnership's ability to avail itself of s. 10(1), since the right to do so was dictated by *corporate status of the mortgagor* – in this case, the nominee corporation that had signed as such).

Partly to settle these kinds of issues, the federal government has recently passed a Regulation under the *Interest Act*, effective January 1, 2012 (titled the *Prescribed Entities and Classes of Mortgages and Hypothecs Regulations*), which expands the list of "prescribed entities" in s. 10(2), thereby broadening the category of organizations that do not fall under the s. 10(1) pre-payment

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regime. Specifically, "prescribed entities" now includes partnerships, as well as trusts settled for business or commercial purposes. (And for Alberta, Nova Scotia and British Columbia, it also includes unlimited liability corporations.) Therefore, mortgages given by these newly-included "prescribed entities" no longer fall within s. 10(1) of the Act and its pre-payment provisions. In light of these recent changes, a borrower or lender should consult with their legal advisors before utilizing any of these additional entities as a borrower with a mortgage extending beyond a five-year term.

Builder Obliged to Complete Home Without Delay

In August 2001, Ahmad Jongazma entered into an agreement to buy a home for $295,000 in Phase I of a development by a builder named Primont Homes. Jongazma paid a deposit, and was told the closing date was in May 2002. The agreement contained delay/extension clauses allowing Primont to extend the closing date in certain circumstances, with notice, by up to 240 days, and to terminate the agreement at that point if the home was still not completed.

Two months before the scheduled closing, Primont wrote to Jongazma advising that his home would not be ready on time, and gave a new closing date of September 2002. Upon receiving the letter Jongazma contacted a Primont representative, and told her he had been intending to sell his current home. The representative did not dissuade him from doing so. By second letter in July 2002, Jongazma was again advised by Primont that his home would not be ready on time. The closing date was extended once again, to January 2003. Primont invited Jongazma and his wife to select finishes on their new home (which they did in September 2002), and continued to lead him to believe it would be completed by January 2003. By this point, Jongazma had already sold his existing residence.

What Jongazma did not know, was that while Primont had already obtained a draft plan approval from the municipality for Phase I of the development in October of 2000 (before signing with Jongazma), at that time it had already purchased certain lands adjacent to the Phase I property. As such, and wanting to make more efficient use of the overall parcel and to minimize its building costs, Primont had ***re-submitted*** a draft plan for approval in July 2001, just before signing the contract with Jongazma in August. While awaiting the outcome of that re-submission application, Primont had deliberately held off on developing the new homes in Phase I, including Jongazma's. The long-awaited approval for the re-submitted application was finally received by Primont in December of 2002.

This timing coincided with the end of the 240-day extension period in the agreement with Jongazma. Relying on the assumption that the agreement had technically expired under the delay/extension clause, Primont then re-sold the same house to another buyer for $90,000 more than Jongazma had been willing to pay. (Primont claimed that all Phase I houses were now being sold at higher prices in order to recoup the losses occasioned by the various development delays.) It did not offer Jongazma the option to re-buy the same home.

Jongazma sued, claiming that Primont had: 1) unreasonably caused the delay that resulted in its failure to have the home ready for the May 2002 closing; 2) wrongly sold him the home knowing it had resubmitted the application a month earlier and that construction delays would result; 3) led him to believe all along that his home would be completed on time; and 4) acted unreasonably and in bad faith toward him, in doing so.

The court agreed. First, it accepted expert evidence that Primont could have finished Jongazma's home on time if it had commenced construction immediately after receiving the first draft plan approval. Next, it found that Primont could not fairly enter into an agreement with Jongazma knowing that it was based on timelines that would change once the re-submitted application was approved. In other words, the delays were entirely foreseeable when Primont sold the home to Jongazma in August 2001.

At the time the deal was signed, Primont should have advised Jongazma that it had re-submitted the application, and that delays exceeding those allowed for by the agreement would likely result. And when it later wrote to Jongazma with the first extension, it should have disclosed to him exactly what was transpiring, and advise him of the real reason for the delay. On this point the court said:

"I find that Primont could have avoided the delays by proceeding on the October approval without filing its resubmission in July 2001. It chose to resubmit, knowing that would likely cause further delays in delivering Phase 1. Nevertheless it entered into the August 19, 2001 Agreement with the Plaintiff. Instead of giving fair warning of the likely delays, Primont withheld information, then later tried to blame the Town of Richmond Hill for them."

Finally, knowing what it knew at the time of sale, Primont should have given Jongazma the opportunity – before he decided to buy – to determine whether he would accept further delays beyond the 240-day extension period. Nor was it open to Primont to sell the home to another buyer without giving Jongazma the opportunity to close the deal at the original price he had agreed to. Primont had not acted reasonably toward Jongazma in this case. Indeed, the court condemned Primont for its unscrupulous conduct in the matter, and in finding for Jongazma awarded him $50,000 in punitive costs, writing:

In March 2002, knowing it could not deliver the house in September, it did not warn the Plaintiff not to sell his house….When it finally was able to get the permissions needed and was in a position to deliver the home, it was not prepared to honour the terms of the contract. Primont tried to recover the extra costs caused by its resubmission from him whose inconvenience it had caused. It persisted in misleading the Plaintiff over a lengthy period of time. It concealed its conduct. It attempted to profit from its misconduct. Its conduct related to the Plaintiff's family home, a matter of obvious personal significance to the Plaintiff. This conduct warrants an award of punitive damages."

The court also awarded Jongazma a further $68,000 in other damages, including $44,000 for the difference in the price of the home he eventually bought, the price of extras, and incidental costs. See *Jongazma v. Primont Homes (Heritage Hollow) Inc.*, 2011 (ONSC).

LEGAL ALERTS

Proposed *Bank Act* Amendments to Resolve PPSA Priority Issues

New federal legislation was proposed in late 2011 to amend the *Bank Act*. The amendments pertain to determining priorities established under that legislation as compared to those arising pursuant to a provincial regime, such as found in Ontario's *Personal Property Security Act*. The proposed amendments would give *Bank Act* securities priority over unperfected interests that exist at the time the *Bank Act* security is acquired, regardless of whether the unperfected interest was acquired earlier. There would be an exception in cases where a bank has knowledge of the existing unperfected PPSA interest. The proposed amendment, found in Bill S-5 (*Financial System Review Act*), has passed third reading in the Senate and is awaiting first reading in the House of Commons.