INNOVATIONS IN THE LAW OF LENDING: A STUDY OF THE PARTICIPATION MORTGAGE AND A PROPOSAL FOR REFORM OF THE LAW OF COMMERCIAL MORTGAGES

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ABSTRACT

The period of high inflation during the late 1970s and early 1980s forced lenders to reconsider their methods of financing commercial real estate projects. During this period, lenders began experimenting with various new forms of mortgage documentation designed to support innovative financing techniques. Many of the innovative techniques developed included a participation feature whereby the lender, in addition to earning a fixed rate of interest, also participated in either the income from a project or the increased value in its equity, or both. As a result of instituting these techniques, both lenders and developers expanded their view of what a commercial mortgage entails. It is unlikely that lenders will return to viewing their role as that of simple renters of money. Since the law of mortgages in Canada has not been sufficiently flexible to adequately accommodate these innovative techniques, there is a need for reform of the law of commercial mortgages.

In this paper, the writer will review the current commercial lending practices and discuss the advantages and disadvantages of the most commonly used forms of participation financing. The conclusion will set out a proposal for the reform of the law of commercial mortgages. Central to its recommendations will be the concept that the commercial mortgage should be regarded as a contract for a debt and not as a conveyance of an interest in property. This concept will allow the commercial lender and borrower the contractual freedom to enter into the bargain that best reflects their financing intentions without being hampered by the historical incidents of a common law mortgage.

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CHAPTER ONE

INTRODUCTION

The recent years of inflation forced lenders and developers to develop innovative techniques to finance commercial real estate projects. A new attitude toward the 'mortgage' evolved during this period. The current period of disinflation allows for an assessment and review of the changes that occurred as a result of this new attitude.

A review of these changes involves three basic objectives. The first objective is to identify some of the innovative financing techniques developed during the inflationary period, all of which include some form of participation financing. The second objective is to explore the problems associated with these techniques. And, the third objective is to discuss recommendations for the reform of the law of mortgages that are necessary to bring the law in line with current commercial attitudes.

Even though there have been innovations in the residential mortgage market, such as the variable rate mortgage, these tend not to be as adventurous as those in the commercial market. Therefore, this paper is restricted to an analysis and review of innovations in the commercial mortgage market[1].

CHAPTER TWO

OVERVIEW OF ECONOMIC TRENDS AND THEIR IMPACT ON FINANCING

I. Economic History of the Development of Participation Loans

Of all the methods of dealing with inflation, the lenders' tendency to ignore it was the one most doomed to failure. Until 1980, the predominant form of real estate financing was the long-term, fixed rate mortgage, which depended on a stable economy and low rates of inflation. Neither the borrow nor the lender assumed great risk in entering into such an arrangement because there was nearly always sufficient cash flow to ensure repayment of the loan, as well as a tidy profit for the borrower. Lenders were content to receive a fixed rate of return for what they considered to be a 'safe' investment. In their view, the borrower took the risk and the lender took the property if default occurred.[1]

During the late 1970s and early 1980s, two changes occurred which forced many lenders to abandon the long-term, fixed rate mortgage. First, spiralling inflation had the effect of reducing the 'real' interest rate received on a mortgage below the fixed rate. Second, by 1981 interest rates broke through 20 percent and borrowers could not afford to service their projects with fixed, double-digit interest rates.

Inflation had the effect of reducing the real interest rate below the fixed rate because the borrower repaid both the principal and the interest in future dollars. Each dollar of principal and interest paid in an inflationary future had a smaller purchasing power than those originally advanced and, therefore, had less real value than the dollars loaned by the lender.[2] In order to calculate the real rate of interest on a loan, distortions in both the principal and future interest payments must be taken into account. Since lenders did not anticipate that inflation would increase as much as it did, their estimates of future distortions were not accurate, and they did not raise interest rates enough to offset the

increase.[3]

For commercial loans made in the United States from 1960 through 1969, the average fixed interest rate was 6.58 percent, but the average real interest earned was only 2.15 percent.[4] For commercial loans made from 1970 through 1975, the average fixed rate was 9.34 percent and, assuming full repayment in 1981, the average real interest earned was -.71 percent.[5] Therefore, although the cost of borrowing money to purchase real estate appeared to have been rising during that period (fixed rates having more than doubled) the cost was actually declining in real terms.

During the inflationary period, lenders' real yields were decreasing and the price of real estate was increasing. Borrowers were purchasing property with lenders' money, repaying the loans with dollars of less purchasing value than those borrowed, and benefitting from the increased value of property.[6] This resulted in an erosion of the lenders' capital bases, which caused them to demand higher fixed rates to provide a cushion against future inflationary increases. This need for an inflationary cushion coupled with interest rates beyond 20 percent meant payments under a conventional fixed rate mortgage were more than what the cash flow of most projects could support.[7]

Participation financing emerged as the solution for both parties. Lenders were willing to reduce the fixed rate in exchange for a participation feature, which provided an opportunity to earn greater rewards by participating in a project's increase in value arising either from the success of the project or from inflation. Borrowers were willing to exchange a participation feature in return for a reduction in the fixed interest rate of the financing for their projects.

A lower fixed interest rate also meant a higher loan-to-value ratio for most projects. A participation mortgage not only lowered the fixed rate, it allowed those lenders, who by legislation or by their own internal investment practices were restricted in the amount they

could loan, to loan more money to any given project. The authorized loan amount for most regulated lenders[8] is 75 percent of the 'value' of a property (not 75 percent of the cost of the property), and because of the way value is calculated, it increases as fixed rates decrease.[9] Therefore, the only way developers could get their accustomed 100 percent financing during the inflationary period was through some type of participation arrangement.[10]

Lenders estimated the value of a participation feature by using a concept known as internal rate of return (IRR)[11], which is the total yield expected by the lender from a loan. It is determined by applying a discount rate which equates the present value of a lender's cash outflow with the present value of its cash inflow from an investment. Cash outflow includes the mortgage loan amount and any equity funds advanced at the outset (for example, equity funds are advanced for the purchase of land in a sale-leaseback transaction). Cash inflow includes fixed interest, principal repayments, income participation, equity participation and the lender's interest, if any, in the value of the property at the end of the mortgage term (residual value).[12] IRR is necessarily speculative in nature because its calculation depends on assumptions as to the growth rate of both income and expenses. Therefore, lenders generally require 1.5 percent estimated participation return for each 1 percent given up in the form of fixed return.[13] During the period 1980 to 1982, lenders were generally prepared to grant a 2 to 4 percent reduction in the fixed rate in return for a participation feature which would net the equivalent of approximately a 3.5 to 6 percent fixed rate.

The abatement of inflation in 1983 made lenders less concerned about hedging against inflation and some lenders, particularly life insurance companies, began once again to lend money on a long-term, fixed rate basis.[14] Interest rates had dropped sufficiently to support 100 per cent financing of most projects without the need to give participation.[15] This situation continued until April 1984 when interest rates again took a significant increase, and

many projects could not generate sufficient cash flow to pay the debt service on a fixed rate mortgage financing 100 percent of a project.[16] When interest rates decreased in 1986 to the rates of 1983, some lenders had become convinced that interest rates would not remain low enough for a sufficiently long period of time to allow a wholesale return of the fixed rate mortgage. Although fixed rate mortgages do continue to be available, they are often for shorter terms than were commonly available in the past, and as such are less attractive to commercial borrowers. As a consequence of fluctuating interest rates, participation financing has become a permanent feature in the lending industry.

The most common types of participation financing are the following:

1. Income Participation Mortgage;
2. Equity Participation Mortgage - of which there are three types:
   a) Mortgage/Equity Option,
   b) Convertible Mortgage, and
   c) Shared Appreciation Mortgage; and
3. Sale-Leaseback with a Leasehold Mortgage.

Income and equity participation mortgages can be blended into one financing package as the two types are not mutually exclusive.[17] Therefore, it is difficult to characterize a 'typical' participation mortgage. One thing, however, that all participation mortgages have in common is that each includes a conventional mortgage coupled with one or more participation features.

Other 'pure' equity financing arrangements were also developed. These include the pure equity joint venture[18] and the combination conventional mortgage/equity transaction,[19] where the institutional lender buys an equity interest in the property at the outset and takes risks on the same basis as an owner/developer. These arrangements will not be emphasized in this paper,[20] instead the paper focuses on those participation arrangements in which the parties

start out as debtor and creditor, and no present equity position is taken.[21]

II. A Changed Perspective for the Lender and the Borrower

The recent, rapid economic swings between inflation and disinflation forced a certain maturity on the players in the lending industry. Traditionally the lenders viewed their role as simple renters of money and wanted only a fixed return on the dollars loaned that would be sufficient to match their equity obligations elsewhere. The consequence was that lenders tended to concentrate on the credit worthiness and financial statements of their borrowers, and spent little time assessing the validity of individual projects and monitoring their development.[22] The borrowers, on the other hand, were totally consumed with their individual projects; their time was spent questing after the perfect 'location' and in jealously guarding their equity positions, instead of in assessing the quality and nature of the financing received.

Participation financing forced both lenders and borrowers to become more sophisticated in their negotiations; the key jostling point between the two being in the area of risk negotiation. A middle ground of risk allocation was found in the combination of a conventional mortgage coupled with one or more types of equity or income participation in the same transaction. Lenders liked this combination because it allowed for participation, while ensuring a fixed prior return on the principal advanced and a priority position in the event of default. Borrowers were willing to offer a participation feature because it was the only way many could afford to finance their projects. The shared participation led to a changed perspective on the part of the lender and the borrower.

The lender, while still concerned with the borrower's financial strength, began taking a much more active role in assessing the project itself. The number of failed projects, which ultimately led to some borrowers' inability to repay loans, made lenders understand they must

take this active role in order to ensure repayment. After all, from a lender's perspective it must be remembered that: ". . . A lender's prime objective and principal concern are not the act of lending, but rather the act of punctual repayment."[23] The basic questions lenders started asking were whether a project would be saleable if a default occurred and, if so, for how much?[24] Positive answers to these questions ensured the lender that in the worst possible outcome the project could be sold, and it would recoup the principal amount advanced under the loan. In order to answer these questions the lender had to assess and find satisfactory answers to the more particular questions following:[25]

1. Is the location appropriate?
2. Is there a current or prospective demand for the project?
3. Are the projected rental rates or sales prices realistic?
4. Are the projected rent-up periods or sell-out periods reasonable in the current market environment?
5. What is the existing competition for the proposed project?
6. What other projects are planned or proposed for the market area?
7. What is the ability and financial strength of the contractor for the project?
8. What is the equity position of the developer in the project? (equity ensures the developer's commitment to the project)
9. If the loan is a construction loan, is the construction budget appropriate and is there take-out financing available?
10. Are there any pending changes in governmental policy or general economic conditions which will affect the project?

The result is that lenders took on a role very similar to that of a responsible owner. This led to some very direct changes in lenders' financing prerequisites. For example, previously lenders had been overly concerned with the security aspects of the project and

insisted on, among other things, long-term leases and abundant amounts of insurance. In contrast, borrowers wanted shorter term leases and showed lower profit margins because of expensive and often excessive insurance. A long-term lease locked the borrower into receiving rents over the long-term which albeit ensured sufficient income to make payments under the loan, but did not enable the project to maximize its profit by sharing in the rises of current rental values. Once lenders began sharing in the profits with borrowers, they also shared some of the borrowers' concerns, and they were more willing to consider each aspect of development and make an individual decision on the basis of current market conditions and demands.[26]

The borrowers, on the other hand, became more financially responsible. The uncertainty of the supply of funds and property in the real estate market and the length of the normal operating cycle (the time taken to assemble and construct a project) made intelligent financing absolutely critical.[27] Borrowers became less emotionally attached to their properties and were willing to allow participation in a project in return for an increased loan amount, a lower interest rate, a longer term, and a share in the responsibility for the development of a project.

In the final analysis it seems that although the lender's overriding concern with loan repayment and the borrower's overriding concern with profit still existed, both parties realized that neither of these ends would be met unless they cooperated and shared in the concerns. The realignment of the traditional roles of lender and borrower made each more responsible and responsive to the needs of the other.

III. Future Outlook

Although it is difficult to predict the future of real estate financing, a compilation of some of the changes which have recently been predicted by others are as follows:[28]

1. There will be an excess of funds available for real estate financing in the next few years primarily because there will be few new projects initiated in the coming years. The reasons given for this change are numerous: commercial real estate is currently overbuilt; there are recessionary low growth rates in Canada, particularly in the west; and, developers are being conservative in developing new projects.
2. Although excess funds will be available, lenders being very conservative will be selective geographically. Lenders will be quality conscious and marginal projects will not be financed. In light of this, lenders will insist on conservative loan-to-value ratios, and in many cases developers will no longer obtain financing to cover 100 percent of their costs in developing a project. Consequently, it will be necessary for many developers to enter into some type of participation arrangement to finance projects even during periods of low inflation.
3. Future economic cycles will likely be shorter than previous ones resulting in continuing volatility, but hopefully of a more moderate nature. The more frequent 'swings' will result in continued lender hesitancy to enter into the long-term, fixed rate mortgages common in the 1970s.
4. The realignment of the traditional roles of lenders and borrowers, that began in 1980, will continue. Many in the real estate industry believe that the only responsible position for a lender, who in some ways has the most at stake having provided all the funding for a project, is that of a 'participant' in the project. Therefore, it seems likely shared ownership responsibilities between lenders and borrowers will remain a permanent part of real estate financing.
5. Life insurance companies and pension funds will be the prime sources of

funds for real estate development, and the emphasis for real estate loans will shift from life insurance companies to pension funds.

a) Life Insurance

Life insurance companies generally prefer long-term, fixed rate loans because the companies are involved in the sale of whole life policies for which they follow a process known as matching funds. Their investment earnings are matched against their outstanding contingent liability under the life policies issued. It is relatively easy to determine the amount of earning an insurance company needs to pay off its whole-life policies. Since the future obligation signified by a $100,000 life insurance policy is $100,000,[29] the insurance company merely has to calculate what fixed rate return it requires to meet this future obligation. Therefore the system of lending on a long-term, fixed rate basis is attractive because of its simplicity; however, during periods of high or fluctuating inflation, insurance companies cannot profitably make this type of financing available.

Continued nervousness about a volatile economy and a decline in the sale of whole-life policies means life insurance companies will have less money available for long-term, fixed rate financing. Life insurance companies may show some interest in participation arrangements, however, a considerable amount of their need for real estate equities will be satisfied by the direct purchase of completed projects or joint venture development ('pure' equity financing).

Therefore life insurance companies likely will not continue to

participate in real estate lending as actively as they have in the past. However, their pension business has expanded greatly in the last decade to the extent that in many life companies pension assets represent as much as half or more of their total assets.[30] This phenomenon will result in increased funds being available for participation financing through the pension fund segment of the insurance business.

b) Pension Funds

Pension funds, unlike life companies, are not sources of 'patient' money. Pension funds require a safe return plus a hedge against inflation because their obligations rise and fall with inflation. The retirement benefits payable to their participants at any given time are determined by the last three to five years of wages earned by the participants.[31] Therefore, the pension funds' obligations require them to make investments at least equal to wage increases. Accordingly, pension funds have always put less emphasis on fixed return and more emphasis on capital gain. Further, participation loans have been shown to produce the highest return for pension funds at all inflation rates.[32] This is due in part to the fact that the pension funds do not pay income tax and the arrangement if properly structured will allow all tax benefits to remain with the borrower, while at the same time allowing the loan payments to be tax deductible by the borrower, and the increased value in the property to be shared between the borrower and the lender. As a result, in almost any economy most pension funds prefer to provide financing with some form of participation.[33] This factor combined with the decline in the insurance industry's interest in lending funds for the development of real estate, makes it likely that pension funds will eventually be the dominant source of real estate loans

in Canada.

In conclusion, on-going creative financing will be necessary in the years ahead and periodic volatile market conditions will at times make conventional types of financing impractical. Although participation techniques will be used most heavily during periods of high interest rates, they will be used in all economies by lenders who wish to participate in long-term increases in property values and by non-taxable lenders, such as pension funds, who benefit from their use no matter what the interest rates are. As a result, participation financing is a permanent feature in the world of commercial finance.

CHAPTER THREE

DESCRIPTION OF PARTICIPATION FINANCING TECHNIQUES

I. Income Participation Mortgages

An income participation mortgage is a conventional mortgage loan under which the lender receives a fixed rate of interest, usually below prevailing market rates, plus a participation in the income from the property. The investment is solely debt and remains debt; the lender never takes any portion of the equity.[1]

Income participation mortgages usually have long terms (15 to 25 years) because lenders like the high returns which generally arise from increased profit in the later years, when the project has become a success and operating expenses are relatively low compared to revenues. As a consequence it is important to the lender that the mortgage be closed with no right of prepayment in favour of the borrower.

There are many different ways of structuring income participation mortgages; however, the lender and borrower must always address these two basic questions:

1. Will the income participation feature be a percentage of gross income or net income?
2. Will there be any upper or lower limit on the amount of participation payable by the borrower?

Lenders usually prefer that the participation be a percentage of gross income rather than net income. This permits the lender to share directly in an increase in income, irrespective of changes in operating expenses. A percentage of gross income is also the simplest form to document and administer as there are no expense deductions.[2] Borrowers, on the other hand, prefer to pay a percentage of net income as it allows for the deduction of debt service and operating expenses before calculation of participation, thereby protecting

the borrower if expenses increase faster than gross income.

The mortgage may deal with upper and lower limits on the amount of participation payable in one or more of the following ways:[3]

1. A percentage of gross income is sometimes only paid above a base amount, usually equal to projected gross income for the first year of operation. This restricts the lender's participation to the growth in income beyond the first year.[4] The base amount, below which participation will not be paid, recognizes the possibility that rents may fall below expectations, and that it is not in the lender's interest to leave the borrower in a negative cash flow situation.
2. Occasionally, a ceiling is put on either the dollar amount paid to the lender or the annual yield that the lender is entitled to receive on its mortgage. This protects the borrower from having to make excessively large payments in later years, as a result either of unanticipated success or high inflation. More typically, no ceiling is imposed on the amount of participation payable to the lender.
3. A few mortgages include a minimum participation guarantee by the borrower, which is paid whether or not it is generated by the project.

Considerable care must be taken in the drafting of the participation clause to ensure that all terms are clearly defined. This is particularly so when participation is based on net income. Disputes often arise as to which expenses are deductible, so they must be clearly defined. The mortgage should also stipulate that the lender is entitled to review the books and records of the borrower, and that the borrower will provide the lender with a detailed breakdown of the participation calculations as certified by an auditor.

The participation percentage set for any given loan will be a function of: (1) the type of participation (whether it is based on net or gross income); (2) the amount of the fixed interest rate; (3) the lender's assessment of the additional yield forthcoming from the

participation on a discounted basis (which in turn includes an assumption about the growth in income); and (4) the term of the mortgage.[5] Each of these factors has an effect on the participation percentage set in a loan. For example, in some projects the lender may receive either 5 percent of gross income or 40 percent of net income, and both will produce approximately the same amount of dollars.[6] As to the proportion which the lender will receive by way of income participation as opposed to fixed-rate return, the lender and the borrower must negotiate the trade-off between the two and they may have somewhat opposed positions. Lenders generally view higher fixed-rate loans with small levels of participation as less risky, while borrowers prefer lower fixed-rates and higher amounts of participation.

The primary advantages to a borrower of income participation over a conventional mortgage are that the borrower may obtain:[7]

1. A 15-20 year loan when lenders are not otherwise prepared to lend on a long-term basis;
2. A fixed interest rate below the current rate and since the lender's participation is tied to the property's performance there is some debt service relief if the property underperforms;
3. Financing for a marginal project; and
4. Tax advantages.[8]

The primary disadvantages to a borrower of income participation are the borrower's inability to retire the mortgage before maturity and a reduction in the amount of income available to the borrower which affects the value of its equity.

The primary advantage to a lender of income participation over a conventional mortgage is that it provides protection against inflation while allowing the lender, in a properly structured transaction, to remain in the protected position of a secured creditor. The disadvantage is that the investment is more speculative in nature than is a fixed rate

mortgage.

II. Equity Participation Mortgages

1. General Description

An equity participation mortgage is a conventional mortgage loan under which the lender receives a fixed rate of interest, usually below prevailing market rates, plus a participation feature either by way of a right to obtain equity in the property at some time in the future (through an option or a conversion feature) or by way of a shared appreciation feature which permits the lender to obtain a cash payment equal to a percentage of the appreciation in the value of the project. As previously mentioned this paper will not deal with any of the financing techniques by which the lender takes an equity position at the outset except for the sale-leaseback.[9] Instead, this discussion focuses on those arrangements by which the lender loans money under a mortgage that contains a participation feature and that also allows the lender to share in the equity of the project in the future.

The three types of equity participation mortgages to be discussed are: (1) mortgage/equity options; (2) convertible mortgages; and (3) shared appreciation mortgages (referred to collectively as "equity participation mortgages").

The advantage to a lender of an equity participation mortgage, over a present equity position, is that the lender starts off as a true lender with the option of becoming an equity owner at a future date when and if it appears desirable. Consequently, the lender has many years to observe the performance of the property and decide whether or not it is successful. If successful, the lender can exercise the option and share in all the benefits of ownership (other than the capital cost allowance) without any of the risks.[10]

The advantage to the borrower is that it retains all the tax benefits and it remains the

sole owner and controller of the project until the lender takes its equity position. Often the lender is not interested in tax benefits generated in the early years of the project, either because it is a non-taxable entity or does not wish to report losses on financial statements. By the lender taking a future equity position, the parties avoid the difficult problem of creating a workable allocation formula for losses. Thus the equity participation mortgage has become a viable alternative to the present equity position.[11]

The advantages and disadvantages of equity participation mortgages over conventional mortgages are the same as they are for income participation mortgages, except there is one further advantage. For regulated lenders, such as pension funds, an equity participation mortgage qualifies more readily as a legal investment than a mortgage where the lender takes an equity position at the outset.[12]

It is incorrect to speak of advantages and disadvantages of equity participation mortgages over income participation mortgages because the two are often combined in one mortgage package. However, there are several reasons why a lender or borrower may prefer the transaction to have only an income participation component, absent any equity participation. Briefly the reasons why a lender or borrower may not wish to add an equity/mortgage option or a convertible component to an income participation mortgage are as follows:[13]

1. The primary reason is that the lender avoids many of the legal and tax problems associated with receiving an equity interest, especially if the income participation mortgage is carefully structured.
2. Income participation mortgages are considerably easier to document and administer if there is no equity option. When an equity position is eventually going to be taken, all the joint venture/co-ownership documents must be negotiated at the time of commitment in order that the parties

know the type of arrangement which will result. By doing this, the borrower cannot nullify future aspects of the transaction by refusing to execute documents acceptable to the lender.

3. Lenders prefer income participation mortgages because, if they are properly structured, the lenders retain the traditional debtor-creditor relationship, do not assume the risks of direct ownership, and yet share in increased profits.
4. Borrowers prefer them because the income participation rights usually expire upon discharge of the mortgage and the borrower is not forced to surrender part of its ownership interest and control over the property.
5. Additional legal problems are created by adding an equity component, which are outlined below under the heading Legal Issues. The primary additional problems are those associated with partnership and clog on the equity of redemption.

In each situation the lender and borrower must determine whether the disadvantages and inconvenience of adding an equity component are outweighed by the advantages. One advantage to the lender is the potentially higher profits to be earned from holding an equity interest, and that this interest continues after maturity. Further, if the lender is eventually to be a joint owner of the property it may have more control over the project during the term of the loan without tainting the entire transaction as a partnership from the outset. The advantage to the borrower is that there are less onerous principal repayment requirements, either because the lender accepts responsibility for part of the debt or converts it into an equity position. Also, the fixed rate of interest may be higher on an income participation mortgage as the participation component is not liquid during the term. An option to acquire or convert to a direct equity position, if properly documented, can be severed from the remainder of the transaction and is therefore more liquid than an income participation component which is an integral part of the mortgage. Because of this lenders

do not attribute as high a value to income participation when calculating their IRR, which results in a higher fixed rate.[14]

The shared appreciation mortgage ("SAM") in many ways resembles the income participation mortgage since the lender does not take an equity position in either case. There are, however, two reasons why a lender may not wish to add a shared appreciation component: (1) there is a greater chance that the contingent interest will not be paid because it is not paid monthly or yearly but is deferred to the end of the term and is dependent upon a successful refinancing or sale; and (2) there is a problem with builders' liens, which is less apparent in the income participation mortgage. The advantage to a lender of adding a shared appreciation component is that there is a potential for greater profit, which usually translates into a lower fixed rate for the borrower.

2. Mortgage/Equity Options

The mortgage/equity option involves the lender offering a conventional mortgage, with a below market fixed-rate of interest, in return for receiving an option to purchase a predetermined equity interest in the property at a future date. Usually the purchase price is determined when the option is exercised by reference to appraisals which establish the then current market value of the property.[15] As the lender does not receive an immediate equity interest in the property, the mortgage generally provides for some form of income participation during the term.

A typical mortgage/equity option transaction has a term of approximately 15 years, an interest rate 3 to 5 percent below the current market rate, and the lender is given the option to purchase between 25 to 50 percent of the property in the last year of the term. If the lender is tax exempt the loss of several years of capital cost allowance is of no consequence.

3. Convertible Mortgages

This type of financing is very similar to the mortgage/equity option. There are two differences, one being timing and the other being the method of payment for the equity interest. Firstly, under the mortgage/equity option, the purchase price is usually established at the time the option is exercised, whereas under the convertible mortgage the purchase price is determined at the outset. Since the lender is required at the outset to commit itself to a price for acquiring the equity interest, the fixed rate may be slightly higher under a convertible mortgage than under a mortgage/equity option.[16] Secondly, under the mortgage/equity option the mortgage debt itself usually continues after the exercise of the option and the lender acquires a percentage of the debt repayment obligation, whereas under the convertible mortgage the mortgage is cancelled in whole or in part as payment for the equity interest obtained.

The term of the mortgage is usually in the range of 12 to 20 years and the lender may have the right to convert the mortgage loan either at one fixed time or progressively over the term of the loan.[17] The percentage of the equity into which the loan is convertible depends on the original mortgage loan-to-value ratio and the present value of the estimated residual value of the equity at the time of conversion.[18] If the lender chooses not to exercise its conversion option, the loan matures and becomes payable. Sometimes the convertible mortgage provides for income participation, if so, the fixed interest rate and/or equity interest may be reduced. Generally if income participation is included, the mortgage loan is converted on maturity and not progressively. The main benefit to a borrower of a convertible mortgage over a mortgage/equity option is that there is no principal repayment. The disadvantage is that the fixed rate and the equity interest may be slightly higher than under a mortgage/equity option. For lenders, the disadvantage is that although they receive

a higher portion of the equity they also run a greater risk that the option will not be viable because the purchase price is determined at the outset.

4. Shared Appreciation Mortgages

It is somewhat of a misnomer to call a SAM an equity participation mortgage as the lender never has the option to acquire an equity interest in the mortgaged property. Nevertheless, many authors discuss this mortgage under the equity participation heading because the lender does share in the capital appreciation of the property during the term of the mortgage.

A SAM is a conventional mortgage with interest at below market rates, which provides the lender with a right to participate in the property equal to an agreed-upon percentage of its capital appreciation over the term of the loan. The participation feature is often referred to as contingent interest[19] and is usually paid on the mortgage due date, although some transactions are structured to provide for payments on a periodic basis.[20] The capital appreciation is determined by calculating the value of the property on the date on which the contingent interest is to be paid, and subtracting the cost or value of the property on the date on which the transaction was entered into and the cost of any capital improvements made by the borrower while the mortgage is outstanding. The value of the property is usually determined by appraisal, although in cases where the property is sold before maturity of the mortgage, the documentation allows the lender the option of determining the mortgage at that time and electing to take its appreciation based on the greater of the sale price or appraisal.

The term of a SAM is usually between 10 and 20 years. In most cases in order to pay the contingent interest, the borrower relies on refinancing or a sale of the property. SAMs often include an income participation feature, so the lender also shares in the benefits of

ownership during the term.

The benefit of SAM to a borrower over the other two types of equity participation mortgages is that the borrower remains the sole owner of the property, thereby allowing it full tax benefits and management rights. The disadvantage to the borrower is that the ability to pay the lump sum contingent interest on maturity is usually dependent on refinancing or a sale, which cannot always be arranged on acceptable terms. An advantage common to both the borrower and the lender is that the documentation is substantially less complex because the parties never share equity ownership. This also means the parties are disassociated after maturity of the mortgage.

The advantage to a lender of a SAM over the other equity participation mortgages is that the appreciation component is more liquid than a future equity position. It is more certain it will eventually be converted to cash. This advantage is even more apparent when the future equity position represents a minority interest only. The disadvantages are that the lender ceases to have any interest in the property after maturity of the mortgage, and the tax treatment is less advantageous for those lenders who are taxable.[21]

III. Sale-Leasebacks with Leasehold Mortgages

One of the earliest financing techniques created to provide a lender with a hedge against inflation is the sale-leaseback transaction. In the typical transaction the lender purchases the property outright from the borrower, simultaneously leases it back to the borrower and provides a conventional leasehold mortgage loan. The three stages of the transaction are as follows:[22]

1. Land Sale

   The land is sold to the lender usually at fair market value, and the lender becomes the registered owner of the fee simple.

2. Leaseback

The lender grants a long-term, ground lease to the borrower. The lease requires the borrower to construct improvements on the land, and the term of the lease is usually at least equal to the expected life of the improvements so that the borrower has the full benefit of the improvements even though it has given up its fee in the land. The lease generally provides for two types of rent. The first is basic rent, which is payable monthly in an amount equal to the current mortgage interest rate on the sum paid to purchase the land. The basic rent is generally subject to review and upward revision on a periodic basis. The second is an income participation rent, whereby the lender receives a percentage of income generated by the property on a basis similar to that discussed under the income participation mortgage.[23]

3. Conventional Leasehold Mortgage Financing

The borrower gives a conventional leasehold mortgage to either the lender who owns the land, or to a third party lender. The amount advanced under the mortgage is sufficient to pay for the improvements that the borrower is required to construct under the lease. Most often the leasehold lender is the owner of the land, in which case the mortgage financing is at an interest rate 2 to 4 percent below the market rate because the lender is entitled to participate in future appreciation of the land and the growth in income from the improvements. If the lender is a third party lender, it is important that the lender-owner be willing to subordinate its rights as landlord under the ground lease to the rights of the lender under the leasehold mortgage. This gives the third party lender first mortgage security

in the land and improvements; without it, a termination of the ground lease would eliminate the third party lender's mortgage. One writer has described the third party's fragile position when the owner does not subordinate, as follows: "A mortgage on a lease ... is like a toy balloon. Prick it and it's gone."[24] Obviously, the third party lender wants to preserve its mortgage until it is paid. The lender-owner will usually agree to subordinate its reversionary interest in exchange for a higher base rent under the lease. The borrower will still get the mortgage at an interest rate below the market rate because the third party lender is receiving security in the land which is not available under other leasehold mortgages.

The benefits of a three stage sale-leaseback transaction to a lender-owner are as follows:[25]

1. The lender as owner of the land receives the reversionary interest on expiry of the lease, and enjoys any appreciation in the value of the project, while only taking ownership risks on the land not the building. Further, the lender takes its equity position without fear of infringing the clogging doctrine applicable to mortgages.
2. The remedies available to the lender as landlord, if the borrower defaults, may be less complex than the remedies available to a mortgagee (i.e., termination of the lease as opposed to foreclosure of a mortgage).[26]
3. The lender receives its participation payments under a lease and therefore has no fear of infringing any of the

usury laws.

4. There is less chance the lender will be considered a partner of the borrower.[27]

5. The lender is in a better position from a tax point of view because a portion of what would otherwise be conventional mortgage funding, attracting ordinary income in the form of interest, has been converted into property ownership which will eventually attract capital gain.

The disadvantages of a sale-leaseback transaction to a lender are as follows:

1. The lender takes an equity interest in the land at the outset without the opportunity to review the project's performance.

2. Some lenders are restricted in their ability, or lack the legal authority entirely, to enter into a direct purchase of real estate. Consequently, utilization of one of the equity option mortgages might be necessary to achieve the same end result.

3. The documentation for the entire transaction can be complicated. In particular there are many concerns which must be taken into account when drawing up a leasehold mortgage.[28]

The benefits of a sale-leaseback transaction to a borrower are as follows:[29]

1. The combination of the leasehold mortgage loan and proceeds from the sale of the land provides the

borrower with financing for 100 percent of the project costs. Instead of mortgaging the fee for 75 percent of its value, the borrower sells it for 100 percent of its value and leases it back. The sale proceeds provide additional cash for the borrower's business operation and because the lender is allowed to participate in the property's growth, it will usually provide leasehold financing to cover 100 percent of the cost of improvements.

2. The borrower gets a lower financing cost than on a conventional mortgage because the lender receives the reversionary interest in the land.
3. The borrower retains all the tax benefits (soft costs and capital cost allowance) because the borrower owns 100 percent of the improvements during the term of the lease.
4. The full amount of the land lease payments are tax deductible, contrasted with mortgage payments where only the interest portion is deductible. In effect, the principal portion of blended mortgage payments become tax deductible.

The disadvantages of a sale-leaseback transaction to a borrower are as follows:

1. The borrower may incur a taxable capital gain on the initial sale of the land to the lender.[30] In addition, if the land is improved at the time of the sale there may

be 'recapture' on the sale.

2. The borrower loses the ability to participate in the real property appreciation as an owner.

3. A leasehold mortgage is considerably more difficult to refinance than a freehold mortgage.

CHAPTER FOUR

LEGAL ISSUES RAISED BY PARTICIPATION FINANCING TECHNIQUES

I. Introduction

New commercial techniques almost always endure a period of uncertainty because evolution in the law rarely precedes the introduction of the new techniques in the business community. The introduction of the participation financing techniques has raised a number of general procedural problems such as the following:[1]

1. They take a long time to negotiate because of their complexity and the inexperience of both lenders and developers in dealing with them.
2. They are difficult to document and require substantially more documentation than do traditional mortgages.
3. They are difficult to standardize and they differ from one lender to another, which in turn results in market confusion because there may be mistaken expectations between the parties or unintended abuses.

In addition to these general procedural concerns, a number of legal issues also have arisen, such as:

1. Does the participation feature cause the lender to be a 'partner' of the borrower, resulting in a loss of priority as a secured creditor and possible liability for other debts of the borrower?
2. Will the provisions of the Bankruptcy Act[2] and the relevant provincial partnership legislation[3] restrict the lender's ability to enforce its claim?
3. Does the Interest Act[4] prevent the lender from receiving any interest in respect of the loan?

4. Has the lender violated any usury provisions of the Criminal Code[5] or the common law doctrine of unconscionability?
5. What difficulties are there in enforcement of the participation loan under the present mortgage laws, and how should the lender handle intentional default by the borrower?
6. What are the income tax consequences of various types of participation financing?
7. Will the provisions of the relevant provincial legislation on builders' liens cause the lender (as a creditor) to suffer by virtue of it being classified as an "owner"?
8. Does the participation feature constitute a clog on the equity of redemption so as to render the loan invalid or unenforceable?
9. Does the relevant provincial legislation on perpetuities render any of the participation features unenforceable?

Not all of these issues are relevant to every participation loan. The issues which relate to participation loans will be fully discussed and if an issue does not relate to a particular type of participation loan, that type will be excluded from the discussion. However, if an issue raises additional concerns for a particular type of loan, those concerns will be discussed under a separate subheading at the end of the general discussion.[6]

II. Partnership

1. Deemed Partnership[7]

The single greatest risk in structuring any participation loan, including the sale-leaseback is the chance that the lender may be confused with an investor, and a deemed partnership may be found between the lender and the borrower. The participation loan, regardless of the form it takes, is by its very nature a technique for sharing profits and by implication a technique for sharing risks, too. It does not fit the mold of a conventional loan and therefore, it is always possible it will be found to be something other than a loan.

A lender who is an inadvertent partner could find itself jointly and severally liable with the borrower to the other creditors of the project or, at the very least, it could lose its mortgage priority vis-a-vis other creditors.[8] A finding of partnership can also have an impact on the way the profits are taxed[9], the remedies the lender is able to pursue[10] and, in the case of regulated lenders, the legal ability of the lender to participate in the project.[11]

The sale-leaseback is the least likely form of participation loan to be deemed a partnership between the lender and borrower. This is because the lender and borrower are simultaneously, purchaser and lender, landlord and tenant, and mortgagee and mortgagor, so there is little chance they will also be characterized as partners, especially since the participation features arise under the lease.

One of the benefits of a participation mortgage is that it does not force the lender to deviate from its usual role as a creditor. However, if the agreement is not carefully structured, the lender may lose the protection of creditor status and become a partner. Such a lender inadvertently assumes all the risks inherent in a pure equity position, without having negotiated a return on the loan commensurate with that risk.[12]

Provincial partnership legislation across common-law Canada has virtually without change followed the English codification of partnership law found in the Partnership Act, 1890.[13] The typical definition of a partnership "is the relation that subsists between persons carrying on business in common with a view to profit".[14] The provincial legislation sets out certain rules to assist in determining whether a business relationship is a partnership but, because the legislation provides only a partial statement of partnership law, the common law interpretation remains important. The courts appear to have developed a four-part test to determine whether a partnership exists. The four factors which the courts look for are:[15] (1) the parties' intention to form a partnership; (2) the sharing of profits; (3) the sharing of losses; and (4) the relative control of the parties over the affairs of the enterprise. In

addition, before a partnership can be found, it is necessary that there be a business carrying on with a view to profit, but this basic test is almost always satisfied by the activities of most real estate developments.

a) Four Part Test

i) Intention to Form a Partnership

In determining whether an agreement constitutes a loan or a partnership the court will attempt to ascertain the parties' intent. Consequently, a participation mortgage should contain a statement negating any partnership intention, making it clear that the parties enter the agreement as lender and borrower. Although such a statement may be helpful, the cases show that an express declaration that no partnership is to be created is not conclusive.[16] Since the courts may ignore the expressed intent of the parties, it seems the determination of partnership is largely dependant upon the remaining three components of the four part test.

ii) Sharing of Profits

In some respects the sharing of profits is the fundamental feature of a partnership. Typically the partnership legislation will establish a prima facie test of partnership using words such as: "The receipt by a person of a share of profits of a business is proof in the absence of evidence to the contrary that he is a partner in the business ...".[17] Notwithstanding this prima facie test, it is well settled that it may be rebutted by introducing evidence of other elements negating a partnership,such as a lack of intent or control.[18]

A further rule of interpretation included in partnership legislation establishes that "the sharing of gross returns does not of itself create a partnership".[19] It is for this reason that

some lenders insist that any income participation must be a share of gross income. Although the situation is more complicated where there is a sharing of net income, some comfort is provided by the partnership rule which states that "the advance of money by way of loan to a person engaged ... in a business on a contract ... that the lender is to receive a rate of interest varying with the profits or shall receive a share of the profits arising from carrying on the business, does not of itself make the lender a partner ... provided that the contract is in writing and signed by or on behalf of all the parties to it."[20] To entitle the lender to the protection of this last stated rule it is important that the loan agreement be in writing and be signed by all parties to it. The inclusion of the words "does not of itself" in these two last-mentioned rules means that care must be taken not to include other incidents of partnership in arrangements which share either gross returns or profits.

Since by definition profit-sharing is present in every participation loan, and since all skillfully drafted participation agreements will include a statement of intention negating any partnership, the two remaining factors for determining the existence of a partnership being, loss sharing and control, will generally be the only factors that vary from case to case.[21]

iii) Sharing of Losses

Loss sharing is a consequence of partnership and if a partnership is found to exist, loss sharing will be implied.[22] Accordingly, the lender must not become involved in any loss sharing with the borrower because it is a strong indication the parties consider themselves to be partners. A loan agreement would not likely provide for direct loss sharing by the lender. However, care must be taken not to provide for an indirect participation in losses, such as an agreement that the lender's right to repayment is contingent upon the project's success.[23]

For example, in the case of Ex parte Delhasse: Re Megevand[24] the applicant made a 10,000

pound loan to a partnership under an agreement which provided that: (1) he was not a partner; (2) he was able to participate to the extent of 37.5 percent in the profits of the partnership business; (3) he was entitled to examine the books of the business; and (4) he was entitled to exercise an option, to dissolve the partnership and demand his loan, if the books showed the original 10,000 pound loan was reduced by losses to one-half or less, in which case he would recover only such amount left after the losses were taken into account. The court found that the applicant Mr. Delhasse was indeed a partner in the business. The only significant feature in the agreement that is distinguishable from the majority of modern participation mortgages seems to be the provision that entitled Mr. Delhasse to only a partial return of his loan in the event of losses. The case establishes that a lender must advance all monies under a participation mortgage as a loan repayable in any event, and that there can be no agreement by which the lender is only to be repaid out of the profits of the business, if any.[25]

The American courts have extended the 'sharing of loss' test to find a partnership where the lender has agreed to be repaid only from the proceeds of the sale of a property, or where the lender has contributed to a floundering business and there is more than a substantial risk the property will be lost.[26]

Although care must be taken not to inadvertently infringe this test, in modern real estate transactions, the situation where a true lender shares in the losses of a business is rare. Therefore, in the majority of cases, the 'creditor versus partner' issue will be determined by the remaining factor, namely the extent of control granted to the lender.

iv) Lender Control

The House of Lords introduced the element of lender control in Cox v. Hickman.[27] It decided that a person who shares the profits of a business does not necessarily incur the

liabilities of a partner unless that business is actually carried on by the person or by its agent. As a consequence, the courts began looking for some element of control by a person in a business before they would deem that person to be a partner simply because he shared in the profits. Although many courts have found a partnership, for which none was contractually provided, based on some element of 'control', it is difficult to find a case that defines what the court means by control.

The most recent and relevant case concerning this issue is Central Mortgage and Housing Corp. v. Graham et al.[28], in which a lender (Central Mortgage) and a borrower (Bras D'Or Construction) were found to be jointly liable to the defendants (home owners) because of the control which the lender had over the business of the borrower. The defendants had purchased homes from and constructed by Bras D'Or Construction. Defects appeared in the homes and the defendants refused to make their mortgage payments to Central Mortgage, which resulted in foreclosure proceedings. The defendants counterclaimed for damages claiming that Central Mortgage and Bras D'Or Construction were engaged in a joint venture. Mr. Justice Jones said:

> "The most recent Canadian case where it was contended that a partnership existed between the financier and the developers is Northern Electric Co. Ltd. v. Frank Warkentin Electric Ltd. et al. (1972), 27 D.L.R. (3d) 519. In that case the Manitoba Court of Appeal held that the sharing of gross returns under a lease did not of itself create a partnership. The relationship was that of mortgagor and mortgagee and not partners .... I am satisfied on the evidence that Central Mortgage was involved in this project from the very start. Central Mortgage proposed the establishment of a shell housing project in Sydney. Agents of the corporation sought civic approval and directly enlisted Bras D'Or to carry out the project. The project was approved upon the submission of a proposal by Bras D'Or. Central Mortgage provided financing to cover the full cost of the project. The houses were sold to specified individuals only upon approval by Central Mortgage. Central Mortgage provided the plans and specifications and all necessary documentation .... The parties had a mutual control and management of the enterprise during the construction of the houses and in the sales .... To the extent that Bras D'Or in carrying on the venture incurred liabilities then both parties are bound.".[29]

It seems evident that the distinguishing factor between the Graham case and the Warkentin case is the control which the lender exerted over the business of the borrower.[30]

Although the court laid out several indicia of control, it did not define what it meant by control.

As there are no definitive Canadian cases[31] on the meaning of control, the American experience may be of some assistance. Mr. Justice Douglas in his article "Vicarious Liability in the Administration of Risk"[32] established a two-prong test that a party will be characterized as a partner when it has the ability to effectively formulate policy, to establish sales prices, and to control the costs of an enterprise.[33] Mr. Justice Douglas' theory of liability is based on the premise that those who have the power to distribute the risk of loss (by controlling cost and sale prices) ought to be economically responsible for the venture.[34] In the context of a real estate transaction, the prohibition on setting prices would, in a project developed for leasing, prevent a lender from establishing lease prices, choosing tenants, or negotiating the leases. In a project being developed for sale, it would prevent a lender from choosing the buyer or negotiating the sales contracts. The prohibition on establishing costs would prevent the lender from negotiating the construction contract, choosing the architect and general contractor, or determining the building materials.[35]

The American courts have not always required that a lender must control both the costs and sales prices before being found liable as a partner. The case of Minute Maid Corp. v. United Foods, Inc.[36] did not follow Mr. Justice Douglas' two-prong theory. Minute Maid sought to collect money owed to it by United, from Cold Storage, a lender to United. Under the loan agreement, Cold Storage was to receive 6 percent interest from United and a share of the profits. The court found Cold Storage to be liable as a partner because although United initially determined how much product to buy, such determination was subject to Cold Storage's right to determine whether the purchases were acceptable. In other words, Cold Storage had the right to control the cost of purchasing products, but the court never discussed whether Cold Storage had any control over the price for which the goods could be

sold, and indeed it had no contractual right to control the price. Therefore, the Minute Maid case indicates that in the United States a person need not always have dual control over both cost and sale prices before being deemed a partner.

In light of this decision, it might at first appear dangerous for a lender in the United States to have any involvement in a borrower's business dealings. However, the courts seem to make a distinction between the power to 'control' costs or sales and 'veto and consultation' rights over these items. Veto and consultation rights might affect costs and sales, but they do not appear to be prohibited under existing American case law.[37] Consistent with the right to veto and consult, a lender who is loaning money in a leasing context would have the right to refuse advances if leases did not meet pre-established standards, or could refuse to subordinate to leases that did not meet these standards. In a project being developed for sale, the lender might have the right to veto a potential purchaser who did not meet standards or the right to refuse to grant a partial discharge of mortgage for a sale it did not approve. Further, the right to veto and consult would also allow lenders to oversee construction and to refuse further advances in the event of cost overruns or non-compliance with approved plans and specifications.[38]

A last issue about lender control is the extent of control which can be exercised in an insolvency or distress situation. The landmark decision is Cox v. Hickman[39] which established that in a distress situation controls that would otherwise not be permissible are allowed. In that case, Stanton Iron Company found itself in financial difficulty and the lenders assigned the company's assets to trustees. Under the loan agreement, the controls granted to the lenders in this situation were characterized by the court as "in substance [the power] to carry on the business under the name and style of 'The Stanton Iron Company' with power to do whatsoever was necessary for that purpose and to pay the net income after answering all expenses." Although the reason for the court's finding that the lenders were

not partners is not entirely clear, it appears to be based on the premise that the lenders ran the business only to recover their loan and not to achieve a profit. Therefore, they acted as creditors, not co-owners.[40] It can be concluded that the Cox decision establishes that more control may be exercised by a lender in a distress situation, but the extent of this control is not certain.

In conclusion, it appears that the authorities do not provide very precise guidelines to lenders. Lenders who share profits must be careful to avoid joint decision making with their borrowers, although the power to set standards and to veto borrower decisions not in accordance with these standards seems permissible. It also makes sense that lenders should avoid the co-mingling of funds. Beyond that, the determination of partnership seems to be a question of fact based in each case on the number of objective indications that the lender has the power to control the business of the borrower.

2. Partnership by Estoppel

This is an issue separate and apart from the issue of what constitutes a partnership between a lender and a borrower. Under this doctrine a partnership does not exist, but liability is imposed because someone has held themselves out or acted as if they were a partner.

For example, partnership legislation in British Columbia states:

> "every one who, by words spoken or written, or by conduct, represents himself, or who knowingly suffers himself to be represented, as a partner in a particular firm is liable as a partner to any one who has, on the faith of any such representation, given credit to the firm, whether the representation has or has not been made or communicated to the persons so giving credit by or with the knowledge of the apparent partner making the representation or suffering it to be made."[41]

The estoppel can be relied upon only by a person to whom the representation (by act or by words) has been made and who has acted on the faith of it.[42] Therefore, the borrower and the lender must be careful not to make joint presentations to third parties. In all

presentations the borrower and the lender must be clearly identified as separate parties. It is important that a project not be developed under a joint project name and that all post-closing activities be as careful to preserve the creditor status as the documentation itself.[43]

3. Additional Partnership Concerns for Equity Participation Mortgages

There are additional partnership concerns for equity participation mortgages which differ for (a) the mortgage/equity option and convertible mortgage, and (b) the SAM.

a) Mortgage/Equity Options and Convertible Mortgages

Under these financing arrangements, the lender will at some point be wearing two hats; at first, it is just a mortgage lender and later, it also becomes an equity owner or in most instances a limited purpose partner of the borrower. Although it is true that the parties in both financing structures do not wish to be deemed partners at an inappropriate time, after the equity option or conversion feature has been exercised, the issue then becomes not how to avoid being deemed partners, but rather what is the form of association between the parties and how shall they conduct themselves. The parties must anticipate the time when they will share ownership of the project. Consequently, all of the considerations that must be taken into account in developing a transaction where the lender takes a present equity position, must also be taken into account in reaching a mortgage/equity option or convertible mortgage arrangement. The lender usually insists that all documentation that reflects its future ownership position be in place at the outset. Certain issues must be resolved by the parties before a decision is made to pursue any equity arrangement.

The first thing to be considered is whether both the lender and the borrower have the authority to enter into the transaction. The only significant restrictions on the typical borrower's authority to own land are generally found in its incorporating documents.

Institutional lenders, on the other hand, can be subject to legislative restrictions on their authority to own land directly. Therefore, the governing legislation of the lender must be reviewed thoroughly in order to be certain the transaction constitutes a "legal" investment.

The next consideration is the choice of project entity for the ownership of the property. Real estate held by more than one party can be held in one of four basic entities: (1) corporation; (2) limited partnership; (3) co-tenancy; and (4) joint venture (the term joint venture is used to mean a limited purpose general partnership). The choice in almost all circumstances involving joint ownership by an institutional lender and a borrower will be a joint venture which, in the context of the venture, is dictated by all the laws of partnership except the income tax laws. Nevertheless, each of the other entities will be looked at briefly.

One factor which initially appears to strongly favour corporate ownership, by which each party holds shares in proportion to its interest in the project, is the extent to which the technique insulates other assets of the parties from liabilities associated with the project. This same insulation, however, can be achieved by using a corporate subsidiary to own the interest within one of the other entities. The corporate structure has disadvantages because the income is subject to double taxation, and because there can be limitations on the shareholders' authority to control the actions of the directors. Although the effects of these limitations can be reduced through the incorporating documents and shareholders' agreements, both lenders and borrowers generally prefer to keep their separate identity.

A limited partnership is a useful vehicle for investment only if the lender wants to maximize its tax position while at the same time limiting its liability to the amount invested in the project. In return for this protection the lender relinquishes all control and participation in the management of the project to the general partner (usually the borrower).[44] The majority of lenders prefer the straightforward liabilities of a joint venture

(or partnership) to this limitation on their ability to make important business decisions.

In certain circumstances the parties may hold the property as co-tenants and not be joint venturers or partners in the project. The mere fact that parties hold title as tenants in common does not make them partners.[45] In the case of A.E. LePage Ltd. v. Kamex Developments Ltd. et al.[46] several parties were co-owners of an apartment building. One of the parties entered into an unauthorized multiple listing contract which entailed a real estate commission of $45,000. The commission was not paid and the real estate agent brought action against all of the parties claiming they were partners. The issue the court had to decide was whether the parties, as co-owners of the building, were partners of one another. The two factors the court looked at most carefully were: (1) whether the parties' intention was merely to hold the land for resale or was to carry on business in common with a view to profit; and (2) whether the parties were obliged to hold the property jointly as partnership property or could each dispose of its share in the land as its own separate property. The court found a clear intention of the parties to maintain their rights as co-owners and the "mere fact that the co-owners intended to acquire, hold and sell the building for profit did not make them partners".[47] Further, the court noted "that the appellants wished to identify and keep separate their respective beneficial interests in the property for income tax purposes. Their intention would have been defeated if they were regarded as a partnership and the apartment building had become the property of the partnership".[48] It is difficult, without looking at the real estate documentation used by the parties in the Kamex case, to see how the decision in this case can be reconciled with some of the other decisions on deemed partnership. It may be that there was no documentation, and the fact that the parties held title as co-tenants in the absence of documentation lead the court to conclude that the parties had intended for each to be able to dispose of its share in the property as its own separate property. In any event, it is unlikely that many equity participation

arrangements, except possibly those relating to raw land, would escape being classed as deemed partnerships. Firstly, in the majority of real estate projects, for example a shopping centre, there is an intention to carry on business which is paramount to any intention of holding and selling the project for a profit. Participation projects which truly are constructed for immediate re-sale should be documented as carefully as possible to rebut any presumption of partnership. Secondly, it is rare to find an arrangement whereby a lender consents to an uncontrolled disposition of its interest in the project by the borrower.

By a process of elimination one can see why, in the majority of cases, the parties will hold their interest in the project through a joint venture. The only real distinction between a joint venture and a general partnership is that a joint venture is formed solely for the purpose of owning and operating a single real estate project and not to engage in the real estate business generally. At first glance the primary obstacle to using a joint venture is the liability to which both the lender and borrower are exposed. The general rule is that one joint venturer can bind all other venturers to the debts of the project. Some of the adverse consequences of this rule can be eliminated if the parties use subsidiary corporations to own their interests in the project, although borrowers often prefer to keep their separate identity and some lenders are legislatively restricted in their ability to do so.[49] The use of a joint venture enables the parties to reach whatever agreement they wish regarding control and management of the project, and it gives them flexibility which is not present in either a corporate or limited partnership structure. Another prime reason for using this vehicle is the ability to avoid the partnership provisions of the Income Tax Act.[50] Therefore, although a joint venture is not perfect, it is the best arrangement for both the lender and borrower to hold equity interests.

Once the choice of project entity is made, the lender and borrower must then make and document their decisions on numerous other issues, such as:

1. What management and veto rights will each party be given?
2. What contributions of skill, money and effort are expected from each party?
3. How and when can the project be sold?
4. Can one party sell its interest without the consent of the other?
5. If the project is sold, how are the proceeds to be divided?

The concern of both the lender and the borrower to avoid having to deal with assigns of the other's interest usually results in restrictions over the transfer of either's interest in the partnership; although, often the lender often has sufficient bargaining strength to negotiate more liberal terms for itself.

The other central concern to an equity relationship is how the parties will conduct themselves if they decide to separate. In the absence of an agreement, the dispute will inevitably go to court, resulting in a judicial "wind-up", followed by reduced prices and high legal costs. Therefore, it is important that the parties agree on some terms of separation at the outset. The following is a list of alternatives that can be utilized:[51]

1. A right of first refusal which allows one of the parties to match any offer made to the other for the sale of its interest.
2. A buy/sell agreement which allows one of the parties to set a price and the other, at its option, to either become a seller or a buyer at the price stipulated.
3. A 'call' which allows one of the parties to require that the other sell its interest on terms already agreed upon.
4. A 'put' which is the opposite of a call and allows one of the parties to require the other to purchase on stated terms.
5. Arbitration on terms set out in the agreement.

6. Parcelling and packaging whereby the parties have agreed on parcels of land and/or buildings which each is to take on dissolution. (This solution can be complicated if the project has central heating and air-conditioning because then the parcels cannot be run independently.)
7. As a last resort, the parties can agree to an auction where the parties meet at a certain time and place, and the highest bidder takes the interest in the project. (This alternative can lead to unhappy results if the parties are overly emotional and as a result overbid.)

b) Shared Appreciation Mortgages

It is as important for the SAM that it not be construed as a partnership as it is for the other participation mortgages. Therefore, all the general considerations outlined with respect to partnership and the participation mortgages are equally applicable to the SAM. However, one aspect of the previous discussion must be elaborated on.

Provincial partnership legislation typically provides that "the advance of money by way of loan to a person about to engage in a business on a contract ... that the lender shall receive a rate of interest varying with the profits or shall receive a share of the profits arising from carrying on the business, does not of itself make the lender a partner ...".[52] In discussing the issue of compliance with this partnership rule, the text Underhill's Principles of the Law of Partnership[53] sets out a list of precautions to take if one wishes to finance a business and receive a share of profits without becoming liable for the business' debts. One precaution listed is to ensure that the lender does not take an interest in or share of the capital. The author warns: "The lender must not take an interest in or share of the capital, because he thereby becomes jointly interested in capital and profits, i.e., he becomes part owner and a partner in the business itself."[54] Although a distinction can be made between taking payments equal to a share in the appreciation of the capital and actually taking a

share in the capital, nevertheless, it seems a SAM by its nature is closer to infringing this rule than are the other participation mortgages. An effort must be made to document the appreciation payment so it is not expressed to be a "profit" share but is expressed to be a share in the sale proceeds after deduction of all amounts representing cost or initial value.[55]

III. Security in the Face of Insolvency

Quite apart from the problem of deemed partnership, which would clearly cause a loss of lender priority, is the problem presented by section 110 of the Bankruptcy Act. The section provides as follows:

> "Where a lender advances money to a borrower engaged or about to engage in trade or business under a contract with the borrower that the lender shall receive a rate of interest varying with the profits or shall receive a share of the profits arising from carrying on the trade or business, and the borrower subsequently becomes bankrupt, the lender of the money is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied."

The issue here is not one of partnership, rather it is one of priority between creditors. Taken literally the section says that if a lender receives interest fluctuating with the borrower's profits, then the lender's claim will be postponed to those of other creditors. This is a problem which is particularly significant to income participation mortgages as an "interest varying with the profits" is just what many income participation mortgages seem to accomplish. It is unlikely that an equity or conversion option would be considered to be a share of profit.[56] It is also unlikely that section 110 would be held to apply to a lease in a sale-leaseback transaction.[57] It is perhaps conceivable, although still unlikely, that a court might consider a share of the appreciation under a SAM to be a share of profits of the business. Therefore, the remainder of this discussion is devoted to the problem as it relates to the income participation mortgage.

One solution to the problem posed by section 110 of the Bankruptcy Act might be to

structure the participation on the basis of gross income only, but for the reasons discussed above not all borrowers prefer participation on this basis. Another solution might be to characterize the participation payments as something other than interest. Such other characterizations have been successfully defended in cases[58] interpreting the meaning of the Interest Act, however, they have not yet been tested in the context of section 110 of the Bankruptcy Act. For now, the jurisprudence has narrowed the application of section 110 to the situation where the participating lender is proceeding to sue on the covenant, as opposed to realizing on its security to recover the indebtness.[59]

The case of Sukloff v. A.H. Rushforth and Company Limited et al.[60] held that if a lender has security, it is entitled to enforce the security notwithstanding that the loan agreement calls for the lender to receive a share of profits. The court relied on the case of Badeley v. Consolidated Bank[61]and quoted from the case as follows:

> "Mr. Wallis says the Plaintiff is here seeking to recover within the meaning of the section. In my opinion he is not seeking to recover any principal or interest. These words must mean, recover as against the property of the debtor not comprised in the security. If there is a security then insisting upon that security is not recovering principal and interest from the debtor. It may enable him ultimately to get it; but insisting upon the security and realizing the security, or, in my opinion, taking proceedings which are necessary in order to recover that which is comprised in the security, cannot be said to be recovering principal or interest within the meaning of that section. In my opinion, that section only means that the lender shall not come in and rank with other creditors in the bankruptcy independently of any security he has in respect of the principal, interest or profits. He is not in any way prevented from insisting upon his security ...."[62]

The Sukloff case concluded with a finding that the lender had priority to the extent of its security. This makes sense as the claims of creditors are always subject to those of secured creditors under section 107 of the Bankruptcy Act. Therefore, if security has been given for a loan, section 110 as it is currently being interpreted has no application despite the fact the lender is entitled to a share of profits. The section, however, is relevant where a loan is not fully secured. In such a case the section imposes remedy limitations disentitling a lender to proceed, for example, by way of a deficiency judgment after a

judicial sale which has resulted in a shortfall. Consequently, it is extremely important for a lender to value its security before committing to an income participation mortgage.

The provincial partnership statutes[63] have provisions equivalent to section 110 of the Bankruptcy Act. A representative example:

> "In the event of a person to whom money has been advanced by way of a loan upon such a contract as is mentioned in section 3 [entitling a lender to receive a rate of interest varying with profits] becoming insolvent ... the lender of the loan is not entitled to recover anything ... until the claims of other creditors ... are satisfied."[64]

The reasoning in the Sukloff case should apply equally to this provision and thus the case should not detrimentally affect a lender who is realizing on loan security. It is difficult to imagine a situation where the provincial provision would apply and not section 110 of the Bankruptcy Act. Section 110 is not presently being carried forward in the proposed revision of the Bankruptcy Act[65], presumably because the situation is covered by the provincial partnership legislation. This raises the question as to whether or not the protection afforded to secured creditors by reason of section 107 of the Bankruptcy Act will still be available. Some comfort can be taken from these words of the Sukloff case: "It appears to me that the Badeley case provides a very close analogy to the present circumstances and that the reasoning advanced by the Court of Appeal in England in that case in relation to Bovill's Act applies with equal force to the provisions of section 98 [now section 110] of the Bankruptcy Act and section 4 of the [Ontario] Partnerships Act."[66]

Since protection for lenders against the provisions of both the Bankruptcy Act and the provincial partnership legislation hinges on the Sukloff case alone, it is important for lenders to keep current with changes in judicial interpretation of this area of the law.

IV. Interest Act

The income participation mortgage and the SAM are vulnerable to problems raised by sections 6 and 7 of the Interest Act. Neither an equity or conversion option likely would be

characterized as "interest" within the meaning of the Act,[67] and because sections 6 and 7 of the Act only apply to mortgages, the participation feature in the lease portion of a sale-leaseback transaction should not be affected.

Sections 6 and 7 of the Interest Act were enacted because Parliament wanted to ensure disclosure of the effective cost of loans to borrowers.[68] Unfortunately the imprecise language of the Act and the complexity of the subject have resulted in a rather weak piece of 'truth in lending' legislation. Section 6 creates three categories of repayment schemes in mortgages which must contain a statement of the interest payable, calculated on a yearly or half-yearly basis, not in advance, otherwise no interest is payable to the lender. If the mortgage does contain the statement, but some other provision in the mortgage increases the interest rate above that contained in the section 6 statement, section 7 requires that only the lower rate can be charged. The three categories of repayment schemes in mortgages which trigger section 6 are those made payable: (1) on a sinking fund plan; (2) on a plan that provides for blended payments; or (3) on a plan that involves an allowance of interest on stipulated repayments.

It is easy to see how these two sections could give rise to a problem where a lender makes a loan secured by a mortgage providing for blended payments of principal and interest, and in addition is entitled in some way to participate in the revenue from the project, particularly if such participation is characterized as "additional interest". In this situation the statement required by section 6 must accurately reflect the interest recoverable as a result of participation. Failure to do so means no interest is recoverable.

The best way to avoid this problem is to ensure that the mortgage does not fall into one of the three categories which trigger the application of section 6 and thereby section 7. (The court must find that a scheme of repayment falls within section 6 before it can apply section 7.) Unfortunately, there is much confusion as to what the three schemes of repayment outlined in section 6 entail. The sinking fund and allowance of interest plans

have had a very short history in the courts, neither has been given a judicial definition.[69] The blended payment plan has been considered and the Supreme Court of Canada, in an attempt to limit the impact of the Interest Act, has given it a restrictive definition.

The Supreme Court of Canada in Re Kilgoran Hotels Ltd. and Samek et al.[70] held that the definition of blended is "mixed so as to be inseparable and indistinguishable".[71] The court was asked to consider a mortgage in which interest was to be calculated quarterly and not in advance. Repayment was to be by quarterly payments, coinciding with the calculation dates and applied first in payment of interest, then to principal. The statement required by section 6 could not be complied with because the interest was to be calculated quarterly and not yearly or half-yearly. The court held that the payments of principal and interest were "distinguished by the very wording of the [repayment] clause .... The arithmetical calculation involved in each payment date could scarcely be simpler."[72]

There have been several different interpretations[73] of what "blended payments" means. The prevailing interpretation emerged in the case of Ferland v. Sun Life Assurance Company of Canada.[74] In discussing what the Kilgoran case meant Mr. Justice Pigeon said: "In short the [Kilgoran] Court held that principal and interest are blended only if the deed does not disclose the true rate of interest payable."[75] The effect of this statement is to so restrict the definition of blended payment it appears to have little meaning. 'True rate' must always be disclosed by a mortgage, otherwise, the contract is void for uncertainty in failing to provide for an essential term.[76] The court's reluctance to attach a meaning to the term is understandable given the harsh penalty for violation of section 6, but it does make it difficult for a lender to know whether or not its mortgage falls under the ambit of the section. To conclude on this point, it seems the best way to ensure a mortgage does not trigger section 6 is to make certain the payments of principal and interest are discrete and not blended.[77]

There still remains the question of compliance with section 7 in the case of a blended

payment mortgage which complies with section 6 but provides for participation payments in addition to the blended principal and interest payments. This question was considered by the Ontario High Court in Re Baliji Apartments Ltd. and Manufacturers Life Insurance Company[78] where the mortgage, in addition to requiring blended payments of principal and interest, provided, by way of a participation clause, for the payment of a percentage of gross annual rentals after a base figure was reached. The participation clause stated that: "any such percentage payment [is] to be in addition to the payments of interest and principal hereinbefore contained". The court placed great reliance upon this statement in its finding that the participation payments were enforceable in light of section 7 of the Interest Act because they were characterized in the mortgage as something other than interest.

The other significant finding in the Baliji case was that participation in gross rentals is not interest because the participation is part of a separate, collateral aspect of the transaction. It is significant that the Baliji mortgage provided that participation was to be paid by one lump sum payment each year and that this payment was not a percentage of, nor in any way related to, the principal sum. In relying on the case of London Loan and Savings Company of Canada v. Meagher[79], which ruled that a lump sum bonus provided for in a mortgage should not be regarded as interest, Mr. Justice Anderson in deciding the Baliji case said: "I see no distinction between a payment by way of "bonus", clearly disclosed as such in the mortgage, and a payment calculated as a percentage of annual income, likewise clearly disclosed as such in the mortgage. If the former was not interest, neither is the latter."[80]

This reasoning was adopted recently by the Ontario Supreme Court in Canada Permanent Trust Co. v. Decanter Developments[81] where rental participation payments (expressed in the mortgage to be a collateral advantage not to be applied in the reduction of principal and interest) were held to be in the nature of "additional income" and not interest.

Although these cases are reassuring to a lender, there are some aspects which should be noted.[82] First, all of the cases in the Baliji line of decisions dealt with mortgages which

provided for participation in gross income and not net income. There does not seem to be any reason to differentiate between the two, however, no case has yet sanctioned a participation in net income. Second, none of the cases considered the determination by the Supreme Court of Canada in Attorney-General for Ontario v. Barfried Enterprises Ltd.[83] that "it is an essential characteristic of interest that it accrues from day to day". It is arguable that this is not an all-inclusive definition because it does not say that all items which accrue day to day must be interest, only that those items which do not are excluded from the definition. In any event, it is likely the Baliji line of cases could be distinguished from Barfried. They all dealt with loans in which there was participation only after a base amount had been reached, and in which the determination of whether or not participation was payable could only be made at the end of a fiscal period.[84] It is difficult to know whether participation payments without a threshold amount could withstand the scrutiny of the Barfried case. Third, all of the courts emphasized the importance of characterizing the participation in the mortgage as a collateral advantage, not as interest.

In light of these problems it may not be wise to rely on the Baliji line of decisions. The lender should structure the transaction so that payments are not blended and thereby entirely avoid the question of compliance with sections 6 and 7 of the Interest Act.

V. Usury

Usury restrictions are of concern to all participation mortgages except the sale-leaseback transaction which escapes concern because the majority of the lender's return is in the form of rent to which the concept of usury does not apply.

There is no simple way to structure a participation mortgage. Contrast the best solution to the deemed partnership problem (the more a transaction is structured as a traditional loan, the less chance a partnership will be found) with the easiest solution to the usury problem (there are no usury limitations if the investment is something other than a

loan). The first principle in any usury analysis is that usury restrictions apply only to lending transactions.

There are three sources of usury restrictions, each to be discussed separately. In this paper the term "usury" applies to all three sources, unless the context indicates otherwise.

1. Criminal Code

On April 1, 1981, section 305.1 of The Criminal Code was proclaimed to create the new offence of agreeing to receive or actually receiving interest at a "criminal rate".[85] Criminal rate is defined to mean "an effective annual rate of interest calculated in accordance with generally accepted actuarial practices and principles that exceed 60 per cent on the credit advanced under an agreement".[86] The term "interest" is defined broadly as "all charges and expenses, whether in the form of a fee, fine, penalty, commission or other similar charge or expense or in any other form"[87], and is broad enough to catch participation payments.

The problem is that a lender cannot be certain at the outset of the transaction whether a participation mortgage will comply with section 305.1 of the Code. The likelihood of offending the section increases in the later years of the loan when participation payments can be substantial, particularly in periods of high inflation, and the principal amount is reduced.[88] Even though a lender must be concerned about prosecution, the greater concern is that even absent prosecution, a court may refuse to enforce a contract which requires the doing of a criminal act. In other words, the lender may not be able to enforce in a civil action the loan for the principal amount owing.

The first civil case to consider the effect of a breach of section 305.1, on a lender's ability to enforce the payment provision in its mortgage, is Mira Design Co. v. Seascape Holding Ltd.[89] In this case the petitioning lender eventually conceded that the mortgage did set a criminal rate, but argued that the section was not meant to apply to commercial transactions between experienced business people. The court did not agree and went on to

consider what result contravention of the section had on enforcement of the mortgage. The court concluded that the purpose of section 305.1 was not to prohibit agreements which received interest at a criminal rate, but to punish anyone who entered into such an agreement. The court also found that the promise to pay interest was collateral to the primary purpose of the loan, which was to repay the principal. On that basis, the agreement was not fundamentally illegal and therefore not void ab initio. As a result, the doctrine of severance was applied to sever the interest provision and entitle the lender to repayment of the principal amount.[90]

After the initial hearing the court reserved its judgment to obtain the report of an actuary as to the effective annual rate of interest calculated in accordance with actuarial practices. After receiving the actuary's report and before the second hearing the lender withdrew any claim for interest and sought the severance of the provision relating to interest. Therefore, it is still an open question as to whether a provision for interest at a fixed rate, which alone is not criminal, can be enforced by severance of an offending participation provision.[91] In support of this proposition is a statement by the Alberta Supreme Court in the case of Stephen Investments Ltd. v. LeBlanc[92] where the court considered a similar question in the context of the now repealed Small Loans Act[93]. A loan provided for an interest charge in excess of the Act and Mr. Justice Milvain said: "The Act does not taint the loan and security with illegality so as to render it void or preclude the Court from lending its assistance, but operates only on the stipulation which prohibits an exaction as the cost of the loan beyond that permitted."[94] It might be argued on the basis of this statement that only the offending payment provision must be severed leaving ordinary interest payable.[95]

It is important to note that there are two ways to commit the offence: (1) to enter into an agreement to receive interest at a criminal rate; and (2) to receive payment of interest at a criminal rate. Each is considered in the context of how a lender can best

protect itself from being criminally liable.

As to the first, it is arguable that, if, at the time the agreement was entered into neither party contemplated or knew a criminal rate would result, then there is no mens rea to commit the offence and the lender does not breach the section unless it actually receives a criminal rate. To ensure protection in this regard, the lender should obtain an actuarial certificate on closing, based on reasonable assumptions, indicating that the interest and other payments in the mortgage are not at a "criminal rate".

As to the second, it is unlikely a lack of intent to charge a "criminal rate" will operate as a defence if in fact the lender receives payments at a criminal rate.[96] The Code provides that the effective annual interest rate is to be "calculated in accordance with generally accepted actuarial practices", which appears to mean that the participation should be added to the fixed interest and averaged over the entire term of the mortgage.

The case of Nelson v. C.T.C. Mortgage Corporation[97] held that the effective annual rate of interest should be calculated over the full term of the mortgage and not over the actual term of repayment. The significant reasons for this finding were that: (1) any other interpretation would lead to an absurd result, if, for example, the borrower exercised a prepayment option that triggered a criminal rate of interest; (2) the interest should be determined by the terms of the document not by the acts of the borrower; (3) although actuarial evidence was sparse it did support this conclusion; and (4) the interpretation that the rate of interest be calculated over the term of the mortgage is in accordance with commercial reality and at the same time it meets the object of the statute, which is to make unlawful agreements that require the borrower to pay interest at a criminal rate.

In the Nelson mortgage, the document itself did not require the borrower to pay interest at a criminal rate; it occurred because the borrower exercised a prepayment option. There still is no decisive case on the question of how interest should be treated in a participation mortgage that by its terms requires the borrower to pay at a criminal rate for a

period, for example during a period of high profit, but does not require a criminal rate when the interest paid under the mortgage is averaged over the term. Actuaries who have been approached on this question generally feel the acceptable approach is to average participation and fixed interest over the term, but very few actuarial principles are committed to paper and there is not a great degree of certainty among actuaries as to what are the "generally accepted actuarial practices."[98] As a precaution the lender might consider including an averaging provision in the mortgage so that in any given year the lender cannot compel payments at the criminal rate, but rather must receive the payments averaged out over subsequent years. As an outside precaution it might be wise to include a provision in the mortgage whereby the borrower is not required to pay any interest above a criminal rate. This of course, could result in the lender receiving something less than it contracted to receive.

2) Common Law Doctrine of Unconscionability

The common law principles relating to unconscionability can be invoked to strike down particular transactions. The basis for determining unconscionability, adopted by modern Canadian courts is twofold: (1) significant inequality of benefits; and (2) inequality of bargaining power.[99] The cases applying the principles usually look at the whole transaction rather than particular terms of the transaction.

It is difficult to imagine a court applying the doctrine of unconscionability in any commercial lending transaction involving two sophisticated parties, if, each has been represented by independent counsel. The English Court of Appeal took this approach in the case of Multiservice Bookbinding Ltd. v. Marden[100] and held that borrowers who "had entered into a bargain with their eyes open, with the benefit of independent advice and without any compelling necessity" were bound to comply with all the terms of a mortgage. Mr. Justice Lambert of the British Columbia Court of Appeal said in Harry v. Kreutziger[101], after

considering the multiple principles of unconscionability established by leading cases:

> "In my opinion, questions as to whether use of power was unconscionable, an advantage was unfair or very unfair, a consideration was grossly inadequate, or bargaining power was grievously impaired, to select words from both statements of principle, the Morrison case and the Bundy case, are really aspects of one single question. That single question is whether the transaction, seen as a whole, is sufficiently divergent from community standards of commercial morality that it should be rescinded."[102]

It seems, if a lender benefits greatly from a participation clause, even if it is in excess of the parties' expectations, the bargain should on that basis alone not be found to be unconscionable under the common law doctrine.[103]

3. Provincial Legislation

Several of the provinces have passed legislation providing for relief of debtors from oppressive transactions. Much of this legislation is for consumer protection and does not apply to commercial transactions. However, at least three provinces, Ontario, Manitoba and Nova Scotia, have passed general legislation[104] broad enough to regulate commercial loans. To fall under the purview of the legislation the loan must be found to be "unconscionable" and the factors that would be considered are the same as those considered under the common law doctrine of unconscionability. Therefore, just as under the common law, it is unlikely these statutes would be relevant in the case of a commercial transaction made between sophisticated parties with independent counsel.

4. Additional Usury Concerns for Equity Participation Mortgages

When considering the question of usury, the courts look beyond what constitutes "interest" for the purposes of the Interest Act and look instead at all the returns allowed for under the transaction. The basic principles of usury as discussed apply to equity participation mortgages, although it is not apparent at first how they relate to the mortgage/equity option or the convertible mortgage.

The item of compensation to the lender under a mortgage/equity option or convertible mortgage that must be considered in a usury context is the option itself. It is possible the courts could include the residual value of any equity received, under either type of option, when calculating the total compensation in a usury action. The question then becomes: When is the proper time for the value to be calculated? An argument can be made that the residual value should be determined at the time the mortgage is made and that it is only worth what the reasonable person would pay for it at that time.[105] Some American states have usury statutes which reduce this uncertainty by providing that a violation will occur only if the interest formula can be determined to a mathematical certainty at the time the mortgage was made to result in a rate of interest violating the applicable ceiling.[106] As to how the value is to be calculated, there is no reason why the actuarial practice of averaging the participation (in this case the residual value in the equity) over the term of the loan should not apply. Following these two principles the value of the equity should generally be low enough to avoid a usury action.

Once the lender has exercised its equity or conversion option, it then, in most cases, becomes a partner of the borrower and there should be no further question of usury, except in the unlikely circumstance the entire transaction is recast as a loan. One way this might happen is if the lender's interest in the project is not at risk, even after exercise of the option. If the lender is over-zealous in protecting itself and negotiates too many features such as guaranteed cash flow distributions, preferred returns on sale or refinancing, or absolute control over sale of the project, it may have taken away any risk of loss and so is not able to receive the protection of partnership.[107] As the lender's risk declines, the usury question becomes more serious.

The usury question with respect to SAMs is more straightforward. The main question is: Will the contingent interest payable on sale or refinancing be deemed interest earned in only the year in which it is paid resulting in a usury problem for the lender, or will it be

spread out over the term of the loan? There is no reason why the normal actuarial practice of averaging would not apply to spread it out over the term of the loan.

VI. Intentional Default and Enforcement

1. Intentional Default

Intentional default is a concern for participation mortgages except for the sale-leaseback transaction where there is no incentive for the borrower to intentionally default to avoid participation payments. In the sale-leaseback the borrower risks termination of the lease and with the lease its rights in the property or the building including any right to receive any of the income generated by the project.

The situation is different for a participation mortgage. When a lender negotiates a participation mortgage it sets both the fixed rate and the participation rate in accordance with an IRR that the lender expects to achieve over the term of the loan. In order to achieve the expected return, the lender must generally receive the participation payments for the entire term of the mortgage. Therefore, the lender is concerned that it not be required to accept repayment of the mortgage prior to the mortgage's maturity date.

In the conventional closed mortgage the borrower has no right to redeem the mortgage before the end of the term. However, if the borrower intentionally defaults and the lender demands payment of the full amount by foreclosure or acceleration, the borrower has the right to redeem the mortgage by simply paying the principal balance together with the principal and interest in arrears to date. The borrower is most likely to intentionally default when interest rates have fallen. Any lender is concerned that the borrower not be allowed to redeem because of the practice of matching funds, but at least a lender under a conventional mortgage has received current market rates to the date of default. Under the participation mortgage, if the borrower intentionally defaults in order to avoid paying participation payments during the later lucrative years, the lender potentially suffers a big

loss because it received below market fixed rates during the lean start-up years. The initial lower rates were to have been compensated by higher participation payments in the later years when the project became successful.

A lender can avoid triggering the defaulting borrower's right to redeem by suing for arrears of interest only[108], even though this will require periodic action to receive judgment for overdue interest and other payments (such as participation payments) as they accrue. The cases have held that any action for sale or foreclosure, even if only in the alternative, will be seen as an election by the lender to resort to its security which triggers the borrower's right to redeem.[109]

The issue of what other types of action will trigger the right to redeem is still unsettled.[110] The case of Re Bank of Montreal and Sam Reichman Investments (London) Ltd.[111] held that the mere taking of possession triggers the right to redeem. However, the British Columbia Court of Appeal in Cameo Developments Ltd. v. National Life Assurance Company of Canada[112] has modified this decision somewhat. In the Cameo case the lender appointed a receiver to seize rents. The borrower claimed the lender had gone into possession through the receiver. Mr. Justice Carrothers said:

> "In order to trigger an equitable right of redemption in the mortgagor as a result of the mortgagee going into possession, the onus is upon the mortgagor to establish that the mortgagee has gone into possession for the purpose of realizing upon the security of the mortgaged premises in order to recover the principal outstanding under the mortgage together with the interest. Here, in my view, this onus has not been satisfied."[113]

The case of Shankman v. Mutual Life Assurance Co. of Canada[114] went even further and said that a claim for possession is not taken against the security and therefore is different from a sale or foreclosure. Mr. Justice Gray stated the test for determining whether the right to redeem had been triggered as whether the lender had elected "to resort to its security", and held that this "means doing something which prevents the mortgagor thereafter from exercising the right to redeem".[115]

Notwithstanding the Cameo and Shanleman decisions, it is advisable for the lender not

to take possession but to obtain a separate assignment of rents. By doing this the lender can then seize rents pursuant to the separate agreement and reduce the risk that the taking of rents will constitute the lender a mortgagee in possession.[116] Perhaps this is a situation for the use of a Rent Receiver Agreement, whereby the borrower and the lender, through a separate agreement, jointly approve the appointment of an independent third party, upon default of the borrower, to receive rents as the agent of the borrower and to pay the participation to the lender with the balance to the borrower.[117]

Another precaution is to provide for participation payments in a document separate from the mortgage. This agreement must stipulate that it remains outstanding despite any prepayment of the mortgage itself, and the mortgage must provide security for the participation.[118] The case of Krelinger v. New Patagonia Meat and Cold Storage Company Ltd.[119] ruled that in the right circumstances a collateral advantage may survive the repayment of a mortgage and its survival is not a clog on the equity of redemption.[120]

Lastly, the right to redeem is an equitable remedy[121] and in order to rely on it, the borrower must come to court with clean hands and if it has intentionally defaulted, in order to benefit from the remedy, it may provoke the court to comment as Mr. Justice Carrothers did in the Cameo case:

> "Those hands [of the borrower] appear to be blemished by the deliberate and wanton stoppage of monthly payment and the further assignment of rents in an attempt to precipitate foreclosure proceedings by a mortgagee against its own interest."[122]

2. Enforcement

a) Income Participation Mortgages

Income participation mortgages can be cumbersome when it comes time for enforcement. As usual where there is a profit there is generally no problem. But there is trouble when the loan goes into default, a foreclosure action is started and the borrower begins to look for ways to defend the action.[123] The remedy of foreclosure is troublesome enough to the

lender, with the possible extension of an already lengthy six-month redemption period, but it becomes doubly troublesome if the borrower resorts to a new defence to the foreclosure action which has been tactically successful in the last few years.[124] The defence is basically an assertion by the borrower that the lender is its partner and is therefore not entitled to foreclose. The assertion raises a factual issue which must then be referred to trial. Once the foreclosure is referred to the trial list, there is a lengthy delay before the matter can be brought to the court which in turn provides a strong incentive to settle. As yet, no case has been decided on this defence of partnership in a participation mortgage context because so far all the cases referred to trial have been settled. The best way a lender can protect itself from this defence is to scrutinize its borrower well before entering into the loan.

b) Equity Participation Mortgages

The problem of the partnership defence is equally applicable to the equity participation mortgage. However, there is an additional problem of enforcement in an equity participation mortgage because in all three types the participation is delayed. The lender has negotiated a lower fixed rate in return for this participation. If it does not receive the participation it will not achieve its expected IRR. Under an income participation mortgage the lender receives monthly or yearly income participation as compensation for the lower fixed rate, contrast this with the equity participation lender who generally receives no equity compensation before the end of the term. The question then becomes: Can the equity participation component be enforced if the borrower defaults before the end of the loan? The whole issue of enforcement is bound up with the doctrine against clogging the equity of redemption.

If the lender chooses to take order absolute on a foreclosure action the question is more or less academic since the lender has received all there is to receive under its security. If, however, the borrower wishes to redeem the mortgage or there is a judicial sale the

question is no longer academic. The questions then become: How much must the borrower pay to redeem and what amount shall be used to calculate a deficiency? One solution for the mortgage/equity option or the convertible mortgage is to embody the option in a separate document and have it registered as a separate charge,[125] so that the option stands on its own and will remain a charge against the land after a judicial sale or redemption of the mortgage. Care must be taken to ensure the option is registered first so it is not in effect "foreclosed" by the enforcement proceedings under the mortgage. If the option cannot be made to stand on its own and it is deemed part of a mortgage transaction, it cannot be enforced as a remedy of the mortgage, nor can the borrower be forced to pay something to redeem the option, as that would constitute a clog on the equity of redemption.

Under a SAM there is no equity option, so there is nothing to protect in a separate instrument. For a SAM two questions arise. Can a borrower be forced to pay something for the appreciation component in order to redeem the mortgage? And, can a judicial sale result in a deficiency judgement equal to the estimated value of the appreciation component? These questions cannot be answered as the issues have not yet been litigated, although there is no readily apparent reason why such claims would not be well-founded. An argument could be made that the appreciation which has been building in the property year by year is akin to interest which has accrued but is not yet due. As accrued interest must be paid on redemption and can result in a deficiency judgement, so should accrued appreciation. In light of this problem some counsel recommend including a term in the mortgage which provides that, on default, the lender's percentage of appreciation accrued to date becomes due.[126]

c) Sale-Leasebacks with Leasehold Mortgages

The enforcement problem under a sale-leaseback transaction is of an entirely different nature. Since there is little chance of a deemed partnership in the sale-leaseback transaction, the partnership defence is not of concern. Rather, the problem is one of

ensuring that enforcement is taken under the appropriate document. Enforcement is looked at from the perspective of the lender-owner, as it is the party which will ultimately own the equity in the project.

If the lender under the leasehold mortgage is a third-party lender and the lender-owner has subordinated its reversionary interest in the fee, the lender-owner must first redeem the third-party lender before any enforcement remedy can be taken. Once the third-party lender has been redeemed, the lender-owner will be in the same position as a lender-owner who provided leasehold mortgage financing at the outset. If the lender-owner terminates the lease that will automatically terminate the leasehold mortgage and its covenant to pay. Further, a termination of the lease generally results in a termination of all the sub-leases derived from it. This is particularly important in situations where the project is an office building or a shopping centre that generates large amounts of revenue from the sub-leases. Accordingly, the best remedy for the lender is to foreclose on the leasehold mortgage and thereby obtain all the benefits that the borrower had under the lease. If order absolute is taken, the lender becomes owner of both the land and the improvements. If there is a judicial sale, there will be a new tenant substituted for the borrower and any deficiency under the covenant to pay will be converted to a deficiency judgment against the original borrower.

VII. Income Tax Consequences

1. General Principles

As each new form of participation loan was created, a host of tax issues evolved. Unfortunately, many of the issues are of the gray variety and it is beyond the scope of this paper to present a detailed tax analysis for any of the transactions. In any event, each participation loan usually has aspects so unique to it, it merits individual analysis from a tax

perspective. The following discussion highlights the basic tax issues[127] and refers the reader to further sources.[128]

A number of tax questions, regarding the nature of participation payments, are common to all participation loans. First, there is the question as to what constitutes "interest". Then, there is the question as to what constitutes a "cost of borrowing". And finally, there is the question as to what limitations the "soft costs" rule imposes.

For an amount to be deductible under the Income Tax Act as interest, it must be paid or payable pursuant to a legal obligation to pay interest on borrowed funds used for the purpose of earning business or property income or used to pay for property acquired for the purpose of gaining or producing income.[129] The Act does not define interest, however, the cases, previously discussed under the heading Interest Act, also establish guidelines as to what constitutes interest from a tax perspective. The criteria established are that interest is generally computed with reference to the principal amount of the loan and that it accrues on a day-to-day basis.[130]

For an amount to be deductible under the Act as a cost of borrowing, it must be an expense incurred in the course of borrowing money used by the taxpayer for the purpose of earning income from a business or property.[131] Interpretation Bulletin IT-314R sets out examples of types of expenses which are deductible as a cost of borrowing. The expenses include, among others: legal fees relating to mortgage financing; commitment or standby fees paid to a lender; mortgage application fees; mortgage appraisal fees; and mortgage insurance fees. The IT Bulletin also provides the example of a borrower who is required as a condition of a loan agreement to pay to the lender a portion of the revenue from a project, and says that such payments are deductible under section 20(1)(e) of the Act in the years in which they become payable.

Section 18(3.1) sets limitations on soft cost deductions. Under the section, deduction of interest or financing costs, otherwise allowed, will not be allowed for such of those expenses

that were incurred during periods of construction, renovation or alteration of a building. Although participation payments should not be an issue during a construction period, they could be caught during a renovation or alteration period. The expense is thus disallowed as a current deduction and must be added to the cost of land or building as the case may be.[132] It should be noted that section 18(3.1) does not apply to a corporation whose principal business is the leasing, rental or sale of property. Therefore, it will not affect the majority of developers.

2. Income Participation Mortgages

Turning to the tax treatment of income participation mortgages, the discussion starts with a characterization of the lender's property. There are three possible characterizations, as follows:

1. The lender has in substance an equity interest in the project and no rights as a creditor.
2. The lender has made a conventional mortgage loan and in addition has received an equity interest in the project (represented by the income participation payments).
3. The lender has made only a conventional mortgage loan and is solely a creditor.[133]

The question as to whether a lender has an equity interest in a property will depend upon the facts of the particular case. If, for example, the facts fulfill the four-part test of a partnership, then it could be said that the borrower and the lender are partners and share ownership of the equity.[134] If the facts support the finding of an equity interest by a lender, the parties must then concern themselves with the proper allocation of expenses, determine who is entitled to capital cost allowance, and determine the proper allocation of capital cost recapture and capital gains.[135] Further, the parties must determine whether, for

tax purposes, they hold the property as partners or co-owners.[136]

Robert Lindsay in his article "Tax Aspects of Real Estate Financing"[137] undertook an extensive review of the Canadian and American jurisprudence on this subject and concluded that a lender's right to receive participation payments, based on gross revenue or profits from a project, does not give the lender an equity interest in the project. Therefore, income participation mortgages, absent any unusual circumstances, have so far been treated by the courts, for tax purposes, as conventional mortgages. The borrower therefore is the sole owner of the project and is entitled to 100 per cent of the capital cost allowance and all of the soft costs.

The next question then is whether or not the income participation payments are deductible by the borrower. Income participation payments do not meet the criteria for deductibility as interest because they are not calculated with reference to the principal amount, and they arguably do not accrue on a daily basis. Therefore, one looks to section 20(1)(e) of the Act to determine if they are deductible as a cost of borrowing. The authoritative case on the subject is Minister of National Revenue v. Yonge-Eglington Building Ltd.[138]. In that case the lender required, as a condition for its commitment to make the loan, that the borrower pay to the lender one percent of the gross rental revenue from a project in every profitable year. The court held that the participation payments were not interest but that the amounts arose from and were incidental to the borrowing of money to finance construction and, therefore, were deductible under section 20(1)(e) as an expense incurred in the course of borrowing money.[139]

Revenue Canada is of the opinion that the Yonge-Eglington decision is restricted to the facts in the case. They argue the case determines only that income participation payments are not interest and that there is no broader principle of deductibility established.[140] If Revenue Canada's position is correct, a borrower can optimize its case for deductibility of the income participation payments by adhering as closely as possible to the facts of the

case.[141] Therefore, it is prudent that the payments be set out in the commitment letter and that they be given in consideration of the lender's commitment to provide the funding, as opposed to being in consideration for the ongoing provision of the funds. One author on the topic suggests structuring the transaction so that the participation payments are subject to a maximum percentage of the principal amount of the loan and thereby being referable to the principal sum, they arguably are interest.[142] The author does not mention whether this argument has ever been used successfully. If, in the future, Revenue Canada is able to restrict the Yonge-Eglington decision and income participation payments are not deductible as either interest or as a cost of borrowing, then the payments will have to be capitalized.[143]

The final issue to be looked at is the tax position of the lender. For an amount to be included in the income of the lender it can be "any amount received by the taxpayer in the year or receivable by him in the year as, on account or in lieu or payment of, or in satisfaction of, interest ...".[144] Therefore, if the payments do not qualify as interest it is arguable that they are received "in lieu of interest" and must be included in the lender's income as they accrue.[145] And even if the income participation payments are not properly characterized as "interest" or "in lieu of interest" they will be caught either as part of the lender's income under Part I of the Act, if the lender is in the business of lending money, or by virtue of section 12(1)(g) as an amount received by the taxpayer dependent upon the use or production from property.

3. Equity Participation Mortgages

a) Common Concerns

As all the equity participation mortgages have either an equity component or equity appreciation component, the income tax analysis starts with a characterization of the lender's interest under the transaction. Because of the equity feature there is a greater chance, than in the income participation mortgage, that the lender will be considered to have taken an

equity position from the start of the transaction.[146] The determination as always, will depend on the facts of the individual case.

Of the three types of equity participation lenders, the SAM lender is the least likely to be considered to have taken an equity position, since no direct equity interest is ever acquired. To that extent, the SAM lender is treated as an income participation lender. If the mortgage/equity option lender or convertible mortgage lender is found to have taken either a full or partial equity interest at the outset, then it must be determined whether that position is, for tax purposes, in the nature of a partnership or co-ownership. From an income tax point of view, the lender probably prefers co-ownership to partnership because it will have the ability to claim capital cost allowance as it sees fit and will not have to contend with the partnership rules under the Income Tax Act. Generally, the parties have used a mortgage/equity option or a convertible mortgage because they hoped to avoid an immediate equity position for the lender. An immediate equity position prevents the borrower from taking all the capital cost allowance and forces the parties to allocate expenses and profits from the outset. Steps can usually be taken to ensure against this but the documentation should be carefully considered by a tax expert. In any event, even if the lender is not considered to hold an equity interest at the outset this determination will become important as soon as the equity option is exercised.[147] Further discussion of the income tax treatment of equity participation mortgages must be done on an individual basis.

b) Mortgage/Equity Option

Pursuant to section 49 of the Income Tax Act, the granting of an option to acquire real estate is deemed to be a disposition of the property by the borrower, the adjusted cost base of which is nil. The borrower therefore has a gain (or income) in the year in which the option is granted, subject to its right to later file an amended return excluding that gain.[148] The lender acquires the option for the amount paid for it, unless the lender has in fact paid

less for the option than its present value. In that case Revenue Canada may attempt to include the difference in the lender's income for the taxation year in which it obtained the option.[149] The lender will then have a cost for the option that includes this difference and it will be added to the cost of acquisition for the property when the option is exercised.

When the option is exercised the borrower includes the option price as part of the proceeds of disposition for the property and refiles its return for the year in which the option was granted, as that is the year the property was deemed to have been disposed. The lender treats the option price as part of its cost of acquisition for the property, which cost will be used when it subsequently resells the property.

c) Convertible Mortgage

From a tax point of view, when the lender exercises its option, it will be considered to have disposed of its mortgage for proceeds of disposition equal to the fair market value of the equity interest which it receives in the property.[150] If the lender has a gain from the disposition of the mortgage, it will be either a capital gain or income depending on the lender's business.

The borrower will have realized a partial disposition of its property for proceeds equal to the face amount of the mortgage or portion thereof converted,[151] unless it is a non-arm's length transaction in which case the fair market rule will apply to determine the proceeds. If the borrower has a gain, it will either be a capital gain or income depending on the nature of the property to the borrower.[152]

d) Shared Appreciation Mortgage

The weight of authority seems to agree that what the lender has in a SAM is a conventional mortgage with the right to an additional amount of money which is contingent in nature.[153] The major concern of the lender, from a tax perspective, is whether this

amount will be included in the lender's income or will be treated as a capital gain. To the extent the shared appreciation payment is not referable to the principal amount of the debt and does not accrue on a daily basis, it does not satisfy the test for income in the nature of interest. It is, however, open to Revenue Canada to argue that the amount should be included in the lender's income because it is received in lieu of interest.[154] Even if Revenue Canada chooses not to make this argument, it may view the money as a bonus which also must be included in income.[155] Interpretation Bulletin IT-114 indicates that a bonus received on a debt which carries a below market interest rate, or which is received by a taxpayer in the business of lending money regardless of the interest rate, will normally be considered to be interest. Therefore, for the majority of lenders the shared appreciation component will be treated as income, one way or another.

If, however, the lender is not in the business of lending money and the interest rate is close to the market rate, the lender may be successful in arguing that the appreciation payment is a capital receipt because it is a lump sum payment determined by reference to the value of a capital asset.[156] If the lender qualifies, and it is a tax-paying entity, then there is a definite tax advantage in using a SAM over the other participation mortgages.

The borrower's chief concern is whether it is able to deduct the appreciation payments. To the extent that the payments are not referable to the principal amount of the debt or do not accrue daily, they are not deductible as interest.[157] Presumably, if the appreciation feature is tied in to the financing commitment, the Yonge-Eglington[158] decision would apply and the payment would be deductible as a cost of borrowing.[159] Finally, since Revenue Canada is likely to treat the appreciation payment as a fully taxable bonus in the hands of the lender, the payment should normally be deductible to the borrower.[160]

e) Sale-Leasebacks with Leasehold Mortgages

The favourable tax treatment of the sale-leaseback is one of the primary reasons for its use. It is especially attractive to those lenders who are exempt from paying income tax, such as pension funds, as they are able to give tax benefits to the borrower at no cost to themselves. In return for these benefits, the lenders receive a higher overall rate of return than they might under one of the other participation techniques.

In order to understand the tax treatment of the sale-leaseback it is necessary to break it down into the three separate transactions. The first transaction is a sale of land, usually at fair market value, which generally results in the borrower incurring a taxable capital gain. The second transaction is the leaseback under which the borrower is able to deduct the full amount of the lease payments (both basic and participation rent), as opposed to just the interest portion of the payments which is all that is deductible under a mortgage. In effect, the non-tax deductible principal repayments become tax deductible. The lease payments in the hands of the lender are of no consequence if the lender is tax-exempt. If the lender does pay tax, the lease payments constitute income and are taxable either as business income or income earned from property.[161] Further, under the leaseback the borrower retains title to the improvements and consequently is able to take all the development soft costs and capital cost allowances. The rate at which the capital cost allowance may be deducted by the borrower is dependent upon the number of years in the term of the lease. The cost of the improvements is added to the cost of the leasehold interest and the leasehold interest is written off on a straight-line basis over the term of the lease, plus the first renewal period (subject to a minimum of five years and a maximum of forty years).[162] Therefore, from a tax perspective it is best to structure the lease with a short initial term and several renewal periods rather than one long term. For example, a 40 year term would require that the cost of the improvements be written off over 40 years. Instead it would be better if the lease had an initial term of four years followed by a renewal period of one year with further

renewal periods of four years and one year.[163] In such a case the initial cost of the improvements would be written off over five years and leasehold improvements incurred thereafter would also achieve maximum write-off. Because the property automatically reverts to the lender on expiry of the lease, no income tax recapture is payable by the borrower at that time.[164]

The third transaction is the leasehold mortgage which is a conventional leasehold mortgage and is treated for income tax purposes like any other mortgage in that interest is treated as income in the hands of the lender and is deductible by the borrower.

It is important that the first and second transactions be viewed by Revenue Canada as a sale-leaseback rather than as a mortgage. If the borrower retains an option to repurchase the property at the termination of the lease, the option will be carefully scrutinized in order to ascertain whether the transaction is in essence a mortgage transaction.[165] If it is determined to be a mortgage, a sale of the property is considered not to have taken place.[166] The parties will be considered to be lender and borrower, not landlord and tenant. Accordingly, the payments made by the borrower will be characterized as mortgage payments rather than rent, the borrower being able only to deduct the interest portion of the payment.[167]

VIII. Builders' Liens

There are two issues which arise when one considers participation loans in combination with builders' liens. The first issue relates to all participation loans and the second only to the SAM.

The first issue is the issue of whether the definition of an "owner"[168] under the provincial builders' lien legislation is sufficiently wide to catch a participating lender, thereby causing a builders' lien to attach to the lender's interest in the property. For the sale-leaseback transaction, the answer is relatively simple. The lender as owner of the fee simple

is also an owner for builder's lien purposes. The issue was decided in the case of Northern Electric Co. Ltd. v. Manufacturers Insurance Co.[169]

For participation mortgages, the situation is not so simple. It seems logical that if a lender takes such an active role in a project that it is deemed a partner rather than a creditor of the borrower (in other words, the lender really holds an equity interest from the outset), then the lender should also be an owner for builders' lien purposes. However, absent a finding of deemed partnership, it is not clear whether other incidents of participation could result in a finding that a participation mortgage lender is an owner for builders' lien purposes. Although no case, other than the Manufacturers' case, has involved a participation lender, consideration should be given to the case of Daon Development Corporation v. Bahrey's Glass Limited, et al.[170] In the case, Daon was the owner of property on which a shopping centre had been built. Several liens had been generated by tenants of the shopping centre who requested that certain work be done to improve their leasehold premises. The builders' lien claimants being unpaid by the tenants had registered liens against the fee simple. Daon submitted it was not an owner because it had neither requested that the work be done nor had it received a direct benefit from the work. The court found that because Daon's lease had required the tenants to construct leasehold improvements, it was implied Daon had requested that the work be done. And because Daon was to receive participation rent, it could be said Daon had received a direct benefit from the work done. These two factors were enough to constitute Daon an owner for builders' lien purposes.

Moreover, it should be remembered for mortgage/equity options and convertible mortgages that once the option is exercised the lender does become an owner and if a builders' lien has been registered against title, the lender will take its interest subject to the lien.

The second issue is whether a builder's lien, attaching to the property after registration of a SAM, has priority over the SAM to the extent of the deferred contingent interest. There has been no reported case in Canada on this issue, but it has been litigated in the United States. The American authors have developed opposing views on the issue.

The first is that a SAM securing an accruing contingent interest payable in the future should have full priority over subsequent builders' liens[171] because a conventional mortgage securing accruing interest that is payable in the future has full priority over builders' liens. Since there is nothing inherently different in a SAM, it too should have full priority. This way of thinking has lead one American author[172] to conclude that the lien priority issue raised by others is the product of overactive imaginations.

The other view is that justice is not served by not recognizing builders' lien work that increases the value of the project and, therefore, the amount due to the lender under the contingent interest.[173] Such thinking could cause a sympathetic Canadian court to find that the builders' lien definition of an "owner" is sufficiently broad to include a SAM lender because of the direct link between the value of the equity and the return to the lender.[174]

IX. Legal Issues Unique to Equity Participation Mortgages

1. Clog on the Equity of Redemption

a) Introduction

The courts of equity having created the equity of redemption, allowing a borrower the right to redeem a mortgage after the contractual right was gone, found it necessary to ensure the right of redemption was not bargained away or burdened by the contractual terms of the mortgage. As a result the doctrine prohibiting clogging the equity of redemption evolved. The rule is that any stipulation which restricts or clogs the equity of redemption is void; in other words, any provision which is repugnant either to the contractual or to the equitable right to redeem is void.[175]

b) Mortgage/Equity Options and Convertible Mortgages

For these two transactions the central issue is whether the exercise of an option by a lender to acquire an equity interest in a project is inconsistent with the proviso which is contained in the mortgage, whereby the borrower is entitled to a reconveyance of the mortgaged property upon payment of the mortgage debt.[176] The answer seems clear that, yes, an option in favour of a lender to purchase the mortgaged property will be unenforceable if it is contained in or is an integral part of what is essentially a mortgage transaction.[177] In the case of Moore and Texaco Canada Ltd.[178] Mr. Justice Grant said: "An option given as a condition to the granting of a loan [mortgage] constitutes a clog on the equity of redemption and is repugnant to the right of the mortgagor to redeem if the transaction is one of loan only."[179] In deciding what was the nature of the transaction at hand, Mr. Justice Grant said:

> "All of the circumstances of the case indicate that the mortgage transaction as well as the option to repurchase are parts of a vendor and purchaser arrangement and that therefore the equitable principle above referred to [clogging principle] has no application and the option attached to such mortgage cannot on that ground be set aside or declared null and void."[180]

Therefore, to be enforceable, the option transaction must either be a distinct and separate transaction from the mortgage, or both the option and the mortgage must be part of a larger transaction such as a purchase and sale agreement.

The following is a compilation of techniques suggested by various authors[181] for ensuring that the option transaction is enforceable. Some of the techniques, while avoiding the problem of clogging, have other drawbacks and wherever possible these are identified:

1. The lender could make an unsecured loan since the clogging doctrine only applies to mortgages. This solution has obvious commercial impracticalities.
2. The option should be expressed as a separate and distinct transaction and should be contained in a separate document. This separation can be made

even more apparent if the option is granted to a legal entity separate from the lender (usually a wholly owned subsidiary of the lender); however, the courts may see the use of a subsidiary as an avoidance technique unless there is at least one legitimate business reason for using it.

3. The mortgage and the option should be entered into and registered on separate dates. The option should be executed delivered and registered prior to the mortgage and should contain a provision allowing the borrower to cancel it if funds are not advanced.

An option that is executed contemporaneously and registered concurrently with a mortgage is at risk of being declared unenforceable given the objective of the clogging doctrine. The courts' primary purpose in invoking the doctrine is to prevent the exploitation and oppression of the necessitous borrower.[182] It is presumed by the courts that an agreement made by a borrower contemporaneously with a mortgage is made under pressure to acquire the loan from the lender. An option which is executed and delivered prior to the mortgage accomplishes two ends. First, under the clogging doctrine a borrower is entitled to a return of the property he has offered as security for the mortgage. If the property when offered is encumbered by an option, then upon repayment of the mortgage the borrower is entitled only to a return of the property subject to the option.[183] Second, in the event of default under the mortgage and foreclosure, the option is not at risk of being foreclosed off title.

Although execution and registration of the option in advance provides some evidence that the option is a separate transaction, the courts could nevertheless find that the option and mortgage were agreed to contemporaneously pursuant to the terms of the loan commitment and, therefore, the applicable time to determine whether the borrower has been exploited is the time of commitment.

4. The documentation should contain the borrower's acknowledgment that the option is a separate transaction and the parties should disclaim any reliance on the doctrine of clogging the equity of redemption. Although this may provide some evidence of the parties' intentions, the court is free to ignore the parties' expressed intent.
5. The lender should pay actual consideration for the option, which will be retained by the borrower whether or not the loan is advanced unless the borrower cancels the option. If an option is not supported by any independent consideration, it runs the risk of being found part of the mortgage transaction.
6. The option price when exercised should be as reasonable as possible. The price in the option itself need not be for market value, if the interest rate on the loan is sufficiently less than the market at the time to make up the difference. In the typical mortgage/equity or convertible mortgage transaction, the lender has provided the borrower with the benefit of a below-market loan, thereby reducing the lender's yield. The lender has given up something of value in exchange for the right to acquire a future equity position. This should be viewed as separate and adequate consideration for the option,[184] however, the fact that the consideration for the option arises pursuant to the favourable terms of the mortgage could lead some courts to conclude the two transactions are tied together into one.

Items 2 to 6 are all aimed at making the option stand as a separate transaction so it is not part of an overall mortgage transaction and therefore not a clog on the equity of redemption. A review of the cases suggests that items 5 and 6 are the most important in determining whether or not the option is a separate transaction. In Lewis v. Frank Love

Ltd.[185] a mortgage and option were placed in separate instruments, but the court had no trouble linking the two together, since the borrower would not grant the option without the loan, and the lender would not make the loan without the option. The best way to make the option and loan acceptable to both parties is if adequate consideration is given for each. But if a lender pays full consideration for the option, then the interest rate on the accompanying mortgage loan rises to market value and the whole reason for a participating mortgage disappears.

7. For the mortgage/equity option transaction, the option should expire before the maturity date of the mortgage (the maturity date being the earliest date that the borrower is able under its terms to redeem the mortgage). For the convertible mortgage, an argument can be advanced that the option completely removes the mortgage by converting it immediately prior to or contemporaneously with the exercise of the option.[186] This argument may work on maturity of the mortgage, but the issue still remains as to what becomes of the conversion option if the mortgage goes into default before maturity and the borrower seeks to redeem the mortgage. A similar issue is raised with respect to the mortgage/equity option, in circumstances where the mortgage goes into default before the option exercise date.

   It seems clear that in either transaction the option cannot become exercisable upon the default of the borrower because then it constitutes a clog on the equity of redemption.[187] The Supreme Court of Newfoundland in Laurin v. Iron Ore Co. of Canada[188] held: "If the 'option' is in fact a remedy, it is a clog on the equity of redemption. If it stands by itself and is not related to default, then it is not a clog."[189] The case concluded that an option associated with a mortgage transaction would be void for clogging the equity of redemption when it provides the lender with a remedy in the

case of a borrower defaulting under the mortgage.[190]

8. A provision could be included permitting the borrower to repurchase the lender's equity interest at the then current market value. Because this repurchase option detracts from the lender's position and is included only to reduce the clogging problem, a premium can be added to the repurchase price (e.g., 10%) sufficient to discourage the borrower but not enough to make the transaction unconscionable. If the borrower does exercise the option, the transaction becomes a SAM.

9. If the equity option covers a partial interest rather than a 100 percent interest, the court may be comforted that the borrower is not giving up its entire interest in the property.

10. The entire transaction could be characterized by the documentation as something other than a mortgage transaction. The two choices are that it be structured as a purchase and sale, or as a lease. The obvious problem with structuring it as a purchase and sale (where the mortgage is only incidental to the main transaction, the sale) is that it carries the partnership and tax dangers of the entire transaction being characterized as a present sale. The documentation should state reasons why the sale is being deferred in an attempt to refute the notion of a present sale. There is also a possibility that a court could find the sale to be a disguised mortgage, and thereby apply all the legal and equitable principles of mortgage law to the transaction.[191]

The better approach is to have the equity option contained in a lease. Under this arrangement, the lender provides financing to the borrower through an income participation mortgage. Some time later, the lender purchases a portion of the land at the borrower's cost and leases it back to

the borrower. Under the lease the lender has the option to purchase a leasehold interest in the improvements at no cost and upon exercise of the option it owns an interest in the land and the improvements identical to what it would have under a mortgage/equity option or convertible mortgage. This is a safer albeit more complicated route to take than the purchase and sale characterization.[192]

11. Perhaps the best approach to avoiding the clogging problem is the use of two separate documents, one being a mortgage and the other being a buy-down agreement which embraces the option. In one document the lender takes a conventional mortgage at market rates. In the other document the lender grants the borrower the right to "buy-down" the interest rate under the conventional mortgage by granting the lender an option to purchase a portion of the borrower's interest in the project. It is this option which entitles the lender to participate in the equity. The mortgage itself is unaffected unless the borrower exercises its election to buy down the interest rate. The technique is probably in substance two transactions and because the option only comes into effect at the election of the borrower, it is likely it avoids the clogging problem.

When one looks at the history[193] of the clogging doctrine it is apparent there have been certain evolutions in the law, although the doctrine is far from extinct. For the meantime, lenders and their lawyers must structure mortgage/equity options and convertible mortgages on the assumption that the clogging rule may be a risk to the enforceability of the option.

c) Shared Appreciation Mortgages

This technique is the safest course for allowing a lender to participate in the capital appreciation of the mortgaged property without offending the clogging doctrine.[194] A

borrower might defend against a foreclosure action of a SAM by claiming that it has forfeited its right to redeem the property by simple repayment of the debt because now it has to pay the lender an additional lump sum equal to a proportion of the appreciated value of the property and, therefore, the equity has been clogged. The borrower would in effect be claiming that although no equity interest has ever, or will ever, be given to the lender, nevertheless, the borrower is being compelled to buy back an equity equivalent in order to redeem the mortgage. There is, however, a clear difference between the lender's rights under a SAM and those found in the cases involving the "clogging" doctrine. The borrower under a SAM never forfeits its right to redeem, and is always able to pay the lender according to the terms of the mortgage and to keep the property. The fact that the contingent interest obligations may be onerous does not change the nature of the borrower's right to redeem.[195] As an extra precaution, the mortgage could include statements making it clear that the parties do not consider that the lender's rights constitute an equity interest.

2. Perpetuities

In some jurisdictions, the parties must be mindful of the rule against perpetuities when the mortgage contains an option to acquire an equity interest in the borrower's property. For example section 13(3) of the Ontario Perpetuities Act[196] provides as follows:

> "In the case of all other options to acquire for valuable consideration any interest in land, the perpetuity period under the rule against perpetuities is twenty-one years, and any such option that according to its terms is exercisable at a date more than twenty-one years from the date of its creation is void on the expiry of twenty-one years from the date of its creation as between the person to whom or in whose favour it was made and all persons claiming through either or both of them, and no remedy lies for giving effect to it or making restitution for its lack of effect."

It appears that the parties cannot contract out of this provision and thus, although the term of the option need not expressly be limited to a period of 21 years, it will be lost if not exercised with the 21 year period permitted by statute.[197]

Other jurisdictions have a perpetuity period which can be significantly longer and is

less likely to come into effect before the option is exercised. For example, section 18 (1) of the British Columbia Perpetuity Act[198] provides as follows:

> "In the case of an option or other contractual right under which an interest in property may be acquired for valuable consideration, the perpetuity period is eighty years from the date of the creation of the option or contractual right, and where under an option or contractual right an interest in property could arise more than eighty years after the creation of the option or contractual right, the option or contractual right is void after the expiration of eighty years from the date of its creation,
>
> a) as between the original parties; and
> b) so far as the benefit or burden is transmissible, as between the original parties and all parties claiming through them,
>
> and no remedy lies for the purpose of giving effect to the option or contractual right or for making restitution by reason of the option or contractual right being void."

X. Summary

The participation techniques which were developed during the 1970s have survived the inflationary period that spawned them. Perhaps the reason for this is that, in addition to softening the blow of inflation, the techniques are flexible enough to accommodate and balance the needs of many different types of borrowers and lenders. From a lender's point of view, the most alluring aspect of the techniques is that they allow the lender to share in the appreciation in the value of a project while, if properly structured, they allow the lender the protection of a secured creditor status. From a borrower's point of view, although the shared appreciation means the borrower must share the profits, the techniques allow the borrowers to obtain large amounts of lower than market value financing, which loans can be structured in such a way that little profit is paid during the lean start-up years. This means that more financing can be obtained for larger projects than might otherwise be afforded by the borrower.

Although there are endless possible varieties of participation techniques, most participation loans can be classified as either an income participation mortgage, an equity participation mortgage, or a sale-leaseback transaction.

Briefly, an income participation mortgage is one in which the lender shares in the profits of a project, the profits being paid to the lender periodically. An equity participation mortgage is one in which the lender shares in the appreciation in the value of the project, the share usually being paid to the lender pursuant to an equity option that can be exercised some years after the initial loan has been made. Income and equity participation mortgages are often combined into one loan package allowing the lender to participate in potentially higher profits generated by the periodic operational profits of the project as well as the increase in the value of the project. Because of increased lender profit, borrowers potentially can raise more money from a loan which combines both income and equity participation. There are several reasons, however, why the parties may prefer not to take a combined income/equity participation mortgage. The primary reason is that without the equity component, the parties avoid many of the legal and tax problems associated with the lender receiving an equity interest. Further, the income participation mortgage is easier to document and administer. Some borrowers also prefer simple income participation mortgages because the income participation rights expire upon the discharge of the mortgage, after which the borrower has absolute ownership and control over the project. The decision whether to combine the two types of participation is dictated by the needs of the individual lender and borrower.

The sale-leaseback transaction differs from the income and equity participation mortgages because implicit in the transaction is equity ownership of the land taken by the lender at the outset. The lender shares in the appreciation of the value of the project by virtue of being the owner of the land, leasing it back to the borrower under a long-term lease. The lease stipulates the developer must construct a building, the ownership of which usually will revert to the lender at the end of the expected life of the building. As well, the lease generally provides for participation rent which is to be paid to the lender. The sale-leaseback manages to escape most of the legal problems associated with the other

participation loans because the participation aspects arise pursuant to a lease rather than a mortgage. The restrictions placed on the contractual relations between a landlord and a tenant are much freer than those placed on the relations between a lender and a borrower. However, the sale-leaseback transaction is potentially a more speculative investment for the lender because it involves a purchase of land at the outset without allowing, as the equity participation mortgage does, the lender the benefit of watching the project perform for a number of years before a decision is made whether to invest as an owner. Some borrowers are not attracted to this form of financing because the borrower loses its interest in the land after the sale and does not participate in the real property appreciation as an owner.

There is one combination of lender and borrower which is consistently attracted to the sale-leaseback transaction, namely, the non-taxable lender and the taxable borrower. Basically, the lender is able to hold the non-depreciable part of the investment (the land) while passing on 100 per cent ownership of the depreciable part (the building) to the borrower, who is able to take full advantage of the capital cost allowance during the life of the building. This combination can produce the highest overall return at all inflation rates.

There is no one form of participation financing which is to be preferred over the other forms. The decision as to which form to choose is dependent upon the financial and tax circumstances of the individual borrower and lender.

Although there are definite advantages to using the participation techniques, the techniques are vulnerable to legal challenge based on common law doctrines and principles of equity developed in some cases centuries before the techniques came into being. Perhaps the greatest single risk, especially for the income and equity participation mortgages, is the risk that the lender-borrower relationship will be seen as a partnership relationship. The best way to avoid this risk is by careful planning of the security documents and by careful monitoring of the amount of "control" the lender has in the management of the project. This risk likely cannot nor should it be reduced by a reform of the partnership laws.

However, there are other risks which should be addressed by a reform of the commercial mortgage laws. The remainder of this paper is devoted to a discussion of reform of the law of commercial mortgages in the areas of enforcement, the clogging doctrine, usury and interest, with a view to modernizing these areas in order to facilitate participation mortgages.

CHAPTER FIVE

PROPOSAL FOR REFORM

New commercial techniques almost without exception encounter uncertainty as to their enforceability and effect. This is because the existing law has evolved to accommodate other techniques. In the commercial world, the law is the follower not the leader.[1] There is always the chance that a court will apply the law incorrectly to a new transaction, either because it fails to understand the evils the law was designed to protect against, or because it fails to understand that the evil is no longer of concern in the modern commercial world.

When a new commercial technique, such as participation financing, is developed out of economic necessity, the technique does not disappear simply because the law does not give it favourable treatment. Instead, lawyers work around the law in an attempt to reinforce the technique. Sometimes, aspects of a transaction are entered into which have no purpose other than to avoid the application of a certain law. This leads to uncertainty and undue complication of the transaction. Eventually, the unflinching presence of the new technique and the tenacity of the parties working with it result in some amendments to the law.

Despite the many legal problems in structuring participation loans, they continue to exist. The remainder of this paper is devoted to an exploration of the aspects of laws[2] which are in need of reform to bring them in line with the requirements and expectations of the parties active in the field of modern commercial mortgages.

Before turning to the specific laws which require reform, it should be made clear that the following recommendations for reform relate only to commercial mortgages. It may be that some of the recommendations are equally applicable to residential mortgages, however, a discussion of the latter involves broad social and political concerns beyond the scope of this paper.[3]

The easiest way to define a commercial mortgage is to say that it is any mortgage in

which the borrower is a corporation. While this definition is sufficient to segregate the majority of commercial transactions from residential transactions, it does not encompasses all possibilities. For example, what about the individual who takes title to a residential home subject to a mortgage originally given by a corporate developer? Without special protection that purchaser has assumed a commercial mortgage and will be subject to all the laws regulating commercial mortgages.[4] Further, what about the person, who has formed a corporation, and for other reasons, wishes the corporation to take title to his or her personal residence? Should a mortgage granted by that corporation be governed by the laws of commercial mortgages? On the other hand, should an individual who wishes to escape the more stringent commercial mortgage laws be allowed to do so simply by carrying on a commercial venture as a sole proprietor and by holding title to the land as an individual? All of these questions indicate that the definition of a commercial mortgage must relate not only to the character of the borrower, but also to the nature of the property.

In the United States, the Uniform Land Transactions Act[5] (ULTA) singles out "protected parties" for special protection in mortgage foreclosure actions. The determination of who qualifies as a protected party starts with a definition of the type of property involved. A protected party[6] is one of the three types of persons who is involved with "residential real estate".[7] Residential real estate is a defined as "a parcel of not more than three acres with four or fewer dwelling units for which the protected party has not been a lessor for commercial purposes".[8]

This provision of the ULTA has been raised as an example of where the definition of a commercial mortgage must start; that is, with the type of property which is to qualify. Canadian standards of commercial activity may indicate that the incidents of residential real estate must be defined differently. For example, it may be that by Canadian standards the construction of up to four dwelling units is an indication that a commercial activity is being carried out on the property. On the other hand, three acres of land is not sufficient

acreage to protect a farming operation. Several American and Canadian jurisdictions have singled out the farming operation for other types of special protection,[9] and perhaps it should qualify for further special protection if a distinction is to be made between commercial and residential real estate.

The following is a list of the writer's recommendations for some of the factors which must be considered in determining what constitutes a commercial mortgage:

1. The definition should describe the type of property which qualifies as protected property and which falls outside the definition of a commercial mortgage. It should include dwelling houses which are occupied by an individual owner, or by a principal shareholder of an owner corporation as his or her personal residence. The protection should also extend to purchasers who otherwise qualify except that they have purchased property subject to a commercial mortgage granted by a developer. The drafters of any legislation in this regard, must also consider whether farming operations should qualify as protected property.
2. There should be limitations on the number of acres that can be in a protected parcel and the number of dwelling houses that can be constructed on the parcel.
3. A general provision should be included in the definition to allow it to extend to any property that is involved in a business or speculative venture, whether the borrower be a corporation or an individual.[10]

The proposals for reform which follow apply to mortgages where any type of business or speculative venture is concerned.

I. The One-Remedy Commercial Mortgage

Participation financing is not the only type of commercial mortgage which would benefit from a simplified enforcement procedure. It, however, seems particularly in need of a

simplified procedure, because it is fraught with many different types of enforcement difficulties. Among the uncertainties of enforcement is the uncertainty as to how long the redemption period is going to last if an enforcement proceeding is commenced. The right of redemption is not statistically important from the standpoint of the borrower as it is almost never exercised.[11] Whereas, the problem from the standpoint of the lender is not with its exercise, but with the simple fact of its existence. The court inevitably orders a redemption period, which means that the property will possibly remain in a state of suspense for a long period, waiting on the slim chance the borrower might avail itself of the redemption right. This state of suspense does not enhance either parties' position. It can erode the property value, and it can waste the loan value, which in turn makes the borrowed funds difficult and expensive to obtain.

The solution to the redemption problem is not as simple as abolishing the borrower's right to redeem. This right is an integral part of the mortgage transaction. The fact is that a mortgage is unduly complicated and simplification of the enforcement procedure must begin with a re-evaluation of the legal notion of what a mortgage is.

A mortgage, at common law, was considered to be a conveyance subject either to a proviso for defeasance or reconveyance. The courts of equity felt strict enforcement of the conveyance on the contractual terms of the mortgage was harsh and so gave the borrower the right to redeem, even after the contractual date for redemption had passed.[12] This right allows the borrower to redeem on a date when contractually the fee to the land is meant to be the absolute property of the lender. In granting the borrower this right, the courts of equity were recognizing that a mortgage is intended primarily as security for a debt and not as a conveyance of legal title. Thus, law and equity contribute to the dual nature of a mortgage. At common law it is considered to be a conditional conveyance and in equity it is considered to be a secured loan. On its face, a mortgage is a deed, but it does not refer to the fact that the sole purpose of the conveyance is as security. This situation has lead some

text-writers[13] to call the mortgage a 'clumsy' security device and has caused the famous legal historian Frederic Maitland to say: "That is the worst of our mortgage deed ... it is one long suppressio veri and sugggestio falsi. It does not in the least explain the rights of the parties; it suggests that they are other than really they are."[14]

Added to this confusion is the Canadian courts' inconsistent treatment of the 'private' or 'contractual' power of sale. As its name implies, it is a remedy given to the lender by the terms of the mortgage contract, allowing for an extrajudicial sale of the property in the event of the borrower's default. The private power of sale was introduced into the standard mortgage contract as a means of providing the lender with a simple and speedy mode of realizing on the debt. Initially the English courts viewed it with disfavour because it circumvented the redemption period implicit in a foreclosure action. However, the power of sale progressed in England where today it is almost the exclusive remedy.[15] It is also considered to be a highly efficient and relatively inexpensive remedy in the United States and is the preferred enforcement method in over one-half of the states.[16] In Canada, the private power of sale has also become a standard term in all mortgage documents; however, not all courts will enforce it. In any event lenders and their lawyers rarely even attempt to use it because the procedure and standard of care are so unclear,[17] except in Ontario where it has been expressly sanctioned by statute.[18] The question arises as to whether ignoring an express contractual term in a mortgage is really furthering the end of commercial certainty.

To continue to ignore the need for reform is to perpetuate legally cumbersome notions. An appropriate place to begin the reform of the law of commercial mortgages is with a recharacterization of the mortgage from a legal conveyance of land (coupled with a right of redemption) to a contract for a debt. It is submitted that if the law of contracts prevailed over the ancient equitable doctrines applicable to mortgages, then there would be certainty in the law of mortgages. The nature of a commercial mortgage would simply be that of a contract, and the parties would be free to contract on whatever terms they like.[19] The

lender's need for security could be met by allowing the mortgage to be registered against the property where it would be secured either as a lien or as an encumbrance, rather than as a 'mortgage' and all that it entails. Mr. P. J. Fitzgerald echoes this sentiment in the text Salmond on Jurisprudence[20] when he writes:

> "The complexity and difficulty of the English law of security - due entirely to the adoption of the system of mortgages - must be source of amazement to a French or German lawyer. Whatever can be done by way of mortgage in securing a debt can be done equally well by way of lien, and the lien avoids all that extraordinary disturbance and complication of legal relations which is essentially involved in the mortgage. The best type of security is that which combines the most efficient protection of the creditor with the least interference with the rights of the debtor, and in this latter respect the mortgage falls far short of the ideal. The true form of security is a lien, leaving the full legal and equitable ownership in the debtor, but vesting in the creditor such rights and powers (as power of sale, possession, and so forth) as are required, according to the nature of the subject-matter, to give the creditor sufficient protection, and lapsing ipso jure with the discharge of the debt secured."[21]

If the mortgage is characterized as a contract and the notion of a conveyance is abolished, then the question arises as to what is the proper means of enforcing the security under the contract. Clearly the abolition of the conveyance would also do away with the present means of enforcement through foreclosure of the equity of redemption.[22] It is proposed that the basic remedy which lenders should have under a commercial mortgage is the power to sell the secured property extrajudicially.[23] The remedy of foreclosure would be abolished, and the remedy of judicial sale would be utilized only in the limited circumstances set out below. The single remedy of extrajudicial power of sale gives the lender the kind of speedy access to its remedies that other secured creditors typically have in default situations, and it provides a uniform remedy in cases where the lender has taken security on both real and personal property in a single instrument (e.g., a debenture). The remedy would ease the delay inherent in existing foreclosure proceedings, which can lead to depreciation in security and indirectly raise the cost of borrowing.

The procedure would start with the giving of notice of default to the borrower and to any other person who might be held liable for a deficiency. The notice would outline the

consequences of default (i.e., that the property might be sold and that the borrower might remain liable for the deficiency) and any rights the borrower has to cure the default. If the lender intends to proceed by way of extrajudicial sale, a further notice of this intention would be given to the borrower, to any other person who might be liable for a deficiency, and to any subsequent encumbrancer whose interest in the property would be extinguished by the sale. This notice could be served in conjunction with the notice of default, and it must contain notice of the time and place of any public sale (if an auction is contemplated) or reasonable notice of the arrangements for a private sale. After delivery of this notice, a delay period of approximately thirty days is appropriate during which time no sale can be held.[24] This period would be used by the borrower and subsequent encumbrances to raise the funds necessary to redeem the mortgage. The shortness of the period would force subsequent mortgage lenders to carefully value their security before granting a mortgage loan and might make the subsequent mortgage market less speculative.[25] This period could also be used for the borrower or subsequent encumbrancer to bring on an action to restrain the lender from exercising the power of sale, if it appears the lender is not exercising the right in compliance with the requirements of the proposed enabling legislation.[26] If, after the expiration of the period, the mortgage has not been redeemed, the lender is then entitled to sell the property.

The lender would be subject to an express standard of care in exercising the sale. In the Status Report of Mortgage Reform made to the Ontario Law Reform Commission, the standard proposed for the exercise of an extrajudicial power of sale remedy is: "That degree of care, diligence and skill that a person of ordinary providence would exercise in dealing with the property of another person."[27] The ULTA stipulates that "every aspect of the sale, including the method, advertising, time, place, and terms, must be reasonable.[28] The ULTA requirement that the sale be conducted in a reasonable manner requires that the person conducting the sale use the ordinary methods of making buyers aware that are used when an

owner is voluntarily selling his land.

To put the lender to a standard of "reasonableness" means the lender owes a duty to take reasonable precautions to obtain a true market value for the property, which is a lesser duty than that owed by a fiduciary or a trustee.[29] Also, to leave the standard at reasonableness without detailed requirements allows for necessary flexibility in determining what is a reasonable way to sell a particular property in a particular market. The best solution in the vast majority of cases will be to employ the services of a real estate agent, who can advise as to the proper marketing techniques and can properly market the property in the circumstances.

The question arises as to whether the lender should be entitled to purchase the property under the extrajudicial power of sale.[30] The lender is entitled to purchase under both the ULTA extrajudicial sale proceedings [31] and the New Brunswick extrajudicial sale proceedings.[32] A lender in New Brunswick may purchase in the sale proceedings even if the sale is being conducted by the lender on the premise that if preparations for the sale have been in accordance with the standards of reasonableness, then theoretically the sale is in the forum of competitiveness, and the inclusion of the lender in the group of prospective purchasers should enhance the sale price ultimately realized. [33] This situation seems fraught with potential conflict as the lender is under a duty to obtain a reasonable price and yet its own interest is to pay the lowest possible amount. Therefore, it is proposed that the lender should be entitled to purchase at the sale, but only if the sale is a public sale, or if it is a private sale, then only if the sale is conducted by some person not related to the lender. [34] As incentive for a lender who is purchasing at the sale to bid the value of the property up to at least the amount of the mortgage debt, the borrower should be allowed to redeem the mortgage at any time up until the time when the lender enters into a binding contract for the sale of the property to another.[35]

The effect of any sale to a good faith purchaser for value pursuant to the extrajudicial

proceeding, except a sale to the lender, would be to pass title in the property free from the mortgage under which the sale occurred and any subordinate interest. This would be so even if the lender responsible for the sale failed to comply with the enabling legislation.[36] This is necessary to provide the certainty to the purchaser that is needed for the property to attract full market value. However, the borrower, subsequent encumbrances and guarantors should be entitled to sue a lender for breaching the standard and to obtain monetary compensation for the breach.[37] As well, a breach of the standard could be raised as a defence by a borrower or a guarantor in any action brought by the lender on the covenant for a deficiency after the sale.

Proceeds from the sale would be distributed in order or priority of registration with any surplus being paid to the borrower.[38] Any of the parties to the sale proceeding would be at liberty to apply for an accounting before the Registrar, either before or after the sale, if necessary to establish the amount owing under the mortgage or under any other encumbrance registered against the title.[39]

There may be need in certain instances for the court to assist in the sale proceeding, in which case any of the parties should be at liberty to apply for a judicial sale. The lender for instance may be uncertain how to proceed with the sale in a given circumstance and should therefore be entitled to apply for a judicial sale. The borrower or a subsequent encumbrancer might also want to apply for a judicial sale in a circumstance where it is taking an inordinate amount of time for the lender to sell the property and it can be shown that further delay is to the economic determent of the applicant (e.g. the market is declining or the amount of arrears is increasing substantially, thereby increasing the amount of a possible deficiency judgment). Further, a borrower or subsequent encumbrancer should be entitled to apply for judicial sale at any time prior to the lender entering into a binding bona fide contract with another, if it can be shown the lender is breaching the standard of the extrajudicial sale. In any instance where the remedy of judicial sale is resorted to, it

would preserve the covenant and would entitle the lender to a deficiency judgment for any part of the debt not repaid by the sale proceeds.

There is one further optional remedy which should be available on judicial application by the lender. Since the mortgage no longer constitutes a conveyance, the borrower remains the owner of the property and as such will ordinarily be the one entitled to possess the property. If the lender decided that possession (either personally or through a receiver) was necessary after default, and its mortgage did not provide for extrajudicial possession, it should be entitled to make application to the court for an order for possession.[40] If the lender wanted to ensure its right to possess extrajudicially, it could contract to do so (as is usual in commercial mortgages) and then, so long as the borrower did not dispute, judicial application would not be necessary for the lender to possess or appoint a receiver.

It is reasonable to conclude, that the recognition of the commercial mortgage as a contract for a debt would lessen the conceptual confusion which is commercially undesirable, and that the introduction of the extrajudicial power of sale as the primary remedy would bring the enforcement of secured land transactions in line with other commercial transactions.

II. Codification of Mortgage Law

In order to bring the reform discussed into effect, it is necessary to codify the law of mortgages. It is too much to expect the courts to reshape the law of mortgages. One can sympathize with those judges who have had to make what, at times, appear to be illogical decisions in the commercial context to avoid throwing the whole law of mortgages into chaos. The only way to bring about controlled, comprehensive change is through legislation.

At present Ontario and New Brunswick have the most progressive mortgage legislation and, because of this legislation, they are the only provinces to use the remedy of power of sale widely. Similar but expanded legislation should be brought into effect in British

Columbia to achieve the following:

1. To define what is meant by a "commercial" mortgage.
2. To establish the mortgage as a contract for a debt, with security taken in the form of a lien or encumbrance.[41] This change necessarily requires abolition of the conveyance and the attendant incidents of the equity of redemption and foreclosure.
3. To establish the procedure for the remedy of extrajudicial power of sale.[42]
4. To set the standard of care required of the lender in exercising the extrajudicial power of sale.
5. To legislate the effectiveness of a transfer of title by a lender when exercising the extrajudicial power of sale.[43]
6. To establish the circumstances under which application can be made for the optional remedy of judicial sale, and the procedure for such remedy.
7. To establish the procedure for the optional remedy of possession.

III. Abolition of the Clog on the Equity of Redemption

If the law of mortgages is reformed to recognize the mortgage as a contract for a debt, then there is no need for reform to abolish the clogging doctrine as it, by necessary implication, will have disappeared along with the concept of a conveyance and the equity of redemption. If such reform does not come into effect an important half-way reform is the abolition of the doctrine. As many authors[44] have remarked, there is no longer a need for the doctrine and its continued existence interferes with the development of much needed innovative techniques for commercial financing. Indeed, if the doctrine is not abolished, it is possible that the mortgage/equity option and convertible mortgage transactions will disappear because of the serious problems of enforcement presented by the clogging doctrine. The foundation of the clogging doctrine, unconscionability and the borrower's necessity, is not

applicable to a situation where an institutional lender and sophisticated developer-borrower enter into a convertible mortgage or equity option agreement.[45] The doctrine has outlived its purpose; the simple application of the doctrine of unfairness and unconscionability will sufficiently safeguard the rights of those parties which are in an interior bargaining position. The doctrine has no application in a sophisticated arm's length transaction free from oppression, instead continued recognition of the doctrine could in some cases mean a fair bargain between equal parties is evaded.[46]

Lawyers have developed many different techniques to avoid the clogging doctrine in transactions that include an option. While most of the solutions developed are workable, they point out the absurdity of the doctrine. In the end, the doctrine is avoided by a series of costly and sometimes fictional manoeuvers, all because of an outdated need to protect against unconscionable bargains.

An extreme solution to the clogging problem was created in 1982 for one specific project. The City of Ottawa wanted to revitalize its downtown core and encouraged private developers to construct a major centre which would include a convention hall, office buildings, and retail and commercial facilities. In order to obtain the most propitious financing, the developers decided to offer their lenders an option to acquire a 35 per cent interest in the centre. There was fear that the option infringed the clogging doctrine and this fear lead to the passage of legislation known as the Rideau Centre Mortgage Financing Act.[47] The following is a portion of the statement that preceded the introduction of the Bill:

> "The Rideau Centre, as members will know, is a major real estate development in downtown Ottawa. Included in this complex are (a) commercial facilities which include a department store and renovated office building, (b) a 500 room, full-service hotel and (c) a 4,000 seat convention centre.
>
> In addition to the usual mortgage agreement arrangements, this legislation permits the mortgagor - the borrower - to give the mortgagee- the lender- an option to purchase an equity share in the project.
>
> Common law forbids such an option to be attached as part of the mortgage transaction. The clogging rule, as it is known, was developed to prevent an

> unscrupulous lender from changing a borrowing transaction into a transfer of property. The viability of the Rideau Centre depends on the successful completion of this loan for $88 million with such an option attached to the mortgage document.
>
> The rationale behind the development of the common-law rule is not applicable in this case, since all parties to the agreement are well aware of the agreement's implications."

The Bill received Royal Assent on July 7, 1982 and section 2 of the Act provides as follows:

> "An option to acquire a legal or beneficial interest in Rideau Centre, granted as part of a mortgage financing of Rideau Centre, is not invalid, unenforceable or void by reason only that the option is inconsistent with or repugnant to, or a fetter or clog on, the mortgagor's legal or equitable right of redemption."

It is an unworkable situation when enactment of special legislation is required to permit the completion of an otherwise commercially acceptable transaction. The viability of other developments may depend on the granting of an option and it is not fair that only those who have access to Parliament have the ability to enter safely into this type of transaction. Clearly, the time has come for the abolition of the clogging doctrine.[48]

IV. Exceptions from the Law of Usury

The passage of section 305.1 of the Criminal Code seemed to catch many lenders and their lawyers off guard. It is clear that the government had for several years contemplated imposing controls on 'loanshark' activities. However, few expected the new section of the Criminal Code to be so widely worded. When the amendments were first presented, a federal official from the Department of Consumer and Corporate Affairs said in comments released to the public to explain the section: "We have consulted with senior Montreal police officials and they assure us that a maximum rate under 90% will be fully effective and provide them with a means to severely restrict loanshark operations. It should be noted that the typical loan made by a loanshark carries a rate between 500 and 800%"[49]

In light of this statement it is somewhat ironic that the first case reported on the section, the Mira Design[50] case, should involve an ordinary commercial transaction between experienced business people in a situation where there was no indication of unconscionable

activity. It is doubtful the supporters of the new section anticipated this result. The danger in this situation is not so much in criminal prosecution, although it cannot be completely discounted, but in the fact that future civil courts may refuse to enforce participation loans because they result in a criminal rate. Since the section is obviously aimed at loansharking it should be amended to make an exception for commercial loans, between sophisticated borrowers and lenders, where there is no question as to unconscionable activity.

While such reform would alleviate concerns with the criminal usury legislation, there still remains the common law doctrine of unconscionability and, in some jurisdictions, provincial usury legislation. When usury laws first evolved there was a real need to protect borrowers as few had the experience to adequately protect themselves. In more recent years, there has been less need for usury protection especially in the realm of commercial transactions. This shift away from the concept of usury has been recognized in many of the American states which now exempt 'large loans', business loans and loans to corporations from the purview of their usury laws.[51] Similar reform in Canada should be considered, in order that commercial transactions between experienced parties are no longer so unnecessarily regulated.

V. Reform of the Interest Legislation

In the words of one author on the subject: "We have archaic (interest) legislation that imposes onerous penalties on a lender and judicial pronouncements that fluctuate in the law applied to reasonably similar factual situation. We are left to deal with them, and apply them to today's complex commercial transactions."[52]

There has also been judicial disfavour expressed in this regard, an example being Mr. Justice Davies in the case of The Canadian Mortgage Investment Company v. Cameron,[53] where he comments on the interest legislation, saying:

> "The sections are carelessly drawn, and the language used somewhat ambiguous. It is not to be wondered at therefore that there has been much difference of judicial opinion

> as to their meaning. I frankly confess myself, I entertained much doubt as to their meaning alike during the argument and subsequently when discussing the sections with my colleagues."[54]

This statement was made nearly 70 years ago and yet there still has been no amendment to the Interest Act. Part of the reason may be that for so many years, when interest rates were low and generally fixed, it was relatively easy to comply with the Interest Act. However, in an economy which is susceptible to inflation, the legislation is no longer in step with the complex needs of the lending industry. A general review of the Interest Act is required in order to consider the appropriateness of various provisions in the Interest Act, particularly sections 6 and 7,[55] and to establish a more workable disclosure system. Perhaps, the most basic matter which must be looked at in this regard is the matter of what is "interest." With all the new commercial techniques, such as participation loans, it is becoming increasingly difficult to determine the parameters of what should be included in the calculation of interest received under a loan.

VI. Conclusion

When participation loans first appeared they were novel financing techniques which presented a variety of practical and legal problems rarely encountered elsewhere. Participation loans are now a permanent part of the lending industry and most of the practical problems have been solved, but many of the legal problems persist.

This paper is not intended as a guide to the 'safe' preparation of a participation loan. No such guide is possible. However, it is hoped it will help more lawyers to understand the problems in structuring a participation loan and thereby comprehend its great flexibility as a financing tool.

Further, it is hoped that support will grow for the concept of the commercial mortgage as a contract for a debt, realizable by the one remedy of extrajudicial sale. The single most important question a lender asks when valuing its security is: If there is default, how much

can this project be sold for? If this is the approach lenders take to their security, then it makes sense that the remedy in the security reflects it. It is nonsensical that real property security, often found in the same document as personal property security, is realized in accordance with ancient and cumbersome mortgage laws, while the personal property security is realized by a summary sale procedure.

The major proposal for reform outlined in this paper is the one remedy commercial mortgage. Suggestions on how to define a "commercial" mortgage are given. Briefly, the one remedy mortgage entails a recognition that there is a need in commercial transactions for the lender to have relatively quick and inexpensive access to a remedy, which in turn brings the cost of borrowing down and increases the availability of funds for loan. It is proposed that the primary remedy under a commercial mortgage be extrajudicial sale in which the period for redemption is shortened to approximately thirty days, after which the lender is free to sell the property either under a public or private sale, and that there be an alternative remedy of judicial sale available upon application in certain circumstances. It is proposed that the borrower and subsequent encumbrancers should be entitled to restrain the lender from selling if it is not acting "reasonably" and to claim damages from a lender that does not sell the property under "reasonable" circumstances. In order that there be certainty in the procedure for exercise of the remedy, it would be necessary to embody the proposed reform in legislation. Presently, there is an unnecessary amount of uncertainty in the law of mortgages in British Columbia, and it is time the province have comprehensive mortgage legislation such as is available in other provinces.

If such wholesale reform is not possible, an important half-way measure is to abolish the doctrine against the clogging of the equity of redemption. The clogging doctrine has failed to progress with modern commercial lending techniques, and it is a dangerous doctrine which can be imposed arbitrarily allowing a party to improperly evade an otherwise fair bargain. In conjunction with the abolition of the clogging doctrine, it is necessary to clarify

the laws of usury. Of course, the principles of unfairness and unconscionability should be maintained to protect the rights of parties in inferior bargaining positions; however, the laws of usury should be examined with a view to making it clear that they must be applied differently to sophisticated commercial transactions than to transactions involving individuals. Currently, the only recognition of the distinction between the two types of transactions is in the consumer protection legislation which affords no relief to commercial transactions.

Lastly, the federal Interest Act is long overdue for major reform. Some of its provisions are unreadable, and certain provisions, such as the disclosure provisions, are unworkable when applied to complicated commercial loan transactions.

The uncertainties and potential dangers in the application of the law indirectly and unnecessarily increase the cost of borrowing. The proposals for reform are meant not only to simplify the procedure for realization, but also to bring the mortgage laws in line with current commercial attitudes. It is time that innovations in financing no longer be limited by archaic mortgage laws.

ENDNOTES

Prepared in accordance with the Canadian Guide to Uniform Legal Citation (McGill Law Law Journal, Toronto: Carswell Company Limited, 1986).

CHAPTER ONE

1. B. Crawford, "Selected Problems in Taking Security" in Business Law: Borrowing From Banks (Ontario: The Canadian Bar Association 1984 Annual Institute on Continuing Legal Education) at 2.

   In this paper the term "mortgage" includes that part of any debenture which contains a fixed charge on land. When a debenture contains such a charge, it is registrable against the land and it is considered to be a mortgage and charge against the land. And when it comes time to enforce the charge, the courts treat that component of the debenture as they would any other mortgage.

CHAPTER TWO

1. D. Sullivan, "Creative Real Estate Financing" in Corporate Management Tax Conference 1983 (Ontario: Canadian Tax Foundation, 1983) 196 at 196.

2. A. Downs & S. Gilberto, "How Inflation Erodes the Income of Fixed-Rate Lenders" (1981) 11 Real Est. Rev. 43 at 43.

3. Ibid. at 45.

4. B. Strum, "Long-Term Fixed Rate Mortgages" in B. Strum, ed., Financing Real Estate During the Inflationary 80s (American Bar Association Press, 1981) 23 at 23.

   These rates are based on American statistics. In Canada the prime rate, as quoted by the Bank of Canada, ranged from 5.75% to 8.5% during the same period, and the inflation rate was approximately the same as the American rate.

5. Supra, note 2 at 46.

   In Canada the prime rate, as quoted by the Bank of Canada, ranged from 8.5% to 9.75% during the same period, and the inflation rate was approximately the same as the American rate.

6. Supra, note 4 at 24.

7. Supra, note 1 at 198.

8. Among these are the Chartered Banks, Insurance Companies, Trust Companies, and Pension Funds.

9. J. McNutt, "How to Mortgage Out - Financial Discipline in the Development Process for Small Centers" (1979) Shopping Center Report, International Council of Shopping Centers

The income approach to value is the primary method used by long-term lending institutions to calculate the value of a project. A realistic estimate is made of the amount of annual gross income to be earned, from which all annual operating expenses are deducted, to arrive at the annual net income. The annual net income is divided by a percentage that is 1/4 to 1/2% higher than the current long-term fixed rate (cap rate) and the result is the value.

$$\text{Value} = \frac{\text{net income}}{\text{cap rate}} = \frac{\$100{,}000}{10\%} = \$1{,}000{,}000$$

10. Supra, note 1 at 198.

11. D. Sullivan, "Recent Trends and Developments in Real Estate Financing: A Market Perspective" in Real Estate Financing in Today's Competitive Markets (Toronto: Insight Press, 1984) at 9.

12. D. Sullivan, "Joint Venture Financing with Financial Institutions" in G. Fields and B. Gershman, ed., Canadian Mortgage Practice Reporter (Toronto: Richard De Boo Limited, 1982) 18-52 at 18-57 (text has been republished as Canadian Commercial Real Estate Manual (Toronto: Richard De Boo Limited, 1986); some articles were not republished in their entirety, therefore, references throughout are to original text.

    In order to include a residual value in the IRR calculation, the lender's equity interest must have marketability. For example, a lender's equity interest will have questionable marketability if the lender is in a minority position (e.g., 15%). In such a case the estimated residual value will be discounted unless it is combined with a "put" option requiring the developer to purchase the lender's interest. Even with this option the residual value may still be discounted because the value of the "put" depends totally on the developer's financial ability to purchase at the time the option is exercised.

13. Supra, note 11 at 9.

    For example, a lender prepared to lend at a fixed-rate of 15% will require a 16.5% IRR on a 12% fixed-rate mortgage which includes participation features. In order to reduce the fixed-rate by 3%, the participation features must be estimated to have a value to the lender equal to a 4.5% fixed return over the term of the loan. In order to achieve this type of return on a participation feature, lenders generally require a 25-35% income participation in net cash flow or a 25-50% equity interest. For further information on these percentages refer to supra, note 11 at 3-4.

14. Supra, note 11 at 9.

    Pension funds for reasons that will be discussed infra still prefer participation financing.

15. The average Canadian commercial mortgage rate for a 5 year term in the first half of 1983 was 10 3/4%, as quoted by the Bank of Canada.

16. The average Canadian commercial mortgage rate for a 5 year term in May, 1984, was 13.5%, as quoted by the Bank of Canada.

17. G. Ross, "Equity Participation Financing" in Innovative Techniques for Real Estate Financing (Toronto: Insight Press, 1985) at 7.

18. Other examples of 'pure' equity arrangements in addition to the equity joint ventures are co-tenancies, limited partnerships, direct purchase of completed properties and syndicates. For further discussion of this topic refer to: supra, note 1 at 247-253 and note 12 at 18-55 - 18-58.

19. A combination mortgage/equity transaction is a joint venture type of financing in which the lender provides conventional mortgage funding for a portion of the project (usually 75%) and purchases the remainder of the project (25%) at the outset.

20. Except for the sale-leaseback transaction which has a present equity component in the land but not the building.

21. Some writers have taken the position that because the participating lender also shares in the cash flow and/or capital appreciation of a project, it does hold a present equity position but in a disguised form. See, for example, supra, note 11 at 6. This hidden equity can result in problems in the conceptualization and documentation of the transactions and in their legal effect and enforcement.

22. L. Lavine & S. Cohen, "Financing Real Estate: The Lender's Perspective" in Tax and Financing Aspects of Real Estate Investment (Toronto: CCH Canadian Limited, 1985) 33 at 35.

23. H. Harfield, "Legal Aspects of International Lending" as referred to in S. Belcher "Financing the Major Development: The Construction Lender" in Real Estate Financing in Today's Competitive Markets (Toronto: Insight Press, 1984) at 8.

24. Supra, note 22 at 37.

25. This is a compilation of questions and comments taken from ibid. at 37 - 39.

26. Supra, note 1 at 201.

27. P. Cohen & J. Prince, "Methods of Financing: The Developer's Perspective" in Tax and Financing Aspects of Real Estate Investment (Toronto: CCH Canadian Limited, 1985) 2 at 4.

28. This is a compilation of predictions taken from supra, notes 1, 22, and 27.

29. B. Strum, "The Roles of Life Insurance Companies and Pension Funds in Financing Real Estate in the 80s" in B. Strum, ed., Financing Real Estate During the Inflationary 80s (American Bar Association Press, 1981) 1 at 5.

30. Ibid. at 2.

31. Ibid. at 5.

32. R. Karp, "Real Estate: Good Returns not Dependant on Inflation" (1982) Pensions and Investment Age J. 31 at 33.

33. Supra, note 11 at 19.

CHAPTER THREE

1. D. Sullivan, "Joint Venture Financing with Financial Institutions" in G. Fields & B Gersham, ed., Canadian Mortgage Practice Reporter (Toronto: Richard De Boo Limited, 1982) 18-52 at 18-58.

2. D. Sullivan, "Creative Real Estate Financing" in Corporate Management Tax Conference 1983 (Ontario: Canadian Tax Foundation, 1983) 196 at 222.

3. A summary taken from ibid. at 222 - 224.

4. This form of participation is often used in shopping centre financing. The base amount is usually equal to the minimum rents payable under tenants' leases. Typically, tenants will pay the greater of their minimum rent (for example, $30 per sq. ft.) and a specified percentage of their sales (for example, 7%). Using the base hurdle limit the lender only participates in the income from the percentage rents.

5. Supra, note 2 at 223.

6. Supra, note 1 at 18-59.

7. A summary taken from supra, note 2 at 225.

8. To be expanded on infra; briefly the borrower is entitled to treat the lender's participation as debt eligible for a tax deduction while at the same time the borrower receives the full capital cost allowance for the building.

9. This is not to imply that there are no advantages to taking an equity position at the outset. If the lender is willing to take the risks associated with ownership, it may share in greater cash rewards in the end. Further, many of the issues and considerations for an equity participation mortgage are the same as those which must be considered for an equity position taken at the outset.

10. Supra, note 1 at 18-71.

11. Supra, note 2 at 239.

12. Ibid. at 246.

13. This is a compilation of reasons given in ibid. at 225 - 239, and G. Howard, "Income Participation Mortgages" in Innovative Techniques for Real Estate Financing (Toronto: Insight Press, 1985) at 1 - 3.

14. Supra, note 1 at 18 - 58.

15. G. Ross, "Equity Participation Financing" in Innovative Techniques for Real Estate Financing (Toronto: Insight Press, 1985) at 7.

    The amount the lender will pay to exercise the option is a function of several things, including the reduction given on the fixed interest rate, the amount of income participation received, and the term of the loan. In some cases the purchase price is predetermined at the time of commitment and is based on a stipulated capitalization rate.

16. Ibid. at 10.

17. Supra, note 2 at 243, footnote 77.

18. Ibid. at 243.

    The lender generally receives approximately 75% of the equity if the loan is fully covered.

19. Although the payments do not fulfill the criteria for interest established in the Baliji case infra, chapter four note 58 and the Barfried case infra, chapter four note 76.

20. Supra, note 2 at 233.

21. The appreciation a lender receives under an equity option is a capital gain, whereas the contingent interest received under a SAM is taxed as income.

22. Synopsis taken from L. Mason, "How to Improve the Financeability of Real Estate" in Real Estate Financing in Today's Competitive Markets (Toronto: Insight Press, 1984) at 5.

23. It is important that these first two stages of the transaction be found to be a sale-leaseback and not a mortgage. Drawing the line between the two is not always easy. If, for example, the borrower is given the option to repurchase the land when the lease expires and the price to be paid by the borrower is not fair market value at the time, then these two stages of the transaction closely resemble a mortgage. If they are characterized as a mortgage, there could be usury problems, denial of tax deductions and difficulties in enforcing the remedies provided to the lender under the lease.

    D. Pierce, "Leasehold Mortgaging" in Real Estate Financing in Today's Competitive Markets (Toronto: Insight Press, 1984) at 1.

24. J. Heath, "Sale-Leasebacks and Leasehold Mortgage" in B. Strum, ed., Financing Real Estate During the Inflationary 80s (American Bar Association Press, 1981) 141 at 153, footnote 4.

25. Compiled from supra, notes 1, 2, 23, and 24. See also G. Fields & B. Gersham, "Advanced Mortgage Lending" in G. Fields & B. Gersham, ed., Canadian Mortgage Practice Reporter (Toronto: Richard De Boo Limited, 1982) at 17-11.

26. This may be a deceptive advantage for reasons discussed under the heading Intentional Default and Enforcement. Further, if the leasehold lender is a third-party lender, the lender-owner must be prepared to pay off the leasehold mortgage before enforcing its rights under the lease.

27. Discussed infra under the heading Partnership.

28. A discussion of these problems is beyond the scope of this paper; however, reference can be made to supra, note 23, note 24 at 150-155 and note 25 at 17-11 - 17-14. See also S. Trumper, "Leasehold Mortgages" in Real Property Mortgage Matters (Ontario: The Canadian Bar Association 1985 Continuing Legal Education) and G. York, "The Ground Lease and Leasehold Mortgage" (1982) 99 Banking L.J. 709.

29. Supra, notes 15 and 25.

30. If the borrower is eligible for the recent $500,000 capital gains exemption the payment of the purchase price can be structured so it is made over a period of several years in line with the structure of the exemption. To be eligible the borrower must be a natural person.

CHAPTER FOUR

1. This is a compilation of procedural problems taken from D. Sullivan, "Creative Real Estate Financing" in Corporate Management Tax Conference 1983 (Ontario: Canadian Tax Foundation, 1983) 196 at 200 and P. Carroll, "Long Term Financing - The Role of the Permanent Lender" in Real Estate Financing in Today's Competitive Market (Toronto: Insight Press, 1984) at 10.

2. R.S.C. 1970, c. B-3.

3. Partnership Act, R.S.B.C. 1979, c. 312 (the "Partnership Act (B.C.)")
   Partnership Act, R.S.A. 1980, c. P-2
   The Partnership Act, R.S.S. 1978, c. P-3
   Partnerships Act, R.S.O. 1980, c. 370 (the "Partnership Act (Ont.)")
   Partnership Act, R.S.N.B. 1973, c. P-4
   Partnership Act, R.S.N.S. 1967, c. 224
   Partnership Act R.S.P.E.I. 1974, c. P-2
   The Partnership Act, R.S.N. 1970, c. 287

4. R.S.C. 1970, c. I-18

5. R.S.C. 1970, c. C-34, as am. S.C. 1980-81, c. 43.

6. As many of the issues relate equally to income participation mortgages and to equity participation mortgages, the term "participation mortgage" will be used in the remainder of the chapter to refer to both. The term 'participation mortgage' will not include a sale-leaseback transaction. This is because the lease is an essential component of the sale-leaseback transaction, and it contains most of the participation features rather than the mortgage.

7. The term 'partnership' includes a joint venture. Although there is some limited authority for the view that joint ventures are a business form distinct from a partnership, the prevailing view is that, whether a joint venture is considered a partnership or merely analogized to one, in all important respects it should be treated as a partnership. For both an expression of the limited view that joint ventures are distinct from partnerships and for further discussion of this topic, refer to S. Beck et al., Cases and Material on Partnerships in Canadian Business Corporations (Toronto: Carswell, 1983) at 59 and R. Simmonds & P. Mercer, An Introduction to Business Associations in Canada: Cases, Notes and Materials (Toronto: Carswell, 1984) at 81.

8. G. Ross, "Equity Participation Financing" in Innovative Techniques for Real Estate Financing (Toronto: Insight Press, 1985) at 25.

See also s. 4 Partnership Act (B.C.) which states in part:

> "In the event of a person to whom money has been advanced by way of loan on a contract ... being insolvent ... the lender of the loan is not entitled to recover anything in respect of his loan ... until the claims of the other creditors of the borrower ... have been satisfied"

and see s. 4 Partnership Act (Ont.) which is virtually identical.

9. Discussed infra under the heading Income Tax Consequences.

10. Discussed infra under the heading Intentional Default and Enforcement.

11. A regulated lender has legislative limitations on its authority to hold real estate. A determination that the regulated lender holds real estate as a joint venturer or as a partner could result in the lender being deemed to have exceeded its legal authority with the result that the loan transaction may be void as having infringed its legislative authority.

12. There are three substantial differences between the 'pure equity' and the 'mortgage/equity' approaches as set out in D. Sullivan, "Joint Venture Financing with Financial Institutions" in G. Fields & B. Gersham, ed., Canadian Mortgage Practice Reporter (Toronto: Richard De Boo Limited, 1982) 18-52 at 18-55.

    First, under the 'pure equity' approach, the lender generally obtains a majority interest in the property (i.e., 75%-85%); whereas, under the 'mortgage/equity' approach, the equity provides the lender with the required incremental yield above the fixed interest rate on the mortgage and consequently the lender usually holds a minority interest. Second, under the 'mortgage/equity' approach the lender has a mortgage, or rather a prior ranking position over the borrower, and has the right to foreclose and to exercise other default remedies in the event of default by the borrower. Consequently, the lender is in a more secure position and has more downside protection than the borrower. Whereas, under a 'pure equity' approach, the lender and the borrower share the profits and risks more or less on the same basis. Third, under the 'pure equity' approach the lender receives a lower cash return than under the 'mortgage/equity' approach and gambles more on the appreciation potential of the property. In the 'mortgage/equity' approach, there is a blend of emphasis on high income and appreciation potential.

13. (U.K.) 53 & 54 Vict. c. 39.

14. See, for example, s. 2(1) Partnership Act (B.C.) which states: "Partnership is the relation which subsists between persons carrying on business in common with a view of profit", and see s. 2 of the Partnerships Act (Ont.) which is virtually identical.

15. These four factors do no include 'Partnership by Estoppel' which is discussed infra. For a judicial statement of this four-part test see Ex parte Delhasse: Re Megevand (1878), 7 Ch.D. 511 (C.A.). In this case the court attempted to ascertain if the parties intended to create a partnership and, at p. 526, Mr. Justice Jones said: "If ever there was a case of partnership this is it. There is every element of partnership in it. There is the right to control the property, the right to receive profits and the liability to share in losses."

16. In Weiner v. Harris (1909), [1910] 1 K.B. 285 (C.A.), Master of the Rolls Cozen-Hardy

stated at 290:

> "It is quite plain that the mere use of a well-known legal phrase you cannot constitute a transaction that which you attempt to describe by that phrase. Perhaps the commonest instance of all, which has come before the Courts in many phases, is this: Two parties enter into a transaction and say 'It is hereby declared there is no partnership between us.' The Court pays no regard to that. The Court looks at the transaction and says 'Is this, in point of law, really a partnership? It is not in the least conclusive that the parties have used a term or language intended to indicate that the transaction is not that which in law it is'."

17. See, for example, s. 3(c) Partnership Act (B.C.) which states in part:

> "the receipt by a person of a share of the profits of a business is proof in the absence of evidence to the contrary that he is a partner in the business, but the receipt of a share, or of a payment contingent on or varying with the profits of a business, does not of itself make him a partner in the business ...".

and see s. 3(3) Partnerships Act (Ont.) which is virtually identical.

18. E. Scammel & R. I'Anson Banks, ed., Lindley on the Law of Partnership, 15th ed. (London: Sweet & Maxwell, 1984) at 89-90.

19. See, for example, s. 3(b) Partnership Act (B.C.) which states: "the sharing of gross returns does not of itself create a partnership, whether the persons sharing the returns have or have not a joint or common right or interest in property from which or from the use of which the returns are derived" and see s. 3(2) Partnership Act (Ont.) which is virtually identical.

20. Section 3(c)iv) Partnership Act (B.C.) and see s. 3(3)d) Partnerships Act (Ont.) which is virtually identical.

21. J. Siegman & R. Liquanti, "The Convertible, Participating Mortgage: Planning Opportunities and Legal Pitfalls in Structuring the Transaction" (1983) 54 Colo. L. Rev. 295 at 305.

22. See, for example, s. 1 Partnership Act (B.C.) which states:

> "Every partner in a firm is liable jointly with the other partners for all debts and obligations of the firm incurred while he is a partner, and after his death his estate is also severally liable in due course of administration for those debts and obligations, so far as they remain unsatisfied, but subject to the prior payment of his separate debts"

and see s. 10 Partnership Act (Ont.) which is virtually identical.

23. Supra, note 8 at 29.

24. Supra, note 15.

25. This principle is also reflected in the case of Pooley v. Driver (1877), 5 Ch.D. 458, where a 'loan' was made to a business under an agreement which specified that the participants would have their original advance repaid upon final accounting unless it appeared that

they had received more than their share of the profits during the term of the business. In that case they were to receive no repayment of the advance and might even have to refund part of what they had already received, up to the amount of the original advance. The court found this amounted to a possible loss of advance and therefore distinguished the case from a true contract of loan because a true loan is to be repaid intact, and the only risk to be run is the insolvency of the borrower.

26. Singleton v. Fuller (1953), 118 Cal. App. 2d 733, 259 P. 2d 687; Hansen v. Adent (1953), 238 Minn. 540, 57 N.W. 2d 681.

27. (1860), 11 E.R. 431, 8 H.L.C. 268 (K.B.).

28. (1974), 43 D.L.R. (3d) 686 (N.S.S.C.).

29. Ibid. at 709.

30. This was affirmed in the case of Fraser-Bruce Maritimes Ltd. v. C.M.H.C. (1980), 42 N.S.R. (2d) 1, 117 D.L.R. 291 (C.A.) Mr Justice Jones in discussing the analogy with the Warkentin case and other lender-borrower cases said at p. 17: "The Graham case, on the other hand, is clearly distinguishable. While on the record Central Mortgage in the Graham case appeared as mortgagee in fact the corporation's involvement is complete."

31. This includes cases in the analogous area of 'control' or 'management' by a limited partner in a limited partnership context. For a discussion of the more important American decisions refer to: B. Gibson, "Limited Partnerships" in Limited Partnerships and Their Use in Syndications (Vancouver: Continuing Legal Education Society, 1983) at 3.03 -

    3.13 and R. Wertschek & W. Ehrcke "An Introduction to Limited Partnerships" (1981) 39 Advocate 387 at 389. Among the most recent American decisions are the following:

    Pelaney v. Fidelity Lease Limited (1975), 526 S.W. 2d 543; Frigidaire Sales Corporation v. Union Properties Inc. (1975), 544 P. 2d 781; Murson Builders Inc. v. Crown Mountain Apartment Associates (1978), 647 F. Supp. 1316; and The Outlet Company v. Wade (1979), 377 So. 2d 722.

32. (1929) 38 Yale L.J. 584.

33. Ibid. at 722-723.

34. Supra, note 21 at 315.

35. Ibid. at 318.

36. (1961), 291 F. 2d 557 (5th Cir.).

37. Supra, note 20 at 313, footnote 64 cites the following cases: Thillman v. Benton (1895), 82 Md. 64, 33 A. 485; Wagner v. Buttles (1913), 151 Wis. 668, 139 N.W. 425; Dean v. Harris (1875), 33 L.T.R. (n.s.) 639; King & Co. v. Whichelow (1895), 64 L.J.Q.B. (n.s.) 801; and In re Estate of Starer (1963), 20 Wis. 2d. 268, 121 N.W. 2d 872.

38. Ibid. at 319.

39. Supra, note 27.

40. Supra, note 21 at 312.

41. Section 16(1) Partnership Act (B.C.) and see s. 15(1) Partnerships Act (Ont.) which is virtually identical.

42. E. Ivamy & D. Jones, ed., Underhill's Principles of the Law of Partnership, 11th ed. (London: Butterworths, 1981) at 67.

43. Supra, note 21 at 321.

44. See, for example, s. 64 of the Partnership Act (B.C.) which states: "A limited partner is not liable as a general partner unless he takes part in the management of the business" and s.12 of The Limited Partnerships Act, R.S.O. 1980, c. 241 which states: "A limited partner is not liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business."

45. See, for example, s. 3(a) of the Partnership Act (B.C.) which states:

> "joint tenancy, tenancy in common, joint property, common property or part ownership does not of itself create a partnership as to anything so held or owned, whether the tenants or owners do or do not share any profits made by the use thereof"

and see s. 3(1) of the Partnership Act (Ont.) which is virtually identical.

46. (1977), 1 R.P.R. 331 (Ont. S.C. A.D.), affirmed [1979] 2 S.C.R. 155.

47. Ibid. at 333.

48. Ibid. at 337.

49. For an example of a legislative restriction see s. 1(t) and s. 1(u) of Schedule III of the Pension Benefits Standards Regulations, 1985, SOR/87-19 which restricts outright real estate investments by pension funds or their subsidiaries to property which is leased to the government of Canada or to a large corporation which meets to Regulation's solvency test, and to property which is used for high yield oil and gas production.

50. D. Carr, "Commercial Aspects of Real Estate Break-Ups" in Tax and Financing Aspects of Real Estate Investment (Toronto: CCH Canadian Limited, 1985) 105 at 118.

51. Ibid. at 109.

52. Section 3 (c)(iv) Partnership Act (B.C.) and s. 3(3)(d) Partnerships Act (Ont.).

53. Supra, note 42 at 9-10.

54. Ibid. at 10.

55. Supra, note 12 at 18-65.

56. Quite apart from s. 110 of the Bankruptcy Act, there is the question whether the exercise of an equity conversion option would be allowed by a trustee in bankruptcy, or whether it would be considered a fraudulent conveyance if at the time of transfer the borrower was on the 'eve of insolvency'. There is no answer, as yet, to this question.

57. Although in the writer's opinion, it is not inconceivable that it might apply to the leasehold portion thereby preventing the lender from recovering in preference to other creditors.

58. See, Re Baliji Apartments Ltd. and Manufacturers Life Company (1979), 25 O.R. (2d) 275, 100 D.L.R. (3d) 695 (H.C.) and Canada Permanent Trust Co. v. Decanter Developments (1983), 30 R.P.R. 104 (Ont. S.C.).

59. G. Howard, "Income Participation Mortgages" in Innovative Techniques for Real Estate Financing (Toronto: Insight Press, 1985) at 27.

60. (1964), [1964] S.C.R. 439, 6 C.B.R. (N.S.) 175.

61. (1888), 38 Ch. D. 238.

62. Supra, note 60 at 468, quoting from ibid at 254. The court was interpreting s. 5 of Bovill's Act, passed in 1865 as c. 56 of 28-29 Victoria.

63. Supra, note 3.

64. Section 4 of the Partnership Act (B.C.).

65. Bill C-17, Insolvency Act, 2d Sess., 32d Parl., 1983-84.

66. Supra, note 60 at 468.

67. Although the possibility cannot be ruled out entirely until the law is more settled in this area.

68. M. Waldron, "Section 6 and 7 of the Canada Interest Act: Curiouser and Curiouser" (1984) 62 Can. Bar Rev. 146 at 148.

69. Ibid. at 156.

The article does provide a textbook definition of "sinking fund" taken from G. Mullings & S. Shao, Mathematics for Management and Finance (1979) as follows:

> "In some cases, the principal of a long-term investment may be repaid on the maturity date, but the interest is paid periodically when it is due. Since a long-term debt is usually for a large amount, debtors often periodically deposit a sum of money in a fund, known as a sinking fund, in order to retire the principal on the maturity date."

70. (1967), [1968] S.C.R. 3; 65 D.L.R. (2d) 534.

71. Ibid. at 5.

72. Ibid. at 5-6.

73. Refer to supra, note 68 at 151-153.

74. (1974), [1975] 1 S.C.R. 266.

75. Ibid. at 271.

76. Supra, note 68 at 154.

It is interesting to note that in the Kilgoran case the interest and payment calculation dates coincided; both were on a quarterly basis. This contributed to the ease of mathematical calculation. Therefore, perhaps the Kilgoran case is restricted to its facts. See, for example, the case of Re Tilson and Dougherty (1975), 8 O.R. (2d) 203, 57 D.L.R. (3d) 491 (Div. Ct.) where the interest was calculated on a half-yearly basis, but the payments were made monthly. The court found that this difference made it very difficult to distinguish the portion of the monthly payment to be applied on account of principal from the portion to be applied on account of interest. The payments were held to be blended and, as a result, s. 7 became operative so that the lender was limited to the rate stated in the repayment clause.

This situation should be contrasted with the cases which hold that a mortgage involving a bonus or prepaid interest do not constitute "blended" payment mortgages. Although the calculation of interest and other payments is difficult in such cases, the problem with s. 6 compliance is avoided because the mortgages fall outside the purview of the section. See, for example, London Loan and Savings Company of Canada v. Meagher (1930), [1930] S.C.R. 378, [1930] 2 D.L.R. 849; Asconi Building Corp. v. Vocisano (1947), [1947] S.C.R. 358, [1948] 1 D.L.R. 794; Attorney-General for Ontario v. Barfried Enterprises Ltd. (1963), [1963] S.C.R. 570, 42 D.L.R. (2d) 137; and Vencer Mortgage Investments Ltd. v. Batley (1984), 54 B.C.L.R. 374 (S.C.).

77. This can be accomplished by providing for payment of interest only during the term, or by providing for discrete payments of principal and interest throughout the term. One way of ensuring the payments of principal and interest are discrete is to attach charts to the mortgage giving amounts for each interest percentage up to the criminal rate.

78. Supra, note 58.

79. Supra, note 76.

80. Supra, note 58 at 279-280.

81. Supra, note 58.

82. The features outlined are taken from G. Milman, "What is Interest" in Interest and Other Matters of Interest (Toronto: Law Society of Upper Canada Continuing Legal Education, 1982) at 1-3.

83. Supra, note 76.

84. Supra, note 82 at 17.

85. Section 305.1 of the Criminal Code, R.S.C., c. C-34, as am. No proceeding is to be commenced under the section without the consent of the Attorney General (section 305.1 (7) of the Criminal Code and it is a hybrid offence punishable by a maximum of 5 years imprisonment (section 305.1(1) of the Criminal Code).

86. Section 305.1(2) of the Criminal Code.

87. Ibid.

88. D. Sullivan, "Creative Real Estate Financing" in Corporate Management Tax Conference 1983 (Ontario: Canadian Tax Foundation, 1983) 196 at 226.

89. (1981), [1982] 1 W.W.R. 744, 22 R.P.R. 193 (B.C.S.C.); Madame Justice Huddart rendered a partial judgment and then granted an adjournment to allow time for an inquiry to be held by the registrar on the issue of what is the "annual rate of interest calculated in accordance with generally accepted actuarial practices and principles" under the agreement. The concluding judgment is found at (1982), [1982] 4 W.W.R. 97, 23 R.P.R. 219 (B.C.S.C.).

90. The loan in the Mira case was a mortgage-back given as collateral security for a contract of purchase a sale of property. The purpose of the loan was more than simply to secure interest income; therefore, the decision should be contrasted with the later decision in Croll v. Henry (1983), 48 B.C.L.R. 306 (S.C.). The Croll case involved a simple loan where the main purpose of the loan was for the lender to receive a high rate of return which was in excess of 60%. The court held that because the agreement was fundamentally illegal, it would not assist a party to enforce the illegal contract; therefore, the offending interest provision could not be severed and no principal could be recovered.

91. Supra, note 59 at 24.

92. (1963), 37 D.L.R. (2d) 346 (Alta. S.C.).

93. R.S.C. 1970, c. S-11, as rep. S.C. 1980-81-82-83, c. 43, s. 8.

94. Supra, note 92 at 346.

95. A. Carnwath, "Calculation, Penalties and Legislative Requirements" in Interest and Other Matters of Interest (Toronto: Law Society of Upper Canada Continuing Legal Education, 1982) at 113.

96. No Canadian case was found on point; however, the American case of Cochran v. American Savings 592 S.W. (2d) 29 (Tex. Civ. App.) considered the following provision in a Texan usury statute: "There shall be no penalty for any usurious interest which results from an accidental and bona fide error." (Tex. Rev. Civ. Stat. Ann. art. 5069-1.06, Vernon Spp. 1971-1980). The case held the provision could not be relied upon to save a mortgage that is expressly usurious and stated the rule on intent as follows: "Intent in usury cases does not mean intent of the lender is irrelevant if, in fact, the lender has contracted for, charged or received interest on a loan in excess of the maximum permitted by law."

97. (1986), [1986] 4 W.W.R. 481, 29 D.L.R. (4th) 159 (S.C.C.).

98. Supra, note 88 at 226 and note 95 at 114.

99. Supra, note 59 at 20-21.

See, for example, Taylor v. Armstrong (1979), 99 D.L.R. (3d) 547 (Ont. H.C.); Harry v. Kreutziger (1978), 9 B.C.L.R. 166, 95 D.L.R. (3d) 231 (C.A.); Bank of Montreal v. Hancock (1982), 137 D.L.R. (3d) 648 (Ont. H.C.); and Lott v. Angelucci (1982), 36 B.C.L.R. 273 (C.A.).

100. (1977), [1978] 2 All E.R. 489 (Ch. D.).

101. Supra, note 99.

102. Ibid. at 177.

Morrison v. Coast Finance Ltd. (1965), 54 W.W.R. 257, 55 D.L.R. (2d) 710 (B.C.C.A.); Lloyds Bank Ltd. v. Bundy (1974), [1974] 3 W.L.R. 501, [1974] 3 All E.R. 757 (C.A.).

103. Supra, note 59 at 21.

104. Unconscionable Transactions Relief Act, R.S.O. 1980, C. 514; Unconscionable Transactions Relief Act, R.S.M. 1970, c. U 20; Money - Lenders Act, R.S.N.S. 167, c. 188.

105. Supra, note 12 at 18-58.

106. M. Keifer, "Participating Mortgages: The Risk for Lenders" (1986) 14 Real Estate L.J. 218 at 221, footnote 6.

107. J. Barton & R. Morrison, "Equity Participation Arrangements Between Institutional Lenders and Real Estate Developers" (1981) 12 St. Mary's L.J. 929 at 941.

108. A first reading of s. 17 of the Law and Equity Act, R.S.B.C. 1979, c. 224 appears to prohibit any action under a mortgage for payment of money without triggering the right to redeem in favour of the mortgagor. The section was first enacted in 1897 as s. 2 of the Mortgagor's Relief Act R.S. 1897, c. 141. Since that time, there have been many instances of mortgagees taking action "for payment of money secured by a mortgage" or for "performance of its covenants". Yet, there is no reported case in which a mortgagor has been reason of the provision in the Law and Equity Act been able to compel a mortgagee to accept full payment of the amount due under the mortgage, thereby entitling the mortgagor to a discharge in a situation where the mortgagee prefers to maintain the mortgage and obtain judgment for the amounts as they come due.

One explanation for the paucity of cases in the area is that the first portion of the section is restricted to those situations where there is a "bond ...secured by a mortgage", which is something different from a situation where there is a mortgage only. The case of A.G. Alberta v. Royal Trust (1929), [1929] 1 D.L.R. 923, [1930] A.C. 144 held a bond is a document under seal and is a specialty obligation. The case of Re Land Registry Act; Mandevill (1917), 36 D.L.R. 292, 24 B.C.R. 137 held a mortgage of land does not come within the meaning to be attached to a "specialty". So, possibly, the first portion of the section is restricted to those instances where there have been two documents granted to the mortgagee, one being a bond and the other being a

mortgage.

A second explanation is that, if the first portion of the section does extend to situations where there is a mortgage only, the section is meant to have limited application to those instances where the mortgagee is seeking to recover "possession of the mortgaged land". The reasons for this explanation are threefold. First, the preamble to the Act speaks of the need to empower the court to prevent mortgages from proceeding to "ejectment" or to "judgment and execution" (both of which ultimately entitle the mortgagee to possess the land). Second, the statutory annotation to the section as it was first enacted is as follows:

> "No suit being then depending to foreclose, the mortgagor's rendering the principal, interests, and costs in Court shall be deemed a satisfaction, and the Court may compel the mortgagee to surrender the premises."

Third, the text of the section as it was first enacted had a comma that is missing in the present legislation and which comma separated the words "for the recovery of the possession of the mortgaged land" from the introductory words "where an action is brought on a bond for payment of the money secured by a mortgage or performance of its covenants or where an action for ejectment is brought by a mortgagee...".

In any event, no matter what type of mortgage or action pursuant to a mortgage the legislation intended to cover, it is certain the courts have not extended the section to cover those situations where a mortgagee is proceeding pursuant to a mortgage to obtain judgment only for money owed or damages suffered by reason of a breached covenant. A relatively recent example is found in the case of Prudential Insurance Company of America v. Hollyburn Properties (Alberta) Ltd. (1984), [1985] 1 W.W.R. 500, 15 D.L.R. (4th) 124 (B.C.C.A), where a mortgagee commenced an action under a participation mortgage for an accounting and payment of moneys due, but did not commence a foreclosure action. The court found that the mortgagor had neither a contractual nor an equitable right to redeem. The mortgagor did not have an equitable right to redeem the mortgage because the actions of the mortgagee did not amount to compelling payment of the entire mortgage debt. The court found that as the mortgagee did not bring an action for foreclosure, the steps taken were to protect its security rather than to enforce it. It should be noted s. 17 of the Law and Equity Act was neither argued nor considered in the case.

109. See Municipal Savings and Loan Corporation v. Wilson (1981), 20 R.P.R. 188 (Ont. C.A.); North American Life Insurance Company v. Beckhuson (1981), 2 W.W.R. 444, 8 R.P.R. 22 (Alta. Q.B.); Beck v. Investors Group Trust Co. (1977), 4 Alta. L.R. (2d) 1 (S.C.) and Heritage Savings & Trust Co. v. Harke (1978), [1980] 3 W.W.R. 308, 14 A.R. (2d) 86 (C.A.).

110. Supra, note 59 at 35.

111. (1973), 3 O.R. (2d) 191 (H.C.).

112. (1984), 56 B.C.L.R. 363 (C.A.). See also Prudential Insurance Company of America v. Hollyburn Properties (Alberta) Ltd. (1984), [1985] 1 W.W.R. 500, 15 D.L.R. (4th) 124 (B.C.S.C.).

113. (1984), 56 B.C.L.R. 363 at 368 (C.A.).

114. (1984), 33 R.P.R. 194 (Ont. H.C.).

115. Ibid. at 198.

116. Supra, note 59 at 37-38.

117. For a precedent, see P. Carroll "Long Term Financing - The Role of the Permanent Lender" in Real Estate Financing in Today's Competitive Market (Toronto: Insight Press, 1984) at Exhibit V.

118. Supra, not 59 at 39.

119. (1913), [1914] A.C. 25 (H.L.E.).

120. A word of precaution, the Krelinger case may be distinguishable on the basis that the loan was only part of a larger transaction. It is unclear how the courts would handle a separate participation agreement in a straight forward loan. The Krelinger case will be discussed further under the heading Clog on the Equity of Redemption.

121. This remedy must be contrasted with the statutory right to redeem which exists under some Provincial legislation.

122. Supra, note 112 at 368.

123. C. Bird, "Participating Mortgages" in the Minutes of the Meeting of the Insolvency Law Section of the Canadian Bar Association B.C. Branch, held October 23, 1985.

124. See for example Yorkshire Trust Company v. Markland Properties Ltd. et al. Vancouver Registry No. H822110 (B.C.S.C.); Canadian Commercial Bank v. Birchview Properties et al. Vancouver Registry No. H822969 (B.C.S.C.); and Westmount Developments Ltd. v. Akbar Investments Ltd. Vancouver Registry No. H820896 (B.C.S.C.).

125. The matter of how to make the option stand on its own is discussed under the heading Clog on the Equity of Redemption.

126. L. Lavine & S. Cohen, "Financing Real Estate: The Lender's Perspective" in Tax and Financing Aspects of Real Estate Investment (Toronto: CCH Canadian Limited, 1985) 33 at 38.

127. Statutory references are to the Income Tax Act S.C. 1970-71-72, c. 63, as am. up to February, 1987.

128. For Canadian articles see:

a) R. Couzin, "Income Tax Treatment of Financing Charges" in Corporate Management Tax Conference 1980 (Ontario: Canadian Tax Foundation, 1980) 191.

b) J. Bernstein, "Current Real Estate Tax Issues" in Tax and Financing Aspects of Real Estate Investment 125.

c) J. Robertson, "Tax Aspects of Real Estate Transactions: A Perspective from Revenue Canada" in Corporate Management Tax Conference 1983 (Ontario: Canadian Tax

Foundation, 1983) 416.

d) N. Boidman, "Non-Resident Investment in Canadian Real Estate" in Corporate Management Tax Conference 1983 (Ontario: Canadian Tax Foundation, 1983) 371.

e) P. Schnier, "Tax Aspects of Real Estate Financing" in Innovative Techniques for Real Estate Financing (Toronto: Insight Press, 1985).

f) G. Corn, "Tax Aspects: Real Estate Financing - Tax Aspects" in Real Estate Financing in Today's Competitive Markets (Toronto: Insight Press, 1984).

g) P. McQuillan, "Tax Aspects: A Survey of Recent Changes and Developments in the Taxation of the Owners of Real Property" in Real Estate Financing in Today's Competitive Markets (Toronto: Insight Press, 1984).

h) R. Lindsay, "Tax Aspects of Real Estate Financing" in Corporate Management Tax Conference 1983 (Ontario: Canadian Tax Foundation, 1983) 258.

i) R. Strother, "Income Tax Treatment of Financing Charges" in Corporate Management Tax Conference 1986 (Ontario: Canadian Tax Foundation, 1986) 81.

For American articles see:

j) S. Tucker, "Creative Real Estate Financing" (1985) 124 Tr. & Est. 44.

k) N. Steuben, "The Convertible Participating Mortgage: Federal Income Tax Considerations" (1983) 54 U. Colo. L. Rev. 237.

l) S. Platt & J. Long, "Equity Participating Real Estate Financing" (1985) 3 B.U.J. Tax L. 1.

m) R. Friend, "Shared Appreciation Mortgage" (1982) 34 Hastings L.J. 329.

129. Section 20(1)c) of the Income Tax Act.

130. See the Baliji case supra, note 58 and the Barfried case supra, note 76.

131. Section 20(1)e) of the Income Tax Act.

132. P. Schnier, supra, note 128.

133. R. Lindsay, supra, note 128 at 261.

134. It is possible for a lender to be found a co-owner of equity with a borrower and yet not be a partner of the borrower. For example, if a deal is struck giving the lender legal authority to dispose of the property (an indication of ownership) but not requiring the lender and borrower to share profits (a negation of partnership), it might be said the lender and borrower were co-owners but not partners. See A.E. LePage Ltd. v. Kamex Developments Ltd. et al., supra, note 46.

135. P. Schnier, supra, note 128 at 10.

136. For a discussion of the issues see R. Lindsay, supra, note 128 at 279. From an income tax point of view, the lender usually prefers co-ownership to partnership. Failure to share net profit is one indication of co-ownership. One reason for avoiding a partnership is that capital cost allowance must be claimed at a partnership level; therefore, it is impossible for the lender to claim it faster than the borrower and vice versa. Another reason is that, if the lender is a taxpayer described in s. 205 of the Income Tax Act, its partnership interest will be a "foreign property" within the meaning of s. 206 (1)h), thus exposing it to Part XI tax.

137. Ibid. at 261-266.

138. 72 D.T.C. 6456 (F.C.T.D.), affirmed 74 D.T.C. 6180 (F.A.D.).

139. Ibid. at 6459.

140. J. Robertson, supra, note 128.

141. P. Schnier, supra, note 128 at 12. See also R. Strother, supra, note 128, where at 128, it is suggested that the profit participation or shared appreciation feature be set up at the time of commitment for the loan to ensure it will be deductible as an expense incurred in the course of borrowing money as it was in the Yonge Eglington case. Alternatively, R. Strother suggests that the participation payment might be subject to a maximum percentage of the principal amount advanced so that, being referable to a principal amount, it might constitute interest.

142. J. Bernstein, supra, note 128 at 132.

143. See for example High Level Hotel Ltd. v. M.N.R. 70 D.T.C. 1731 (F.C.T.D.).

144. Section 12(1)c) of the Income Tax Act.

145. Section 12(3) of the Income Tax Act.

146. R. Lindsay, supra, note 128 at 291.

147. The tax treatment, both on receipt of and on exercise of an option, is unclear and may be complicated. Detailed analysis is beyond the scope of this paper. Further reference should be made to the articles written by P. Schnier and R. Lindsay, supra, note 128.

148. R. Lindsay, supra, note 128 at 292.

149. Ibid. at 292.

150. P. Schnier, supra, note 128 at 22.

151. This is so even if the value of the convertible mortgage may be higher than its face amount at the time of the conversion. See Brickelli v. M.N.R. 48 D.T.C. 134 (F.C.T.D.) and Belle-Isle v. M.N.R. 64 D.T.C. 5041 (Ex. Ct.).

152. P. Schnier, supra, note 128 at 22.

153. R. Lindsay & P. Schnier, supra, note 128.

154. P. Schnier, supra, note 128 at 19.

155. R. Lindsay, supra, note 128 at 286.

156. Ibid. at 289.

157. Section 20(1)c) of the Income Tax Act.

158. Supra, note 142.

159. Section 20(1)e) of the Income Tax Act. If the appreciation payment is not deductible as interest under s. 20(1)c) nor as a cost of borrowing under s. 20 (1)e), then at least one-half should be deductible as a discount on a mortgage obligation pursuant to s. 20(1)f(ii).

160. Supra, note 132 at 18.

161. The treatment of income earned from leases is complex. For a discussion of the principles affecting leasing see E. Richardson, "Holding Real Estate for the Production of Income" in Corporate Management Tax Conference 1983 (Ontario: Canadian Tax Foundation, 1983) 1 and W. Howick, "Leasing" in Corporate Management Tax Conference 1986 (Ontario: Canadian Tax Foundation, 1986) 254.

162. Supra, note 142 at 165.

163. This the best situation from a tax perspective; however, the borrower, as tenant, may prefer the certainty of a longer initial term.

164. Supra, note 88 at 232.

165. If the repurchase price is not at fair market value, it increases the likelihood that the transaction will be deemed a mortgage. See Interpretation Bulletin, IT-233R, for further information on Revenue Canada's position in determining whether the payments under a sale-leaseback transaction are in essence repayment of a mortgage loan.

166. Supra, note 142 at 134.

167. D. Pierce, "Leasehold Mortgaging" in Real Estate Financing in Today's Competitive Market (Toronto: Insight Press, 1984) at 5.

168. Typically "owner" is defined to include: "a person who has, at the time a claim of lien is filed in the land title office, any estate or interest, legal or equitable, in the land on which the improvement is made, at whose request and on whose credit, or on whose behalf, or with whose privity or consent, or for whose direct benefit, the work is done or material supplied, and all persons claiming under him". Taken from s. 1 of the Builders Lien Act, R.S.B.C. 1979, c. 40 (hereinafter the "Builders Lien Act (B.C.)").

169. (1976), [1977] 2 S.C.R. 762, 79 D.L.R. (3d) 336.

170. (1982), 19 Alta. L.R. (2d) 41 (Alta. Q.B.).

Section 13 of the Builders Lien Act (B.C.) provides inter alia that "all improvements done with the knowledge ... of the owner ... shall be held to have been done at the instance and request of the owner". It seems the legislative test for request is even less stringent than that in Alberta. See also the case of Benzanson Millwork & Construction Inc. v. John Kritikos et al. (Action No. F 855309, Vancouver Registry) where the court held that knowledge of the possibility of work being done was not sufficient, rather the owner is required to have knowledge of the specific work being done.

171. R. Friend, supra, note 128 at 356.

172. Ibid. at 357.

173. P. Freeman, "Alternative Mortgage Instruments" (1982) 14 Urban Lawyer 760 at 761.

174. This issue needs to be clarified by legislation. A Californian SAM statute addresses this problem and solves it by providing that the SAM mortgage has priority from the time of registration for principal and interest (both accrued and unaccrued), including contingent interest. See Cal. Civ. Code ss. 1917.166 (West Supp. 1982).

The recent Working Paper No. 47 (1985) of the Law Reform Commission of British Columbia on "Mortgages of Land: The Priority of Further Advances" expresses sympathy for lenders in the analogous contest of priorities created by s. 6 of the Builders Lien Act (B.C.) between lien claimants and lenders making subsequent advances under prior registered mortgages. At p. 35, the Paper concludes on the point by stating: "It is our tentative conclusion that the U.S.L.T.A. (an American statute which gives priority to the lender over the lien claimant) provisions concerning the priority of construction liens strike a more realistic balance of the competing interests and we believe they should be adopted, in principle, in British Columbia."

175. W. Rayner and R. McLaren, ed., Falconbridge on Mortgages, 4th ed. (Toronto: Canada Law Book Limited, 1977) at 53-54.

Case law has established that income participation mortgages do not offend the doctrine of clogging the equity of redemption. See Commonwealth Savings Plan Ltd. v. Triangle "C" Cattle Co. Ltd. et al. (1966), 56 D.L.R. (2d) 453 (B.C.C.A.), where payment of an index amount based on the Consumer Price Index was not a clog. See also the more recent case of North American Life Assurance Co. v. Beckhuson supra, note 109, where an income participation clause was found to be a collateral advantage but did not restrict or clog the equity of redemption. Therefore, so long as an income participation clause is not usurious or unconscionable, it does not infringe the doctrine.

176. J. Bogart, "Options to Purchase In Association with Mortgages" in G. Fields and B. Gersham, ed., Canadian Mortgage Practice Reporter (Toronto: Richard De Boo Limited, 1982) 18-87 at 18-87.

177. Supra, note 12 at 18-71.

178. (1965), [1965] 2 O.R. 253, 50 D.L.R. (2d) 300 (H.C.).

179. Ibid. at 258.

180. Ibid. at 260.

181. See supra, notes 8, 12, 88 and 176. See also, H. Kane, "The Mortgagee's Option to Purchase Mortgaged Property" in B. Strum, ed., Financing Real Estate During the Inflationary 80s (American Bar Association Press, 1981) 123 and B. Maller, "Legal Concerns in Convertible Mortgage Transaction" (1985) 13 Real Est. L.J. 277.

182. J. Cooper-Hill & J. Slama, "The Convertible Mortgage: Can It be Separated from the Clogging Rule?" (1986) 27 South Texas L.R. 407 at 427.

183. For an expression of such reasoning see MacArther v. North Palm Beach Utilities 202 So. (2d) 181, where in considering the validity of an option which had been contemporaneously executed with a mortgage but registered prior to it, the court said at 186:

> "Out of the [clogging] doctrine developed the proposition that when the borrower repays his loan he is entitled to a return of that which was mortgaged as security for the loan - but no more. In the case at bar, the buyer of the land, who was the borrower of the money, acquired the land incumbered by the option, and thus when the borrower repaid the loan, ... he was entitled to a return of the mortgage estate still subject to the burden of the option .... Here, the buyer-borrower never owned the land in fee simple, it was incumbered by the option at the same time the buyer-borrower acquired it."

184. Supra, note 182 at 415.

185. (1961), [1961] 1 all E.R. 466.

186. Supra, note 176 at 18-96.

187. Ibid. at 18-96.

188. (1979), 7 R.P.R. 137, 82 D.L.R. (3d) 634 (Nfld. S.C.T.D.).

189. Ibid. at 645.

190. Supra, note 176 at 18-96.

191. For a discussion of the principles and a case where the court did not recharacterize the transaction see Kreick v. Wansbrough (1973), [1973] 4 W.W.R. 350 (S.C.C.).

192. The structure of such a transaction is complicated. For more information see supra, note 11 at 18-73 and not 88 at 241-242.

193. For a thorough overview of the cases see supra, note 176.

194. Supra, note 8 at 22.

195. M. Levin & P. Roberts, "Future Forms of Financing - Lending Devices Addressed to Inflation and Tight Money" in B. Strum, ed., Financing Real Estate During the Inflationary 80s (American Bar Association Press, 1981) 31 at 48.

196. R.S.O. 1980, c. 374.

197. R. Bauer, "Participation Mortgages" in Creative Trends in Financing and Structuring Real Estate Interests. (Ontario: The Canadian Bar Association 1982 Annual Institute on Continuing Legal Education) at 26.

198. R.S.B.C. 1979, c. 321.

CHAPTER FIVE

1. J. Siegman & R. Liquanti, "The Convertible, Participating Mortgage: Planning Opportunities and Legal Pitfalls in Structuring the Transaction" (1983) 54 Colo. L. Rev. 295 at 297.

2. The emphasis for the exploration will be on the provincial law of mortgages in British Columbia and the Federal usury and interest legislation. However, reform recommendations may be applied to other common law jurisdictions and some aspects of other laws will be discussed.

3. Generally, the borrower and the lender in a residential transaction do not have equal bargaining power and the borrower requires extra protection not required in a commercial context.

4. A failure to take this situation into consideration has lead to very convoluted amending legislation in Alberta, to extend the protection granted under the Law of Property Act, R.S.A. 1980, c. L-8 (which limits a mortgagee's remedy to recovery from the land when the mortgagor is an individual) to an individual taking title subject to a mortgage given by a corporation. See M. Trussler, "Foreclosure of Corporate Mortgages: 1984" (1985) 23 Alberta L. Rev. 332.

5. 13 U.L.A. 560 (West Master ed. 1980) as provided by the Commissioners of Uniform Laws in the United States. Although several authors have written supportive articles the ULTA, in its present form, has not been adopted in any state in the United States. Currently, the Commissioners are in the process of printing another Act called the Uniform Land Security Interest Act. This Act is really the present Article 3 of the ULTA set out as a separate Act. Perhaps the reason for the resistance to the ULTA in the various states is best expressed by a supportive Texan author who says: "A basic premise of the Act is that more efficient and less costly secured land transactions may be achieved through uniformity among state laws. This purpose effectively has been frustrated to date as, thus far, no state has enacted ULTA into law. There is little incentive for Texas to adopt an act to achieve uniformity when there is no other jurisdiction with which its laws would then be uniform. (Taken from P. Rant, "ULTA and Non-Judicial Mortgage Foreclosures in Texas" (1981) 12 St. Mary's L. J. 1104 at 1126.)

6. The types of persons who may be protected parties are: 1) a person who occupies or intends to occupy the premises as his residence; 2) a person who is primarily or secondarily liable on the loan and is related to an individual who occupies or intends to occupy the premises as his residence; and 3) a person who purchases residential real estate and assumes or takes subject to the obligation of a prior protected party. See

ULTA S. 1-203(a).

7. J. Durham, "In Defense of Strict Foreclosure: A Legal and Economic Analysis of Mortgage Foreclosure" (1985) 36 South Carolina L. Rev. 461 at 486.

8. See ULTA s. 1-203b) for a definition of "residential real estate". Section 3-505 ULTA stipulates that there shall be special foreclosure rules for "protected parties".

9. See, for example, s. 43.3(3) of the Law of Property Act, R.S.A. 1980, c. L-8, as am. S.A. 1983, c. 97.

10. In determining what a speculative venture is, a decision must be made whether protection can extend to such situations as an individual owner renting premises to others for residential use.

11. Report of the Commissioners on Uniform State Laws, "Cost and Time Factors in Foreclosure on Mortgages" (1968) 3 Real Property Probate and Trust J. 413 at 413.

12. For a modern judicial expression of the treatment accorded a mortgagor under the laws of equity see C.I.B.C. Mtge. Corp. v. Burnham and Burnham, (1985) 2 B.C.L.R. (2d) 130, where are 134 Madame Justice Southin says:

    "... in my view the better course in a case such as this where a mortgagor is in possession and the apparent cause of the default is a severe economic downturn is simply to shorten the redemption period, a course more in keeping with equity's tender, perhaps overly tender, concern for the mortgagor."

13. R. Friend, "Shared Appreciation Mortgage" (1982) 34 Hastings L.J. 329 at 408, and G. Osborne, Mortgages, 2d ed. (St. Paul, Minnesota: West Publishing Col, 1970) at 8.

14. R. Friend, ibid. at 409, footnote 397.

15. P. Delcambre, "Due Process Problems of Mississippi Power of Sale Foreclosure" (1976) 47 Miss. L.J. 67 at 68.

16. Supra, note 11 (results of a state by state survey).

17. For a recent example of a court refusing to exercise a private power of sale, in accordance with the contractual terms of the mortgage document, see the British Columbia Court of Appeal's decision in South West Marine Estates Ltd. v. Bank of British Columbia (1985), 65 B.C.L.R. 328. The court would only allow a commercial lender to proceed under a power of sale if the lender proceeded under the same terms and conditions it would proceed under for a sale sought in a foreclosure proceeding.

18. Mortgages Act, R.S.O. 1980, c. 296, sections 23-40.

19. For a relatively recent decision which gives a clear indication that the modern mortgage should be considered as a contract rather than a legal conveyance refer to Stephen v. Gulf Oil Canada Ltd. et al. (1976), 11 O.R. (2d) 129 (C.A.).

20. 12th ed. (London: Sweet & Maxwell Publishing, 1966).

21. Ibid. 116.

22. For those jurisdictions governed by a Torrens system of land registration, the concept of a conveyance has been abolished; however, the legislation gives back the traditional remedies and rights of foreclosure and equity of redemption. It should be noted that although British Columbia has a type of Torrens system, the mortgage is nevertheless treated as a legal conveyance because the Land Title Act, R.S.B.C. 1979, c. 219 does not provide the lender with the traditional remedies. See the cases of North Vancouver (District) v. Carlisle (1922), [1922] 3W.W.R. 811, 31 B.C.R. 372 (C.A.) and North West Trust Co. v. Christianna Inn (1974) Ltd. (1976), [1976] 4 W.W.R. 662 (B.C.S.C.).

23. For an example of a similar proposal see B. Reiter, Project Director, The Law of Mortgages Project - Status Report (Toronto: Ontario Law of Mortgages Project, 1983) at 3.

    This approach has also been adopted in the province of New Brunswick where the Revised Rules of Court (New Brunswick Reg.82-73 enacted under s. 73 & 73.2 of the Judicature Act, R.S.N.B. 1973, c. J-2, as am.), which came into effect on June 11, 1982, have narrowed the available remedies by effectively doing away with the ability to proceed by way of a "foreclosure action". The private power of sale used in conjunction with the statutory provisions of the Property Act, R.S.N.B. 1973, c. P-19, as am. (the "Property Act (N.B.)") is the primary remedy. When considering the amendments to the Rules of Court, the Final Report of the Barristers' Society of New Brunswick concluded that "the New Brunswick sale process is envied by some for having evolved to the point where the process cannot be characterized as time consuming or costly." For further discussion of the New Brunswick process refer to J. Robertson, "Foreclosure by Power of Sale: Securing a Proper Price in New Brunswick (1983) 32 U.N.B.L.J. 83.

24. It is questionable whether there should be any delay period in a commercial mortgage extrajudicial sale proceeding. Resolution of the issue requires a survey of lenders' practices, particularly subsequent lenders.

    There are many instances of judicial insistence that a borrower should be given an almost guaranteed six month redemption period; however, the vast majority of such expressions are in cases which involve residential property. There is generally less sympathy for commercial borrowers, and it is more common to find a shortened redemption period in such cases. Given the under-utilization of the remedy of redemption by borrowers, and the fact that the uncertainly of security and enforcement of mortgages makes some commercial lenders hesitant to lend, which in turn impairs the ability of would-be borrowers to raise capital, it is proposed that the commercial mortgage be given a shortened redemption period to give commercial real estate lenders the same speedy realization that other commercial lenders enjoy. Of course, if such a system were adopted, there would be nothing to preclude a commercial borrower from contracting for a longer notice of default period thereby effectively increasing the redemption period.

    The ULTA Section 3-508(a) provides for a 5 week delay period and Section 31 of Mortgages Act, R.S.O. 1980, c. 296 stipulates that "the sale shall not be made for at least thirty-five days after the notice has been given".

25. This period would allow subsequent lenders to evaluate their position. If the subsequent loan were for a proportionately larger amount of the equity in the property than the first

loan, then there would be nothing to preclude a subsequent lender from redeeming the loan and taking the position of the first lender. Either the borrower or a subsequent encumbrancer could redeem the mortgage at any time before the lender entered into a binding contract for the disposition of the property.

26. See s. 3-513 of the ULTA for other bases of restraint.

27. B. Reiter, supra, note 23.

28. Section 3-508(a) ULTA.

29. For judicial recognition of this lesser duty see the case of British Columbia Land & Investment Agency v. Ishitaka (1911), [1911] 45 S.C.R. 302 where at 316-317 Mr. Justice Duff said:

> "...[the mortgagee] is bound to observe the limits of the power and he is found to act in good faith, that is to say, he is bound to exercise the power fairly for the purpose which it was given. If the mortgagee proceeds in a manner which is calculated to injure the interests of the mortgagor and if his course of action is incapable of justification as one which in the circumstances an honest mortgagee might reasonably consider to be required for the protection of his own interests; if he sacrifices the mortgagor's interests "fraudulently, willfully, or recklessly", then, as Lord Hershall says it would be difficult to understand how he could be held to be acting in good faith. But that is a vastly different thing from saying that he is under a duty to the mortgagor to take (regardless of his own interests as mortgagee) all the measures as a prudent man might be expected to take in selling his own property. The obligation of a trustee, when acting within the limits of the power, would be no higher ... and it is clear that in exercising his power the mortgagee does not act as trustee."

See also Cuckmere Brick Co. Ltd. v. Mutual Finance Ltd. (1971), [1971] 2 All E.R. 633 (C.A.) where at 643 Mr. Justice Salmon said:

> "Once the power has accrued, the mortgagee is entitled to exercise it for his own purposes whenever he chooses to do so. It matters not that the moment may be unpropitious and that by waiting, a higher price could be obtained. He has the right to realize his security by turning it into money when he likes. Nor, in my view, is there anything to prevent a mortgagee from accepting the best bid he can get at auction even though the auction is badly attended and the bidding exceptionally low. Providing none of these adverse factors is due to any fault of the mortgagee, he can do as he likes."

For an excellent review of the law on the standard of care expected in Ontario see G. Payne "Recent Developments in Power of Sale" in Real Property Mortgage Matters (Ontario: The Canadian Bar Association 1985 Annual Institute on Continuing Legal Education, 1985).

30. In British Columbia a lender exercising a power of sale cannot sell to itself, or to its agents, or to a group of people of which it is a member. See Carter v. Bell (1915), 8 W.W.R. 47, B.C.R. 55 (C.A.).

31. Section 3-508(a) ULTA.

32. Section 44(4) Property Act (N.B.).

33. J. Robertson, "Foreclosure by Power of Sale: Securing a Proper Price in New Brunswick" (1983) 32 U.N.B.L.J. 83 at 114.

34. Section 3-508(a) ULTA.

    See also Rule 455 of the Ontario Rules of Court, which allows the lender instituting the action to bid at the sale if the sale is conducted by one of the other parties.

35. This is the current situation in most of the American states where lenders are entitled as of right to purchase at a foreclosure sale. See G. Osborne, supra, note 13.

36. Section 3-511 ULTA.

37. Section 3-513 ULTA.

38. Section 3-510 ULTA.

39. In the case of Devany v. Brackpool (1981), 31 B.C.L.R. 256 (B.C.), Mr. Justice Taylor held that the court might waive the requirement for an accounting, but only for a very special reason. In the instant case, being one that involved the sale of a residential property, the court held that an accounting was required. Such precautions possibly should be mandatory for residential sales; however, in the case of a commercial mortgage proceeding, there are many instances where all parties to the proceeding are sophisticated enough to understand and to agree upon the amounts involved without the need of an accounting. Since the point of the extrajudicial proceeding is that it be as speedy and inexpensive as is reasonable, then an accounting should only be required upon the request of one of the parties.

40. Sections 3-502 and 3-503 ULTA.

41. In some American states, by statute, a mortgage whatever its form does not convey title. See for example Colo. Rev. Stat. s. 38-35-117 (L973), a typical statute which states:

    "MORTGAGES, NOT A CONVEYANCE
    LIEN THEORY

    Mortgages, trust deeds, or other instruments intended to secure the payment of an obligation affecting title to or an interest in real property shall not be deemed a conveyance, regardless of its terms, so as to enable the owner of the obligation secured to recover possession of real property without foreclosure and sale, but the same shall be deemed a lien."

42. It is proposed this remedy be in addition to any rights the lender has to reduce the contractual obligations of its claim to judgment. Section 3-501 ULTA preserves the right of the lender not to accelerate but to instead proceed to judgment for any deficiency.

43. Since title would remain with the borrower, in the absence of a legislated transfer, a transfer could only be effected where the borrower co-operated by giving an executed transfer.

44. See G. Ross, "Equity Participation Financing" in Innovative Techniques for Real Estate Financing (Toronto: Insight Press, 1985) at 21; G. Howard, "Income Participation Mortgages" in Innovative Techniques for Real Estate Financing (Toronto: Insight Press, 1985) at 16; and L. Viverito, "The Shared Appreciation Mortgage: A Clog on the Equity of Redemption?" (1982) 15 John Marshall L. Rev. 131.

45. J. Cooper-Hill & J. Slama, "The Convertible Mortgage: Can It Be Separated from the Clogging Rule?" (1986) 27 South Texas L. Rev. 407 at 428.

46. For an example of judicial expression of this sentiment see Samuel v. Jarrah (1904), [1904] A.C. 323, where at 327 Lord MacNaughten said the rule should be modified "so as to prevent its being used as a means of evading a fair bargain come to between persons dealing at arm's length and negotiating on equal terms."

47. S.O. 1982, c. 35.

48. In 1984, the Californian legislature eliminated the clogging defence to convertible mortgages in all transaction except those involving four or fewer residential units. Ca. Civ. Code ss. 2906 (West Supp. 1985).

49. Annotation by M. Bauer to the case of Mira Design C. Ltd. v. Seascape Holdings Ltd. (1981), 22 R.P.R. 193 (B.C.S.C.) at 194.

    See also J. Ziegel, "The Usury Provisions in the Criminal Code: The Chickens Come Home to Roost" (1986) 11 Can. Bus. L.J. 233 where at 244 the author says:

    > "If one could agree that the section serves a sound economic and social purpose, the price [of the legislation] might be worth paying, but as I have endeavoured to show, it does neither. It seems to have no visible impact on loan sharks against whose operations it was directed."

50. (1981), [1982] 1 W.W.R. 744, 22 R.P.R. 193 (B.C.S.C.); (1982), [1982] 4 W.W.R. 97, 23 R.P.R. 219 (B.C.S.C.).

51. See for example The Depository Institutions Deregulatory and Monetary Control Act, Pub. L. No. 96-221 (1980), which exempts large loans and business loans from usury laws.

52. G. Milman, "What is Interest?" in Interest and Other Matters of Interest (Toronto: Law Society of Upper Canada Continuing Legal Education, 1982) at 24.

53. (1917), 55 S.C.R. 409.

54. Ibid. at 414.

55. For one author's proposed reform of s. 6 and 7 of the Interest Act refer to M. Waldron, "Section 6 & 7 of the Canada Interest Act: Curiouser and Curiouser" (June 1984) 62 Can. Bar Rev. 146 at 178.

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