TAB 1

Understanding The Mortgagee's Right To Three Months Interest After Default And Enforcement – Statutory Right Or Unenforceable Penalty?

Richard Horodyski
Rina Patel, Articling Student
Gowling Lafleur Henderson LLP

The 2nd Annual Real Estate Law Summit
April 6, 2005

LET RIGHT PREVAIL
The Law Society of Upper Canada | Barreau du Haut-Canada

Continuing Legal Education

UNDERSTANDING THE MORTGAGEE'S RIGHT TO THREE MONTHS INTEREST AFTER DEFAULT AND ENFORCEMENT – STATUTORY RIGHT OR UNENFORCEABLE PENALTY?

Richard Horodyski
Gowling Lafleur Henderson LLP

I. INTRODUCTION

The right of a mortgagee to an interest bonus or prepayment compensation when a defaulting mortgagor wishes to pay out a mortgage has been enforceable for over 200 years. It is now a statutory right in Ontario found in s.17 of the *Mortgages Act.* This paper examines the history and development of that right as well as challenges to it and in particular, its possible infringement of s. 8 of the *Interest Act.*

II. COMMON LAW ORIGINS

Since at least the 18th century, real property law has recognized the right of a mortgagor to redeem a mortgage and obtain a conveyance of the property. This right of redemption was recognized by the equitable Courts despite provisions in mortgages that the right to redeem was lost in the event of a breach of a mortgage covenant.[1] Equity required, however, that a defaulting mortgagor wishing to redeem give to the mortgagee notice of such intention or in the alternative, interest in lieu of such notice. This requirement was founded on the premise that a mortgagor who looked to equity for relief from the forfeiture of his right to redeem was required to deal equitably with the mortgagee to afford the mortgagee reasonable time to find an alternative investment for the money which was being repaid. In

[1] The right to redeem is now contained in ss. 22 and 23 of the *Mortgages Act*, R.S.O. 1990, Chapter M.40

other words, the equitable maxim *"he who seeks equity must do equity"* governed the resolution of disputes relating to post-default payment of principal.[2]

This equitable rule was discussed in the decision of the Court of Chancery in *Browne v. Lockhart*.[3] Vice Chancellor Gladwell observed that it was the usual practice for a mortgagor whose intention was to pay off a mortgage after default to give proper notice of the intention to do so. He stated that he believed that there was no law of the Court of Chancery or any other court, which required notice to be given but that it rested entirely upon custom.[4] This custom was based on the rationale that:

> [I]t is only fair that the party who has lent his money upon the security should have a reasonable opportunity before the transaction is put an end to, of finding some other security on which he may lay out his money when it has been repaid to him."[5]

In *Cromwell Property Investment Company Limited v. Western and Toney*,[6] the Court of Chancery reiterated that the rationale behind the rule was to allow the lender "to obtain suitable investments" for the money repaid by the mortgagor.[7]

Smith v. Smith[8] addressed the length of the notice that a mortgagor must give to a mortgagee if the mortgagor wished to pay out the mortgage after default. The Chancery Court held that the mortgagee was not bound to accept repayment except on six months notice or payment of six months interest in lieu of notice. The Court stated that though this was a "well settled general rule," it was nevertheless subject to some exceptions. One

---

[2] Traub, W.M. *Falconbridge on Mortgages* (Canada: Canada Law Book, Inc. 2004) at pp. 29-15 – 29.16.
[3] (1840), 10 Sims. 420 at 424 [hereinafter "*Lockhart*"].
[4] *Lockhart* at para. 424.
[5] *Lockhart* at para. 424.
[6] [1934] Ch. 322 [hereinafter "*Cromwell*"].
[7] *Cromwell* at para 331.
[8] [1891] 3 Ch. 550 [hereinafter "*Smith*"].

noteworthy exception was that if the mortgagee had himself demanded repayment of the debt, or had taken steps to compel payment, neither notice nor payment of interest in lieu thereof would be required.[9]

The Court of Chancery decided in *Fitzgerald's Trustee v. Mellersh*[10] that where it could be inferred from the transaction that the mortgage loan was intended to be of a permanent character,[11] the mortgagee was entitled to six-months notice of the intention to repay it entirely after default or, in the alternative, payment of six months interest.[12]

The English rule was recognized as the law of Ontario in *Archbold v. Building and Loan Association.*[13] The facts in this case were rather convoluted. In essence, the mortgagee refused to accept a payout of a mortgage debt claiming that it was entitled to six months notice or six months interest in advance of the payout.[14]

The Ontario High Court of Justice, Queen's Bench Division, adopted the rule of the English Courts of Equity. It held that a mortgagor must, after default, give the mortgagee six months notice of his intention to pay off the mortgage, unless the mortgagee had demanded or taken any steps to compel payment. With respect to the length of the notice period (six months) the Court commented that "... that period was fixed by the Court of Chancery in England more than a century ago, and has been adopted by the Court of Chancery here as the

---

[9] *Smith* at 552-553.
[10] [1891-4] All. E.R. Rep. 979 (Q.L.) [hereinafter "*Fitzgerald's Trustee*"].
[11] The court contrasts mortgage loans of a 'permanent character' with loans under which money is generally borrowed for a short term, and often at a higher rate of interest, because it is expected that the loan will shortly be paid off. In the latter situation, where the transaction is merely temporary, the court stated that it is not reasonable to require that notice be given: *Fitzgerald's Trustee* at paras. 5-6.
[12] *Fitzgerald's Trustee* at para. 5.
[13] [1888] O.J. No. 1888 (H.C.J.) (Q.L.) [hereinafter "*Archbold*"].
[14] *Archbold* at paras. 1-16.

proper period, and I think it must be treated as being a part of the law of the land."[15] Falconbridge J. concurred with the decision of Street J. but stated that "...considering the circumstances of the case, I shall not be sorry hereafter to find that I am wrong in my opinion".

This principle was ultimately embodied in statute in Ontario although the six month period was reduced to three months. The *Mortgages Act*[16] now provides in s. 17 that:

> **Payment of principal upon default**
>
> 17 (1) Despite any agreement to the contrary, where default has been made in the payment of any principal money secured by a mortgage of freehold or leasehold property, the mortgagor or person entitled to make such payment may at any time, upon payment of three months interest on the principal money so in arrear, pay the same, or the mortgagor or person entitled to make such payment may give the mortgagee at least three months notice, in writing, of the intention to make such payment at a time named in the notice, and in the event of making such payment on the day so named is entitled to make the same without any further payment of interest except to the date of payment.
>
> **Exception**
>
> (2) If the mortgagor or person entitled to make such payment fails to make the same at the time mentioned in the notice, the mortgagor or person is thereafter entitled to make such payment only on paying the principal money so in arrear and interest thereon to the date of payment together with three months interest in advance.
>
> **Saving**
>
> (3) Nothing in this section affects or limits the right of the mortgagee to recover by action or otherwise the principal money so in arrear after default has been made.

---

[15] *Archbold* at paras. 18-20.
[16] R.S.O. 1990, Chapter M.40 [hereinafter "*Mortages Act*"].

III. POTENTIAL CONFLICT WITH THE *INTEREST ACT*[17]

Section 8 of the *Interest Act* provides that:

> (1) No fine, penalty or rate of interest shall be stipulated for, taken, reserved or exacted on any arrears of principal or interest secured by mortgage on real property that has the effect of increasing the charge on the arrears beyond the rate payable on principal money not in arrears.
>
> (2) Nothing in this section has the effect of prohibiting a contract for the payment of interest on arrears of interest or principal at any rate not greater than the rate payable on the principal money not in arrears.

In *The Law of Interest in Canada*,[18] Professor Mary Waldron suggests that this provision has its origins in decisions of Courts of Equity that relieved defaulting debtors from the effects of clauses in contracts which effectively increased the contracted rate of interest after default or alternatively resulted in the imposition of an additional charge under a contract because of a default. Such clauses were generally considered to constitute penalties because when interest rates were stable, it was difficult to envision how lenders would incur a loss greater than interest that should be paid at the contract rate. Such provisions in contracts were therefore considered provisions *in terroram* and consequently void.[19]

Several cases have decided that this provision of the *Interest Act* could limit a mortgagee's right to three month's notice or interest.

Tapio v. Kajandar[20] was an application for an order to discharge a mortgage. The mortgage contained the following clauses:

---

[17] Interest Act, R.S.C. 1985, c. I-15 [hereinafter "*Interest Act*"].
[18] (Canada: Thomson Canada Limited, 1992).
[19] *Waldron* at p. 86.
[20] (1964), 48 D.L.R. (2d) 302 (Ont. Dist. Ct.) (Q.L.) (hereinafter "*Tapio*").

(a) Provided also that in default of payment of any of the moneys hereby secured or payable or on any proceedings being taken by the Mortgagee under this Mortgage, he shall be entitled to require payment in addition to all other moneys hereby secured or payable hereunder, of a bonus equal to three months interest in advance at the rate aforesaid upon the principal money hereby secured, and the Mortgagor shall not be entitled to require a discharge of this Mortgage without such payment.

(b) Provided that the Mortgagor shall have the privilege of making additional payments and of paying off the whole of the moneys hereby secured at any time before maturity thereof without notice and without bonus.[21]

The mortgagor was in default. He wanted to pay off the mortgage and have it discharged. He obtained a discharge statement from the mortgagee, which included a three months interest bonus. The mortgagee refused to discharge the mortgage unless the whole amount stipulated in the discharge statement was paid.[22] The mortgagor paid the principal and interest owing, but not the bonus.

Ross D.C.J. ordered that a discharge be provided, stating that though the extra interest amount was termed a bonus, it had the effect of a penalty for failing to provide timely payment. Because it had the effect of increasing the charge on the arrears beyond the rate of interest payable on the principal money not in arrears, it came within the express prohibition of s. 8 of the *Interest Act.* Despite finding in favour of the mortgagor, the Court had little sympathy for him and deprived him of costs as the mortgage was "badly in default". Judge Ross examined the interplay between the two clauses set out above and recognized that it was certainly possible to interpret clause (b) to override clause (a) to find in the mortgagor's favour. He stated, however, that counsel had invited him to base his decision on argument about whether clause (a) was invalid as a contravention of section 8 of the *Interest Act.*

---

[21] *Tapio* at pp. 1-2.
[22] *Tapio* at p. 2.

Apparently, counsel wanted this point decided because, while clause (a) was contained in virtually every printed mortgage form its validity had rarely been the subject of a ruling.

Parkhill et. al. v. Moher et. al.[23] was an action by a plaintiff mortgagee to compel payment by the defendant mortgagors. At issue was whether, pursuant to the clauses in the mortgage, the defendants were obliged to pay an amount representing three months interest in addition to the principal outstanding and the interest owing to the date of payment. The mortgage contained the following clauses:

> (c) And the said mortgagor covenants with the mortgagee that in the event of non-payment of the said principal monies at the time or times above provided, he shall not require the mortgagee to accept payment of said principal monies without first giving six months notice in writing or paying a bonus equal to three months interest in advance on the said principal monies.
>
> (d) Provided also that on default of payment of any of the monies hereby secured or payable or on any proceedings being taken by the mortgagee under this mortgage, he shall be entitled to require payment in addition to all other monies hereby secured or payable hereunder, of a bonus equal to three months interest in advance at the rate aforesaid upon the principal money hereby secured, and the mortgagor shall not be entitled to require a discharge of this mortgage without such payment.[24]

Van Camp J., noted that s.16 of the *Mortgages Act* (now s. 17) was inapplicable when the mortgagee was attempting to effect recovery of money owing under a mortgage after default. Therefore, the agreement between the parties in the mortgage should govern unless there was some statutory provision which prohibited such an agreement.[25] She then looked to a series of cases which held that the payment of such a bonus in the event of sale or foreclosure constitutes a penalty for default within the prohibitions of s. 8 of the *Interest* Act because it increases the interest payable beyond the rate on principal not in arrears. The

---

[23] (1977), 17 O.R. (2d) 543 (Ont. H.C.J.) (Q.L.) (hereinafter "*Parkhill*").
[24] *Parkhill* at pp. 1-2.
[25] *Parkhill* at pp. 2-3.

contract provision was therefore held to be null and void, disentitling the mortgagees to payment of the bonus.[26]

In *Tomell Investments Ltd. v. East Marstock Lands Ltd. et. al.*,[27] the Supreme Court of Canada considered the constitutionality of s. 8(1) of the *Interest Act*. The mortgagee had issued a Notice of Sale which the Court was asked to assume was valid. The mortgagor had paid all of the principal, interest and costs. The Court was asked to decide whether the mortgagee was also entitled to a bonus as provided in the mortgage. The provision in dispute provided that:

> ...on default of payment of any of the moneys hereby secured or payable or on any proceedings taken by the Mortgagee under this Mortgage, he shall be entitled to require repayment, in addition to all other moneys hereby secured or payable hereunder, of a bonus equal to three months interest in advance at the rate aforesaid upon the principal money hereby secured, and the Mortgagor shall not be entitled to require discharge of this Mortgage without such payment.[28]

The Court upheld the constitutionality of s. 8 of the *Interest Act*, stating that this provision was within the competence of Parliament in exercising its legislative power over "Interest". It confirmed the decision of the trial judge[29], which the Ontario Court of Appeal had affirmed without reasons, that the provision in question contravened the *Interest Act*.

The following excerpt from the reasons of the trial judge, Galligan J., was quoted:

> It is my opinion...that the bonus clause in this mortgage has the effect of increasing the charge on arrears beyond...the rate of interest payable on principal money, and therefore is in violation of Section 8 of the Interest Act.[30]

---

[26] *Parkhill* at pp. 3-4.
[27] (1977), 77 D.L.R. (3d) 145 (S.C.C.) (Q.L.) (hereinafter "*Tomell*").
[28] *Tomell* at. P. 3.
[29] (1975), 8 O.R. (2d) 396, 58 D.L.R. (3d) 175 (H.C.J.) (Q.L.).
[30] *Tomell* at p. 3.

Galligan J. decided that the clause was unenforceable because it required the payment of a penalty on the occurrence of an event of default. The Court does not mention whether the Notice of Sale requested any bonus. Surprisingly, neither the decision of Mr. Justice Galligan nor the Supreme Court make any mention of s. 17 of the *Mortgages Act*.

In *Dickson v. Bluestein (in trust),*[31] the applicants had borrowed from the respondent and given a mortgage as security. The mortgage contained a clause reflecting s. 17 of the *Mortgages Act* that in the event of non-payment of the principal as agreed, the mortgagors could not oblige the mortgagee to accept payment of the principal without three months notice or without first paying a bonus equal to three months interest. The clause reads as follows:

> AND the said Mortgagor convenants with the Mortgagee that in the event of non-payment of the said principal moneys at the time or times above provided, he shall not require the Mortgagee to accept payment of said principal moneys without first giving three months previous notice in writing, or paying a bonus equal to three months interest in advance on the said principal moneys.

The day before the mortgage matured, the mortgagee gave the mortgagor a discharge statement. The discharge amount was disputed and the mortgage was not paid out on the day of maturity. One week later, the mortgagee advised the mortgagors that it required an additional three months interest. Four days after this, the mortgagors paid the mortgagee the amount to repay the mortgage, excluding the three months interest. The issue was therefore whether the mortgagee was entitled to charge the three months interest.[32]

---

[31] (1990), 2 O.R. (3d) 131 (Gen. Div.) (Q.L.) (hereinafter "*Dickson*").
[32] *Dickson* at pp. 2-3.

Sheppard J. conceded that the clause in the mortgage between the parties reflected the *Mortgages Act*. He nevertheless held the clause unenforceable because of the *Interest Act*.[33]

Noteworthy was Sheppard J.'s view that he could not subscribe to the view expressed in *Parkhill* that in deciding whether a bonus is payable, one must distinguish between the case where the mortgagor is attempting to make payment after default, and the case where the mortgagee is attempting to recover moneys that are in default. Sheppard J. asserted that, subject to statutory provisions, as a general principle, contractual rights between parties should be determined by reference to the terms of their contract and not to which party is bringing the action. The underlying rationale of s. 8 of the *Interest Act*, according to Sheppard J., is to prohibit the collection of any bonus interest upon default. Therefore, if the mortgagee is prohibited from recovering three months interest upon the institution of an action on its own behest, so should a mortgagor-in-default be relieved from paying three months interest to restore the mortgage to good standing at the mortgagor's request.[34]

IV. RECONCILING SECTION 17 *MORTGAGES ACT* AND SECTION 8 OF THE *INTEREST ACT*

In *Mastercraft Properties Ltd. et. al. v. El Ef Investments Inc.*,[35] appeals in two proceedings were heard together. The mortgage in one of the proceedings contained the following provision:

> And the said Mortgagor covenants with the Mortgagee that in the event of non-payment of the said principal monies at the time or times above provided, he shall not require the Mortgagee to accept payment of the said principal

[33] *Dickson* at p. 7.
[34] *Dickson* at p. 5.
[35] [1993] O.J. No. 1704 (C.A.) (Q.L.) (hereinafter "*Mastercraft*"); leave to appeal dismissed February 3, 1994.

> monies without first giving three months previous notice in writing, or paying a bonus equal to three months interest in advance of the said principal monies.[36]

The mortgage in the second proceeding contained a clause substantially similar to one above. The mortgagees argued that their respective covenants did not offend s. 8 and were valid and enforceable because they fell within the ambit of s. 17 of the *Mortgages Act.*[37]

Madam Justice McKinlay delivered the judgment for the Court of Appeal. She emphasized that s. 8 prohibits the payment of an amount which (1) constitutes a "fine, penalty or rate of interest...on arrears of principal or interest" and (2) has the prohibited effect of "increasing the charge on the arrears beyond the rate of interest" payable under the mortgage contract.[38]

In her opinion, "fine" and "penalty" are interchangeable terms. Each constitutes a form of monetary punishment for breach of the repayment terms of the mortgage contract. She found that the "bonus" described in the mortgage in these cases was not an amount paid in punishment for a breach of the mortgage contract. Instead, it was a payment required for the privilege of paying arrears without the necessity of giving the three month's notice for which the parties had contracted. She concluded that therefore this bonus as not a "fine" or "penalty".[39]

Justice McKinlay then went on to consider whether the bonus was a "rate of interest" charged on "arrears of principal or interest". She decided that it was not, since a covenant

---

[36] *Mastercraft* at p. 3.
[37] *Mastercraft* at p. 3.
[38] *Mastercraft* at p. 3.
[39] *Mastercraft* at pp. 3-4.

stipulating a "rate of interest" would be one that stated that interest on arrears was to be paid at rate higher than the mortgage rate. The covenants in these cases did not deal with a "rate of interest" at all, but merely an amount of money calculated with reference to the mortgage rate.[40]

McKinlay J.A., stated that in situations where the mortgagor did not want to give three months notice, the extraction of the 'bonus' could have the effect of increasing the charge on the arrears beyond the rate of interest as prohibited by s. 8. This was irrelevant, however, because in her opinion the amounts did not fall within the categories "fine", "penalty" or "rate of interest".[41]

McKinlay J.A. was careful to distinguish this case from its predecessors by emphasizing that, whereas in previous cases which had found bonus covenants unenforceable, the provisions in this case allowed for three months notice *or alternatively* three months interest payment.[42]

She then turned to an examination of s. 17 of the *Mortgages Act*, finding that by its terms, it is incorporated into every mortgage in Ontario, and overrides any contrary provision in any mortgage. This section affords to the mortgagor the right, upon default of the payment of principal, to repay the principal on giving three months notice to the mortgagee of his intention to pay and protects him from further payment of interest except to the date of payment. Without specific reference to them, McKinlay J.A. also affirmed *Browne* and *Cromwell,* observing that the *Mortgages Act* also affords the mortgagee protection through

---

[40] *Mastercraft* at p. 4.
[41] *Mastercraft* at p. 4.
[42] *Mastercraft* at p. 5.

the extension of a three-month period during which to arrange for reinvestment of his principal, or monies to compensate for lack of that notice. The option belongs to the mortgagor.[43]

McKinlay J.A., further stated that "covenants which go beyond what is provided for in the *Mortgages Act* may well run afoul of s. 8 of the *Interest Act*," but "covenants which provide the protection intended by the *Mortgages Act* are in harmony with the provisions of s. 8."[44]

Finally, McKinlay J.A., declined to express an opinion on whether the *Mortgages Act* applies only to situations where the mortgagor is attempting to pay off a mortgage which is in default, and not to situations where the mortgagee is taking action to recover monies owing, since it was irrelevant to the facts of the two appeals.[45]

Mastercraft is the last word from the Ontario Court of Appeal on this issue. Applications for leave to appeal to the Supreme Court of Canada were dismissed.

Approximately two years later in *O'Shanter Development Co. v. Gentra Canada Investments Inc.*[46] the Ontario Divisional Court faced the issue of whether the following prepayment clause contravened s. 8 of the *Interest Act*:

> 5.2 If prepayment of any part of the Principal Sum is made prior to the Maturity Date, whether by reason of payment after acceleration upon the occurrence of an Event of Default or as otherwise permitted hereunder, the

---

[43] *Mastercraft* at 7.
[44] *Mastercraft* at 7.
[45] *Mastercraft* at 8.
[46] [1995] O.J. No. 2546 (hereinafter *O'Shanter*)

> Mortgagor agrees to indemnify and save harmless the Mortgagee from all costs and losses resulting therefrom and to pay the Mortgagee the greater of:
>
> > (a) three month's interest on the Principal amount prepaid at the Applicable Rate of Interest payable at the time of prepayment as hereinbefore set out; and
> >
> > (b) the full amount of any reasonable cost, loss, expense, penalty, or charge incurred or suffered by the Mortgagee, as a result of such prepayment.[47]

In this case, the second mortgagee, O'Shanter, had issued a Notice of Sale. Thereafter the first mortgagee, Gentra, issued its own Notice of Sale with a redemption date of March 31, 1994. Gentra's Notice of Sale did not include any bonus amount as part of what was necessary to pay out Gentra's mortgage in full. On July 11, 1994 O'Shanter entered into an agreement to sell the property under Power of Sale under its Notice of Sale. As a condition of granting a discharge of the first mortgage Gentra required payment of the bonus or "prepayment amount" to use the Court's terminology. O'Shanter paid all amounts owing except for the prepayment amount. O'Shanter then brought an Application under the *Mortgages Act* for an Order that Gentra's mortgage had been paid in full and should be discharged.

At first instance, Mr. Justice Somers decided that Gentra could insist on receiving the prepayment amount even though it was not included in its Notice of Sale and further, that the prepayment amount did not violate s. 8 of the *Interest Act*. Saunders J. and White J. formed the majority in the Divisional Court. While they agreed on the result and generally on the reasoning to reach that result, they each wrote separate reasons. Rosenberg J. dissented.

---

[47] *O'Shanter* at p. 4.

In his analysis, Saunders J. noted that the clause in this case differed from the covenants in *Mastercraft* in two respects. Firstly, the *O'Shanter* clause did not allow for notice as an alternative to payment. Secondly, in the amount payable under the *O'Shanter* clause could exceed the amount of three months interest.[48] On the facts of the case, however, the prepayment amount happened to be less than three months interest.

Mr. Justice Saunders held that s. 17 of the *Mortgages Act* was automatically incorporated into every Ontario mortgage and that when the operative clause in the mortgage was read with s. 17, the effect was virtually identical to the *Mastercraft* clauses because the alternative of giving notice or making a payment of interest in lieu thereof was provided to the mortgagor. O'Shanter had the option of either giving the notice under s. 17 or paying the requisite amount under the mortgage clause. Even if the amount under the mortgage clause exceeded three months interest, O'Shanter could have limited the payment to three months by reliance on s. 17.[49]

Saunders J. determined that the prepayment amount had inadvertently been omitted by Gentra in its Notice of Sale. He decided, however, that Gentra had the right to include a prepayment amount in the Notice of Sale based on the wording of the mortgage contract presumably as modified by s. 17 of the *Mortgages Act*. O'Shanter had argued that because of s. 43 of the *Mortgages Act* Gentra could not insist on the payment of the prepayment amount when it was not included in the Notice of Sale. That section provides:

> 43.(1) Where such demand or notice requires payment of all money secured by or under a mortgage, the person making such demand or giving such notice is bound to accept and receive payment of the same if made as required by the terms of such demand or notice.

---

[48] *O'Shanter* at p. 6.
[49] *O'Shanter* at p. 6.

Mr. Justice Saunders decided, however, that s. 43 would be applicable if payment of the payout amount stipulated in the Notice of Sale was made before the redemption date set out in that Notice. In this case the payment was not made before the redemption date expired and O'Shanter could not rely on s. 43(1) to avoid paying the prepayment amount. Both he and Justice White found that there was no cogent evidence to support an argument of estoppel raised by O'Shanter.

Saunders J. and White J. also both relied upon *Mastercraft* and found that the prepayment clause did not contravene s. 8 of the *Interest Act.*.

Rosenberg J. in dissent would have given effect to O'Shanter's estoppel argument. He also believed that service of a Notice of Sale by Gentra triggered the right to redeem without payment of the prepayment amount which he termed a "penalty".

IV. SUMMARY

O'Shanter appears to be the last reported Ontario case on the issue. It and the cases which preceded are not all easily reconcilable. Different conclusions reached in some of the cases can be attributed to the fact that the clauses in question were different. Some of the cases reviewed s. 8 of the *Interest Act* without any mention of s. 17 of the *Mortgages Act*. In other cases, all of the pertinent case law does not appear to be have been brought to the Courts' attention.

I believe that the following conclusions can be drawn from the case law, however, mortgagees and mortgagors will not be truly certain about their rights and obligations until the Supreme Court of Canada revisits the issue on a full hearing and analysis of all statutory provisions and case law.

1. The Court will enforce a properly worded prepayment compensation clause and permit recovery of prepayment compensation up to a maximum of three months interest.
2. The prepayment amount may be included as an item in the accounting set out in a Notice of Sale.
3. If the prepayment amount is not set out in the Notice of Sale and the mortgagor or a subsequent encumbrancer pays out the mortgage on or before the redemption date set out in the Notice of Sale, the prepayment amount will not be recoverable by the mortgagee.
4. If the prepayment amount is not set out in the Notice of Sale and the mortgage is not paid out on or before the redemption date, the mortgagee can restate the amount for payout to include the prepayment amount unless the mortgagor/subsequent encumbrancer can show that it has relied on the account as set out in the Notice of Sale to its detriment.
5. If the mortgage contains a clause that upon default and enforcement the mortgagor can pay out only with three months interest without reference to the three month notice alternative, the prepayment amount may not be recoverable unless a Court follows the *O'Shanter* reasoning that s. 17 of the *Mortgages Act* is incorporated as a term of every mortgage and overrides other clauses in the mortgage.

6. Despite the reasoning in *O'Shanter* about incorporating s. 17, the above argument may not succeed in view of the higher Court decisions in *Tomell* and *Mastercraft.* It should be remembered that in *O'Shanter* the Court was dealing with a very substantial commercial mortgage and sophisticated commercial entities rather than a small investor and home owner.
7. If the mortgage contains a clause that the mortgagor cannot pay arrears without payment of three months interest, ie. pay an amount in addition to instalment in arrears, late interest and costs to reinstate the mortgage, the three month interest provision would likely be unenforceable because it is not a true prepayment compensation amount as full interest for the period of default is being paid. As well, the *Mortgages Act*, s. 22 specifically gives the borrower the right to reinstate on payment of the instalments, late interest and expenses.
8. If the mortgage contains no prepayment amount clause it is arguable whether the three month interest payment can be recovered after default and enforcement unless the mortgagor is given the three month notice of intention to make payment. This is based upon the *O'Shanter* incorporation of s. 17 reasoning above which arguably may not survive the scrutiny of a higher Court.

Many lenders will attempt to collect the three month interest bonus on a request for payout after acceleration. Institutional lenders, however, may be wary of taking an aggressive position on the issue because there is a risk of a class action at some later time on behalf of all payers of the bonus. Any such action may ultimately cause more expense, costs and loss of goodwill to institutional lenders than the collected funds warrant.

APPENDIX

The following is what I regard to be an effective clause to protect a mortgagee's rights as well as they may be protected given the current statute and case law. It was drafted by my partner, Harry VanderLugt as part of Standard Charge Terms No. 2000228 and modified by me for the purpose of this paper.

Prepayment Privileges and Compensation. The Charge is closed to prepayment except as follows:

(a) **Prepayment Before Maturity or Default**. You may, at any time during the term of the Charge or if renewed, during the term of the last renewal of the fixed term loan secured by the Charge, prepay the full outstanding balance upon payment of the greater of:

(i) three months interest at your existing interest rate as set out in the Charge or, if renewed, in the agreement for the last renewal of the fixed term loan secured by the Charge; or

(ii) the interest rate differential based on the difference between your existing interest rate as set out in the Charge or, if renewed, in the agreement for the last renewal of the fixed loan and the then current rate for the term remaining on the Charge or renewal of the fixed term loan based on our posted rate for a mortgage loan for a term that is the next shortest to the remaining term of your Charge or if renewed, of the agreement for the last renewal of the fixed term loan secured by the Charge

calculated on the full principal amount being repaid;

(b) **Prepayment After Default**. If we declare the Principal Amount or balance of the fixed term loan secured by the Charge payable upon the occurrence of an event of default under the Charge and the balance declared due is paid prior to the Balance Due Date or the maturity date of the last renewal of the fixed term loan secured by the Charge, you agree to compensate us for prepayment by payment of the greater of the amount determined in accordance with (i) and (ii) of paragraph (a) above;

(c) **Payment After Maturity**. Where there is default after the Balance Due Date or maturity date of the last renewal of the fixed term loan secured by the Charge, you may pay the outstanding principal amount of such loan only upon payment of three months interest calculated on the outstanding principal amount or three months written notice in lieu thereof.