If it Sounds too Good to be True…

Francis N.J. Taman and Ksena J. Court

It's always amazed us that no matter how good the economic situation and how much money can be made legitimately, there is always someone who seems to want more. The popping of the property value bubble of the mid-2000s in the Calgary real estate market exposed a number of schemes that exploited the system in ways that were at best unethical and, in some instances, were in fact fraudulent. "Straw man" schemes appear to have been one of the more prevalent methods employed to defraud banks.

The scheme itself is simple, although each one seems to vary slightly in the details. The rogues behind the scheme (as we will refer to them) find an individual (the "straw man") and offer them an opportunity to make some money. This is sometimes characterized as an investment opportunity or as providing bridge financing. Usually these individuals are paid $4,000-5,000, although we have seen payments as high as $20,000 in some instances.

The rogues use the straw man to apply for a loan and purchase a house. The purchase price is usually artificially inflated. When the mortgage goes into default, the bank is left with a property that is worth far less than it thought. Since many of these schemes involve insured mortgages, the straw man is also left with something to remember the rogues by – a large judgment against him.

While the property in these straw man deals is usually sold back to the bank, the straw man occasionally contests the applications for deficiency judgments. Often the bank is awarded the deficiency judgment on a summary basis. Recently, however, we had an exception.

MCAP Service Corporation v. Halbersma[1] was a trial decision of Madam Justice R.E. Nation of the Court of Queen's Bench of Alberta. There were some unusual twists to the facts in this instance, but the basic mechanism of the scheme involved a classic straw man scenario.

The Defendant, Halbersma, had immigrated to Canada from the Philippines in 1975. There was no suggestion, however, that she was unable to understand the nature of a purchase transaction involving a mortgage. Indeed, Halbersma had purchased a condominium in Calgary on her own and so was familiar with the process of obtaining a loan and executing paperwork for the transaction at a lawyer's office.

Halbersma ran into an old work acquaintance ("M") in the summer of 2007. Her story was that M owned a business that helped foreign workers gain entry to Canada. Halbersma paid M $10,000 to help her nephews and nieces come to work in Canada.

Later, Halbersma claims, she gave M $5,000 to invest, but she said it was a loan. At her request, a document was drawn up which stated that $5,000 had been paid to M's company and the investment would receive interest at 20 per cent for two months.

Halbersma said she insisted on more formal documentation, apparently for the whole $15,000. She was taken to a lawyer's office. There, according to her, she met with a woman and was given a pile of documents to sign. She was told to sign by the Xs. She did so. She did not read the documents to see if they outlined the deal that she had with M. No one, according to Halbersma, explained the documents to her. She acknowledged she didn't ask any questions nor did she indicate to anyone that she didn't understand the documents.

The documents themselves actually were for the purchase and financing of a residential property in Calgary. This included a CMHC insured mortgage in favour of the Plaintiff. Not surprisingly, shortly thereafter the mortgage went into default.

The Plaintiff sued Halbersma and sought a judgment for any shortfall under the mortgage. Halbersma defended the action. The property was sold to the Plaintiff for its then-fair market value, leaving a shortfall on the mortgage of approximately $139,000.

The matter went to trial. At trial, the paralegal that met with Halbersma and the lawyer testified they didn't recall specifically meeting the Defendant. However, the paralegal testified that her normal practice was to go through the documents with the individual and explain about the purchaser's liability under the CMHC insured mortgage. She would then put an X next to where the individual was to sign or initial. The paralegal indicated that she was always alert for any sign that the individual didn't understand the documents or was being coerced. Justice Nation rejected Halbersma's version of the facts and accepted that the paralegal did, in fact, explain the documents in accordance with her usual practice.

Halbersma raised a number of defences to avoid liability. Most were simply unsupported by the facts, but two were examined by the Court in detail. The first was the allegation that the Plaintiff was barred from recovering the shortfall due to the conduct of the lawyer, who had acted for both the Plaintiff and Halbersma. A number of irregularities were pointed out.

The pre-authorized debit form was clearly not signed by Halbersma. In fact, it appeared to have been signed by M. No one remembered the document being signed, but it was forwarded by the lawyer to the Plaintiff as part of an 18-page fax requesting funds be advanced to close the sale.

The transaction involved a skip transfer with a large increase in purchase price, which the lawyer was aware of[2].

As a part of the transfer, the paralegal had signed an affidavit of transferee stating that the value of the property was $380,000. This happened after Halbersma swore an affidavit in front of the paralegal stating the property was worth $445,000.

Halbersma argued that this proved that the lawyer and the paralegal were parties to the fraud. As the lawyer acted for the Plaintiff, it was argued that the Plaintiff was tainted by this involvement and should be unable to enforce its mortgage. Although not stated in the decision, the usual basis alleged for this argument is the fact that a solicitor at common law is an agent of its client. The client is therefore bound by any actions of the lawyer and is deemed to know what the lawyer knows.

The Court cited with approval *Isaacs v. Royal Bank of Canada*[3] which noted that the difficulty with this argument is that in the usual residential real estate purchase, the lawyer acts in a dual capacity, as lawyer for both the bank and the borrower. As such, the lawyer's knowledge and conduct is attributed to both parties.

Justice Nation also held that the facts set out above were simply not sufficient to establish that the lawyer or the paralegal were directly involved in the fraud. While they did not follow "best practices" this did not equal fraud. Finally, the Justice accepted the evidence of the lawyer and the paralegal that skip transfers were not unusual.

The second significant defence raised was that the Plaintiff had failed to exercise diligence in reviewing the transaction to avoid the fraud being perpetrated against it. It was argued that if the Plaintiff had been more diligent, M could not have perpetuated the fraud.

In dealing with this issue, the Court began by approving of two of the findings in the decision of *MCAP Service Corporation v. Molina-Tan*[4]. Specifically, Her Ladyship held that the conditions for the advancement of a loan are the lender's and the lender can choose to enforce, alter or waive those conditions. She also held that there is no obligation on lenders to look beyond the documents provided to them in apparent good faith by borrowers.

Justice Nation then cited *Isaacs*, noting that a lender, *per se*, has no special relationship with a borrower and has no obligation to take steps or examine documents for the protection of the borrower. There must be special knowledge held by the bank or exceptional circumstances that would change the nature of the normal debtor-creditor relationship to one that would attract a duty to protect the borrower in some fashion.

Finally, Justice Nation addressed a number of 2012 cases where the banks' summary application for a deficiency judgment were dismissed due to some potential evidence of the bank's employee or agent being involved in the fraud. She held that these were not a new line of cases that somehow limited the lender's ability to enforce its judgment. Rather they were situations where there was a need for a trial to evaluate whether there was in fact any involvement by the bank's employee or agent in the scheme.

In the end, the Plaintiff was awarded judgment for the full amount of the shortfall. *Halbersma* is an important decision for a number of reasons beyond being a rare trial decision on a straw man mortgage fraud.

First, it has made it clear that mere mistakes and irregularities in a transaction are not sufficient on their own to provide a defence for participants in a straw man scheme. In this instance, the Court noted specifically that the lawyer likely had "not followed best practices."

Second, the decision acknowledged that skip transfers are legitimate transactions. Even when combined with what arguably were mistakes by the lawyer, skip transactions do not automatically lead the associated mortgage transaction to be defeated by the straw man.

Third, the Court appears to affirm the principal that the knowledge and omissions of a lawyer in a dual representation situation will be attributed to both clients. Arguably, that neither party will be able to rely upon any potential involvement by the solicitor in the fraud to set aside the transaction. This is a fair outcome in situations where the lender had no real knowledge of what was going on in the background. Moreover, in light of the fact that the practice in Alberta residential deals is for the borrower to choose the lawyer and the bank to use that same lawyer as well, it more truly represents the reality of the situation. The lender usually has no real connection with its solicitor and no ongoing relationship that would lead them to have confidence in this solicitor. They are merely relying upon the fact that lawyers are supervised by the Law Society and, like most people, are generally honest.

Fourth, Justice Nation has affirmed that a lender's conditions and due diligence are for the benefit of the lender. A borrower cannot rely upon the fact that a lender's condition was unfulfilled or that their due diligence was not exhaustive as a defence. That would suggest that any gaps or, arguably, even errors made in the underwriting will not be fatal to a lender provided they fall short of actual knowledge of the fraud. While this would seem obvious on its face, defendants have repeatedly attempted to use lender's conditions and their due diligence as a defence in Alberta.

Halbersma is a significant tool in the box for lender's counsel. It provides a trial level decision that undermines a number of the usual defences brought forward by straw buyers.

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1 2013 ABQB 185. In the interests of full disclosure, Ksena Court was the trial counsel for the Plaintiff in this Action.

2 The purchase that had been undertaken actually involved two transfers. The first was from a third party to a company controlled by M. The second was from M's company to Halbersma. The two transfers happened one after the other on closing. This is termed a skip transfer. Both the lawyer and the paralegal testified that skip transfers were not unusual at the time of the transaction because property values were rising quickly.

3 2010 ONSC 3527 aff'd 2011 ONCA 88 ("Issacs")

4 2009 ABQB 472, 503 A.R. 1 (Q.B.). Again in the interests of full disclosure, this was also one of the cases in which we represented the Plaintiff.