Line of Credit Mortgages — Once More into the Breach!

Francis N.J. Taman and Ksena J. Court

Sometimes the law seems to be something of a pendulum — becoming more or less restrictive as it seeks to find a middle ground that correctly respresents the proper interpretation of the law. The law respecting mortgages which are collateral to lines of credit ("LOC Mortgages") and other agreements is one area that has experienced such ebb and flow over the last few years.

Bank of Nova Scotia v. Mawer[1] is a recent decision of the Court of Queen's Bench of Alberta that reflects a more restrictive approach with respect to the enforcement of LOC Mortgages. In *Mawer*, the Defendants applied for a conventional mortgage for a revenue property from the Bank of Nova Scotia (the "Bank") in December 2006. They provided proof of employment income. The property was appraised at $375,000 and the Defendants were approved for a loan that was 75 per cent of the purchase price.

The Bank and Defendants entered into a Scotia Total Equity Plan ("STEP") agreement, which allowed for a variety of different types of loans to be made by the Bank to the Defendants, all secured by the mortgage. A separate agreement was to be signed for each loan.

The mortgage loan of $235,000 under the STEP was documented by a Personal Credit Agreement (the "First PCA") and an initial collateral mortgage registered for the same amount (the "Original LOC Mortgage").

In May 2007, the Defendants applied to have their STEP limit increased to include a ScotiaLine Visa. The Bank considered their employment income and property ownership over three properties. The Bank's underwriting notes indicated that an appraisal of the mortgaged lands would be completed and that that the Defendants would have a monthly surplus of rental income.

1 2013 ABQB 587 (Master) ("*Mawer*").

The property securing the STEP was appraised at $445,000 and the STEP limit was increased to $356,000, which was 80 per cent of the appraised value. The Defendants signed a Personal Credit Agreement (the "Second PAC") for the ScotiaLine Visa. A new collateral mortgage for the appraised value was registered against the property (the "New LOC Mortgage"). The Original LOC Mortgage was discharged.

A second ScotiaLine Visa account was established in 2008 under the STEP and over the course of 2009 and 2010 the limit was increased three times. In each instance, a Personal Credit Agreement was signed by the Defendants that referenced the prior credit limit of $356,000 established by the STEP and referred to the security as being the New LOC Mortgage.

Ultimately, the Bank commenced foreclosure proceedings. The property was sold to the Bank for less than what was owed by the Defendants and the issue before the Court was whether the Bank was entitled to a deficiency judgment.

The starting point for the analysis was s. 40(1) of the *Law of Property Act*[2] which, in general terms, limits the Bank's recovery for the debt to the land itself. The Master noted that although s. 40(1) appears to be an absolute prohibition, there are a number of exceptions that could apply. However, the "court must inquire into the whole of the surrounding circumstances at the time of the transaction to determine its substance whatever form it may have taken."[3]

2 RSA 2000, c. L-7 (the "LPA").

3 *Clayborn Investments Ltd. v. Wiegert* (1977), 5 AR 50 (S.C. App. Div.) at 59. Other decisions where section 40 have been discussed are: *Merit Mortgage Group v. Sicoli*, 1983 ABCA 130 quoted in *Tuxedo Savings and Credit Union Limited v. Krusky*, 1987 ABCA 29 ("*Tuxedo*") at para. 8; Ibid. at para. 10, citing *Krook v. Yewchuk*, 1962 CanLII 62 (SCC). This can include other *in rem* security. The Court notes that the distinction between indirectly enforcing the covenant and enforcing other security is difficult to state.

While additional security beyond the mortgage is generally enforceable, the Court wants to ensure that the lender is not able to indirectly recover a personal judgment on a mortgage simply by re-structuring its security. Put another way, the issue before the Court is whether the lender is trying to "end run" s. 40(1) of the *LPA*.

The Master reviewed the circumstances to be considered in order to determine whether s. 40(1) should limit the lender's recovery.[4] One factor was the lack of a covenant to pay in the mortgage.

This factor is a common feature of almost all collateral mortgages. The mortgage is collateral to another document, such as a line of credit agreement, guarantee or a promissory note. The covenant or requirement to pay is contained in that other document. In *Mawer*, while the New LOC Mortgage was one that did not contain a covenant to pay on its face, it incorporated by reference Standard Mortgage Terms that were registered at the Land Titles Office, which did contain a requirement to pay.

Master Smart went on to note that the Original LOC Mortgage was one where the funds were advanced to purchase the lands in question and it was conceded that "the Mortgage Debt acted as Mortgage Debt."[5] The Master took this as an acknowledgement that the Original LOC Mortgage and the First PCA were caught by s. 40(1) of the *LPA*.[6]

This portion of the decision makes a good deal of sense. In *Stallman*, Master Hanebury described the test to be applied was whether the loan and mortgage were "coextensive in form and substance."[7] From this perspective, it is fairly easy to see that the Original LOC Mortgage would be caught by the restriction on recovery in s. 40(1).

4 These were summarized in *Royal Bank v. Stallman*, 2009 ABQB 766 ("*Stallman*").
5 *Mawer* at para. 14
6 *Ibid*. at para. 14.
7 *Stallman* at para. 21.

The Defendants had applied for a conventional mortgage loan and had been approved on that basis. Viewed together, the STEP agreement, the Original LOC Mortgage and the First PCA were essentially a conventional mortgage loan. The loan was used to acquire the residence and was advanced in a single tranche for a single loan product. For the Bank to concede that the Original LOC Mortgage was caught is correct.

Master Smart then added that not only was the Original LOC Mortgage and First PAC caught by s. 40(1) of the *LPA*, but "by extension" the New LOC Mortgage was as well.[8] This is a bit more difficult to rationalize. Indeed, the Bank argued strongly against this position.

One of the problems, as Master Smart noted, is that the concept of a mortgage that encompasses a variety of loan facilities was not "contemplated or even conceivable" when s. 40(1) was enacted.[9] Master Smart stated that the Court's functional analysis was to take into account common sense and commercial reality.

Master Smart noted that the STEP agreement tied all the loans together and linked them to the New LOC Mortgage. While the New LOC Mortgage was for the full amount of the value of the house, the STEP loans were restricted to 80 per cent of the loan to value ratio. His view of the STEP package was that it simply allowed the Defendants to borrow up to the STEP limit without having to remortgage. This analysis was sufficient for Master Smart to dismiss the Bank's application for judgment for the deficiency and limited the Bank's recovery to taking title to the property alone.

While this is one perspective on the commercial reality of the underlying transaction, it is important to note that the two lines of credit are actually ScotiaLine Visas. This is less the situation of a number of additional advances under a mortgage loan and more an extension of a credit limit on a credit card.

8 *Mawer* at para. 14.
9 *Ibid*. at 15.

Moreover, the increases in the credit limit on the second ScotiaLine Visa account appear to have been done without any reference to the then current value of the mortgaged lands.

Although the above analysis sufficed to dismiss the application, Master Smart chose to continue his analysis. The Bank argued that while the First PCA was for the purposes of financing the acquisition of the mortgaged lands, the ScotiaLine Visas were personal lines of credit. Moreover the New LOC Mortgage was for more than 75 per cent of the loan to value ratio. The Master simply stated that the protection provided to borrowers by s. 40(1) is given for all mortgages, not just for conventional mortgages. While there have been some exceptions created, they have been in often extraordinary circumstances.

The Bank also asserted that they were looking that the Defendants' ability to pay rather than solely at the land. Master Smart dismissed this argument by noting that the Defendants couldn't support the payments being proposed without the rent from the mortgaged premises and concluded that the Bank was not relying upon the ability of the Defendants to pay.

This is somewhat problematic for lenders from a cash flow perspective. One point not argued by the Bank was that these were clearly business loans. It appeared that the purpose of the loans was to acquire income properties, which would, by definition, produce cash flow. Moreover, it appeared that the Defendants already owned a number of income properties when they purchased the mortgaged lands.

The commercial reality was that the cash flow from the mortgaged premises and the other buildings were legitimately part of the income of the Defendants. Once the Defendants owned the mortgaged lands, it made perfect business sense to consider the income from the mortgaged lands to determine whether the Defendants could financially support increased payments. If the Defendants had run a retail business or restaurant from the mortgaged lands, it would have been clear that the income should be considered. The fact that it was a different type of income shouldn't, at least in our opinion, matter.

Although the Bank did not make this argument, the Master did note that business loans were involved in a number of the cases where s. 40(1) was held to not apply to limit the lender's recovery. Master Smart noted that those cases were distinguishable as in each instance the loan had been in the context of a commercial or farming operation and the mortgage was a part of a larger bundle of security.

Another issue that hadn't been raised by the Bank was that the face amount of the New LOC Mortgage was the full appraised value of the mortgaged lands, but no explanation or rationale was given for using that amount. Master Smart noted that the STEP had a lower credit limit that was 80 per cent of that amount. He found that the difference between the two numbers was one of form, not substance. This comment is a bit difficult to understand outside of the context of the prior case law. In essence the Master appears to be suggesting that the real limit was the STEP credit limit. The New LOC Mortgage face amount, however, acts as a limit to how much principal advanced under a line of credit will be secured. It is a hard, legal limit that will not change even if the STEP credit limit changes. So while the face amount isn't determinative, it certainly is not irrelevant. Indeed, it should be noted that the limits under the ScotiaLine Visa were increased apparently without any reference to the value of the mortgaged lands or the face amount of the mortgage.

Certainly, not all Masters have taken the same perspective. We have had success in obtaining deficiency judgments for our lender clients in a number of instances, both with business loans for condominium rental properties *(Chinook Credit Union Ltd. v. Clarke)*[10] and with multi-loan facilities similar to the STEP facility *(HSBC Bank Canada v. Pleskie)*[11]. It will be interesting to see whether this judgment signals a move by the Court to an even more restrictive approach than what currently exists.

Francis N.J. Taman and Ksena J. Court practice commercial and residential foreclosure and secured and unsecured debt collection at Bishop & McKenzie LLP in Calgary, Alberta.

10 Court of Queen's Bench of Alberta Action Number 1201-10614 (unreported).

11 Court of Queen's Bench of Alberta Action Number 1108-00291 (unreported).