June 16, 2015

A Trap for the Unwary: Assuming High Ratio Mortgages

By: Jonnette Watson Hamilton

Case Commented On: *CIBC Mortgages Inc v Abdallah*, 2015 ABQB 363 (CanLII); *Bank of Montreal v Hoehn*, 2010 ABQB 405 (CanLII)

Five years ago, in *Bank of Montreal v Hoehn,* Master Jodi L. Mason decided that one small piece of consumer protection legislation was not properly created by Alberta lawmakers in 2003. As a result, a law that should have required a prominent warning to borrowers on high ratio residential mortgages was not available to protect individuals who unknowingly assumed these types of mortgages. The problem Master Mason identified could have been easily remedied by the legislature — but it was not. One of the consequences of the legislature's failure to act can be seen in *CIBC Mortgages Inc v Abdallah.* As Madam Justice Barbara Romaine notes in this decision, the absence of mandatory warnings about assuming high ratio mortgages "creates a high-risk scenario for unwary transferees and creates hard cases like this one" (at para 33).

Background

A "high ratio" mortgage is defined by section 1(2) of the *Law of Property Regulation*, Alta Reg 89/2004 as "a mortgage of land given to secure a loan under which the specific principal sum of the mortgage, together with the specific principal sum of any existing encumbrance on or mortgage of the same land, exceeds 75% of the market value of the land at the time the mortgage is given." Borrowers who have less than 20% for a down payment for a home can only get a high-ratio mortgage. And in order to get a high ratio mortgage, these borrowers must qualify for mortgage default insurance through the Canadian Mortgage and Housing Corporation (CMHC), Genworth or Canada Guaranty (see Part I of the *National Housing Act*, RSC 1985, c N-11).

Most borrowers who need a high ratio mortgage are, of course, first-time home buyers. They may have only a five or ten percent down payment. After they buy, if real estate prices tumble or interest rates skyrocket or borrowers lose their jobs, then they may not be able to make their mortgage payments. They may even end up owing more than their home is worth. Although borrowers make large premium payments on mortgage default insurance, the insurance protects lenders, not borrowers, in the event of borrowers' default. Section 8(2) of the *National Housing Act* explicitly states: "For lenders, the purpose of insuring housing loans is to indemnify lenders in the event of default by borrowers. The obligations of borrowers or other persons are not released or discharged by that insurance or indemnification" (emphasis added).

However, in Alberta, it is not these risks — risks that any Canadian mortgagor with a high ratio mortgage faces — that explain why adding a prominent warning about high ratio mortgages was

considered a good idea in 2003. The real issue in Alberta is deficiency judgments, i.e., if the property foreclosed upon is worth less than the amount owed on the mortgage, who makes up the shortfall?

At common law, lenders had the right to sue borrowers on their personal covenant to pay in mortgages, as well as a right of to recover against the mortgaged property by foreclosing and selling that property. In order words, if mortgaged properties were sold by the lenders for less than was owed on the mortgages, lenders could sue the borrowers and get the difference in a deficiency judgment against borrowers.

In 1939, Alberta's Social Credit government limited lenders' remedies to recovery from the land: *The Judicature Amendment Act*, SA 1939, c 85, s 2. This was originally temporary legislation that reflected the idea that deficiencies based on "distressed" market values were inequitable and contributed to the severity of the Great Depression (Lawrence D Jones, "Deficiency Judgments and the Exercise of the Default Option in Home Mortgage Loans" (1993) 36 JL & Econ 115 at note 6.) Thus, since 1939, lenders who foreclose on residential mortgages given by individual Albertans (not corporations) have been prevented from taking any action against those borrowers beyond taking the property — even if that property is worth less than the amount owing on the mortgage. This is what is known in Alberta as a "conventional mortgage." And although the anti-deficiency law was originally intended to be only temporary relief, during the 1980s the prohibition on deficiency judgments was strongly defended by the then Progressive Conservative government in legislative debates about one dollar home sales and foreclosures (*Alberta Hansard*, 20th Legislative, 2d Session, April 3, 1984, 273-381).)

The 1939 anti-deficiency law was modified shortly after because of the enactment of federal legislation — the *National Housing Act* — to exclude loans made under that Act. As Master Mason explained in *Bank of Montreal v. Hoehn*, 2010 ABQB 405 (CanLII) at para 11:

> In 1945, the right to sue on the covenant was restored for mortgage loans made under the *National Housing Act*, S.C. 1944, c. 46: *The National Housing Loans Act (Alberta)*, S.A. 1945, c. 6, s. 2. These loans were for a larger percentage of the value of the property secured than allowed in a conventional mortgage. This was part of a federal policy to stimulate the economy and allow greater home ownership. Loans made under the current *NHA* [*National Housing Act*, RSC 1985, c N-11] are a permitted exception to section 418 of the *Bank Act*, S.C. 1991, c. 46, which precludes banks from making mortgage loans that exceed 80% of the value of the property at the time of the loan.

Loans made under the *National Housing Act* were insured by a federal Crown corporation, the CMHC: *Canada Mortgage and Housing Corporation Act*, RSC 1985, c C-7. The incentive for financial institutions to lend money to borrowers who would not otherwise qualify for mortgages was for CMHC to insure the loans made. Lenders were put into a "no lose" position, recovering from CMHC if borrowers defaulted.

The result of the 1945 amendment was that, even in Alberta, CMHC was not restricted to recovery from the sale of the land when borrowers defaulted. Borrowers and subsequent buyers who assumed these mortgages were also liable on the covenant to pay in the mortgage. (See Marguerite J Trussler, "Foreclosure of Corporate Mortgages: Update 1984" (1985) 23 Alta L Rev 332 for a review of this legislative history.)

The current version of the ban on deficiency judgments is found in section 40(1) of the *Law of Property Act,* RSA 2000, c L-7. And it is now section 43(4) of the *Law of Property Act* that exempts *National Housing Act* loans insured by CMHC from the anti-deficiency provisions.

The latest change, effective in 2004, put "high-ratio mortgages" insured by private insurers in the same position as those ensured by CMHC. In 1945, CMHC was the only entity in Canada providing mortgage default insurance, but private entities have recently entered the market. This amendment is found in section 43(4.1) of the *Law of Property Act.* It allows all high ratio mortgage lenders to sue borrowers on covenants to pay, and not just CMHC. On second reading of Bill 29, which introduced this change, the Bill's sponsor, the then Member for Calgary-Lougheed, explained that "[t]he exemption for CMHC gives CMHC a competitive advantage over its private-sector competitor, the previously mentioned GE Capital Mortgage Insurance Canada, and of course any other private company that may want to enter the mortgage default insurance business in this province" (*Alberta Hansard,* 25th Legislature, 3rd session, March 27, 2003, 802). Thus, since August 1, 2004, there are more types of mortgages that do not afford borrowers in Alberta protection from being sued for any deficiency.

The government deliberately left out the definition of a "high ratio mortgage" from the amendment to the *Law of Property Act*. Instead, they left the definition to regulations to be made later "to allow further input on how the term should be defined and whether or not it should reflect the definition of high-ratio mortgage in the federal Bank Act" (*Alberta Hansard,* 25th Legislature, 3rd session, March 27, 2003, 803). Why the government felt the need to proceed so quickly is not revealed in the *Alberta Hansard* debates on the amendment, although opposition members' discomfort with the lack of a definition is. Section 50.1was added to the *Law of Property Act* by the Legislature to provide that "[t]he Lieutenant Governor in Council may make regulations defining "high-ratio mortgages" for the purposes of sections 43(4.1) and (4.2) and 44(4.1) and (4.2)" (emphasis added).

Under section 1(2) of the *Law of Property Act Regulation,* "high ratio mortgage" is defined to mean "a mortgage of land given to secure a loan under which the specific principal sum of the mortgage, together with the specific principal sum of any existing encumbrance on or mortgage of the same land, exceeds 75% of the market value of the land at the time the mortgage is given." In defining what a "high ratio mortgage" is, the Lieutenant Governor in Council (i.e., the executive branch of government, Cabinet) did exactly what the Legislature's amendment to the *Law of Property Act* said they could do.

However, the Lieutenant Governor in Council did more than simply define high ratio mortgages. In section 2 of the *Law of Property Regulation,* Cabinet also demanded lenders add what Justice Romaine refers to as the "High Ratio Warning Statement" to each such mortgage:

> 2(1) A high ratio mortgage for the purposes of sections 43(4.1) and (4.2) and 44(4.1) and (4.2) of the Law of Property Act must also contain the following statement:
>
> > This mortgage is a high ratio mortgage to which sections 43(4.1) and (4.2) and 44(4.1) and (4.2) of the Law of Property Act apply. You and anyone who, expressly or impliedly, assumes this mortgage from you, could be sued for any obligations under this mortgage if there is a default by you or by a person who assumes this mortgage.

> (2) The statement referred to in subsection (1) must be published prominently on the mortgage document. (emphasis added)

This "High Ratio Warning Statement" provision came into effect on August 1, 2006. However, it did not last long.

Bank of Montreal v Hoehn

Bank of Montreal v Hoehn, 2010 ABQB 405 (CanLII) involved five test cases brought by two lenders and heard by Master Jodi L. Mason. In each of the five cases, the lenders wanted a deficiency judgment on a high ratio mortgage. In each case, the high ratio mortgage being foreclosed upon did not contain the High Ratio Warning Statement required by section 2(1) of the *Law of Property Regulation*. The absence of the warning was the only defence the borrowers raised. In answer to that defence, the lenders sought and were granted leave on notice to the Attorney General to argue that section 2 of the *Law of Property Regulation* was *ultra vires* the Lieutenant Governor in Council.

By insisting that mortgage lenders add a prominent warning about the high ratio mortgage to every such mortgage, the lenders argued that the Lieutenant Governor in Council had overstepped its authority. Section 50.1 of the enabling statute, the *Law of Property Act*, merely allowed the regulation to define "high ratio mortgage" and that power was not broad enough to allow cabinet to require a High Ratio Warning Statement on those mortgages. The Master accepted the lenders' position in a comprehensive judgment that appears to have benefited from thorough arguments by the Attorney General.

It is well established that subordinate legislation must be authorized by the empowering statute (*Hoehm* at para 25, citing *BCPL Holdings Inc. v. Alberta*, 2008 ABCA 153 at para 9). The test for determining whether regulations are unlawful because they do not conform to the regulation-making powers of the Governor in Council (if federal) or the Lieutenant Governor in Council (if provincial) were recently considered by the Supreme Court of Canada. In *Katz Group Canada v Ontario (Health and Long-Term Care)*, 2013 SCC 64 (CanLII), at paras 24-28, the Supreme Court summarized how the *vires* of a regulation is tested:

> (1) Is the impugned regulation consistent with the objective of its parent statute – in order to demonstrate invalidity a person must establish that the regulation is not consistent with such objective or that it addresses a matter which is not set out in the regulation-making provision of the parent statute;
> (2) There is a presumption of validity such that the onus or burden is on the challenger to demonstrate that the regulation is ultra vires – so where possible a regulation will be read in a 'broad and purposive' manner to be consistent with its parent statute;
> (3) The inquiry into the *vires* of a regulation does not involve assessing the policy merits of the regulation, nor does the reviewing court assess whether the regulation will successfully meet its objective. (See Shaun Fluker, "Syncrude v Canada: Where is the gatekeeper when you need one?")

Master Mason, deciding the matter before her prior to that Supreme Court decision, concluded (at para 61):

> The requirement of the High Ratio Statement in section 2 of the LPA does not form part of the definition of "high ratio mortgage" and thus exceeds the scope of power granted by section 50.1 of the LPA. It adds a new substantive requirement that is outside the scope of the LPA. The requirement of the High Ratio Statement has been adopted for a purpose beyond providing a definition, namely to provide a warning of the potential legal consequences of entering into a high ratio mortgage. While this may be a worthy exercise, it is not encompassed by the defining power granted by section 50.1. Section 2 of the LPA Regulation is therefore *ultra vires* (emphasis added).

In her decision, Master Mason focused on the objectives of the relevant Part of the *Law of Property Act,* as well as on the regulation-making provision of section 50.1 of the *Law of Property Act Regulation,* and she also properly ignored the policy merits of the challenged provision of the regulation. Thus it seems likely that the same decision would be reached today using the test in *Katz Group Canada v Ontario (Health and Long-Term Care)*.

Despite the fact that the Attorney General appeared before Master Mason and addressed the *vires* issue, the government of the day seemed content to do nothing after the provision was found *ultra vires*. The provision still sits on the books as though it had some legal force. And there does not appear to have been any attempt by either the legislature or cabinet to implement a lawful requirement for a warning about high ratio mortgages. If cabinet thought it was good policy in 2003, why did they not act to implement it lawfully after 2010?

That obfuscating lack of reaction on the government's part is what brings us to the June 5, 2015 decision of Madam Justice Barbara Romaine in *CIBC Mortgages Inc v Abdallah.*

CIBC Mortgages Inc v Abdallah

Justice Romaine was hearing an appeal from a decision of a Master, coincidently Master Mason. The appellant, Mr. Abdallah, assumed a mortgage when he bought a condominium. When he defaulted on the mortgage and the lender foreclosed, the Master found him liable for a deficiency judgment under the covenant to pay in the mortgage and section 58 of the *Land Titles Act*, RSA 2000 Chapter L-4. This *Land Titles Act* provision codifies a covenant of indemnity between a buyer and seller of land and creates privity of contract between the buyer and the seller's lender, so that the lender can sue the buyer who assumed the mortgage directly (at paras 18-26).

On the appeal, Mr. Abdallah argued that he thought he assumed a conventional, as opposed to a high-ratio, mortgage. He thought this because, when he assumed the mortgage, there was nothing in the mortgage to indicate that it was granted under the *National Housing Act* or that it was high-ratio. Neither was he advised of his potential liability prior to his assuming the mortgage. Indeed, at the time he assumed it, the mortgage was not in fact high-ratio to the value of the property; Mr. Abdallah bought the property for $199,000 and assumed a $144,000 mortgage.

Nevertheless, Justice Romaine dismissed Mr. Abdallah's appeal. There was no duty on the seller to tell Mr. Abdallah that the mortgage was a high ratio one and the time to meet the definition of a high ratio mortgage is at the time the mortgage is given, and not when it is assumed: s. 1(2) of the *Law of Property Act Regulation*. She found that "Mr. Abdallah was caught by the trap for the unwary created by the failure of the legislature to provide an enforceable method of identifying a

mortgage as a high-ratio mortgage to a subsequent transferee who may assume such a mortgage without such notice" (at para 3, emphasis added).

The "trap for the unwary" that Justice Romaine refers to was set because the assumed mortgage did not indicate on its face that it was granted under the *National Housing Act* or that it was CMHC-insured or a high-ratio mortgage. It did not have the High Ratio Warning Statement that had been required by the *Law of Property Act Regulation* that was struck down in *Hoehn* as *ultra vires*. There was nothing in Mr. Abdallah's now deceased lawyer's file to indicate that Mr. Abdallah was advised that the mortgage was a high-ratio CMHC insured mortgage. The "Statement of Mortgage Account for Assumption Purposes" sent to Mr. Abdallah's lawyer by CIBC Mortgages did refer to a CMHC number, but it was dated almost a year after Mr. Abdallah assumed the mortgage. Justice Romaine summarized the situation as follows (at paras 32-33):

> [T]he uncontroverted evidence is that Mr. Abdallah purchased a property subject to a mortgage that appeared to be conventional, at a purchase price that would indicate that it was conventional. There was nothing on the face of the mortgage to indicate otherwise, and it was not until Mr. Abdallah's lawyer received the assumption statement, many months later, that there was anything that would indicate the status of the mortgage as high-risk.
>
> Since the High-Ratio Warning Statement required by LPA Regulation was struck down in 2010 in *Bank of Montreal v Hoehn*, there exists nothing that would compel mortgagees to make it clear on the mortgage itself, as opposed to collateral documentation, that the mortgage is high-ratio.

Going Forward?

The legislature and cabinet were sloppy on the enactment of the High Ratio Warning Statement bit of consumer protection legislation in 2003. A statute was amended without a definition of the only topic of the amendment. The High Ratio Warning Statement was added by cabinet to the new regulation for no known reason; it was not the topic of debates in the legislature. No consequences were specified by the lawmakers for non-compliance with the requirement for the warning. Master Mason in *Hoehn* was therefore required to discuss, at considerable length, the consequences of non-compliance with the High Ratio Warning Statement provision (at paras 63-109). Was it mandatory or directory? Could the purpose of the statement be fulfilled by other methods?

There is good reason to want substantive requirements in statutes, and not regulations. This seems to be particularly the case when the provisions are consumer protection provisions.

Although proposals for legislation, drafting of bills, consultations, and other steps leading up to the introduction of a proposed statute in the federal Parliament or a provincial Legislature do not necessarily take place in public, the actual legislative process is a public and transparent one. Individuals can attend Parliament and Legislatures and see and hear statutes being debated, they can read a transcript of the debates about legislation in Hansard (see the Alberta Hansard website here), and they can read about controversial bills in the media.

Of course there is a need for subordinate legislation such as regulations and rules. Most statutes include a provision authorizing the federal Governor in Council or provincial Lieutenant Governor in Council to make subordinate legislation that sets out the operational details that make statutes work.

But the making of regulations is a much less transparent and public process. Cabinet discussions do not take place in public. There is no publically available record of their regulation making process. True, the final regulation must be published and registered. The Alberta *Regulations Act*, RSA 2000, c R-14 section 3(1), for example, requires publication in *The Alberta Gazette*.

The *Alberta Gazette* Part II, published by Alberta Queen's Printer twice each month, contains new regulations as well as amendments to regulations filed with the Registrar of Regulations. But how many borrowers are readers of the *Alberta Gazette* Part II? It is an obscure publication.

Requiring lenders to warn of high ratio mortgages could be beneficial to borrowers and, especially, to those who assume such mortgages. The result of prominently publishing a provision like the *ultra vires* High Ratio Warning Statement may illuminate the potential legal consequences of entering into a high ratio mortgage. It should eliminate the "trap for the unwary" that Mr. Abdallah was caught in.

It would be easy enough for the Legislature to fix this problem. If the Legislature thinks warning borrowers of the possible perils of assuming high ratio mortgages is a good idea, then it could expressly provide for a warning statement in the *Law of Property Act* itself or authorize the Lieutenant Governor in Council to do so in a regulation in clear and express language.