

ONTARIO

**SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)**

IN THE MATTER OF THE *COMPANIES' CREDITORS
ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR
ARRANGEMENT OF SAPPHIRE TOWER DEVELOPMENT CORP.

APPLICATION UNDER THE *COMPANIES' CREDITORS
ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

FACTUM OF THE INTERIM RECEIVER

PART I - THE FACTS

1. The first charge that had been registered on title to the Property owned by the Applicant was a mortgage in favour of Graphic Arts Building Incorporated (“**Graphic Arts**”) which was registered on May 5, 2005 in the amount of \$10,500,000 (the “**GA Mortgage**”). The GA Mortgage was a “vendor take back mortgage” granted to Graphic Arts by the Applicant as part payment of the purchase price of \$14,500,000 for the purchase of the Property by the Applicant.

Eighth Report of BDO Dunwoody, Court Appointed Interim Receiver of
Sapphire Tower Development Corp. (the “Eighth Report”), para. 21-22

GA Mortgage, Appendix B, Eighth Report

2. The balance was due under the GA Mortgage on December 1, 2006. The GA Mortgage has a rate of interest of 9%, compounded monthly, not in advance. The monthly payments, as stipulated in the mortgage, were \$78,750.00, on account of interest only. The GA Mortgage could be renewed at the sole discretion of Graphics Arts. To the

knowledge of the Interim Receiver, the GA Mortgage was not renewed and matured on December 1, 2006. Graphic Arts issued a notice of sale on June 12, 2007.

Eighth Report, para 22

3. Graphic Arts has filed a proof of claim for amounts owing under the GA Mortgage in response to the call for claims by the Interim Receiver (the “GA Claim”). In the GA Claim, Graphic Arts claimed that it was owed \$11,703,125.01 as at December 24th, 2007, with per diem interest of \$2,736.38 after January 14, 2008.

Eighth Report, para 23

GA Claim, Appendix “C”, Eighth Report

4. As part of its claim for interest, Graphic Arts attached to the GA Claim the Notice of Sale setting out an interest calculation which states:

“\$236,250.00...3-month pre-payment penalty as per mortgage terms.”

Eighth Report, para 23

GA Claim, Appendix “C”, Eighth Report

5. The Interim Receiver reviewed the GA Claim and the calculation of the amounts owing as at January 14, 2008 declared therein, compared the claim to the books and records of the Applicant, and recommended that principal and interest in the amount of \$11,473,963.01 be distributed to Graphic Arts out of the proceeds of sale. The Interim Receiver disputed the entitlement of Graphic Arts to the additional \$236,250.00 of interest claimed in the GA Claim, pursuant to the “penalty interest” provisions of the default clause in the GA Mortgage (the “**Penalty Interest Clause**”).

Eighth Report, para 24

6. By the Order of Justice Spence dated January 14th, 2008 (the “**Interim Distribution Order**”) a payment to Graphic Arts in the amount of \$11,473,963.01 was approved, and the Court directed the Interim Receiver to establish a reserve for the claim by Graphic Arts to additional “penalty” interest payable. An additional payment of \$39,215.70 was made to Graphic Arts as approved by the Order of Justice Spence dated January 30th,

2008 (the “January 30th Order”) to remedy an arithmetical error made by Graphic Arts in the calculation of interest under the GA Mortgage made by Graphic Arts.

Eighth Report, para 25

Interim Distribution Order, Appendix “A”, Eighth Report

January 30th Order, Appendix “D”, Eighth Report

7. The “default clause” of the GA Mortgage which contains the Penalty Interest Clause reads:

Upon default of any payment of interest and/or principal secured by the Charge/mortgage the principal amount secured by the Charge/mortgage shall, at the option of the Mortgagee, immediately become payable, and upon default of payment of instalments of principal promptly as the same mature, the balance of the principal and interest secured by the Charge/mortgage shall, at the option of the Mortgagee, immediately become due and payable. The Mortgagee may in writing at any time or times after default waive such default and any such waiver shall apply only to the particular default waived and shall not operate as a waiver of any other or future default. For each Notice of Sale under Mortgage issued by the Mortgagee there shall be a charge of Fifteen Hundred Dollars (\$1,500.00) by the mortgagee to the mortgagor. In addition, on the issuing of a Notice of Sale, the Mortgagee shall be entitled to collect a penalty from the Mortgagor equal to the payment of three (3) months’ interest. The Mortgagee shall also be entitled to charge a monthly charge equal to any late payment charge provided for in this mortgage from the date of default until the date that the mortgagor otherwise redeems the mortgage or the date that the property is sold under Power of Sale.

In addition, for each Notice of Sale under Mortgage issued by the Mortgagee there shall be a charge of Fifteen Hundred Dollars (\$1,500.00) plus GST and Disbursements payable by the Mortgagor to the Mortgagee’s lawyer for the preparation and issuing of the Notice of Sale under Mortgage. These fees shall be in addition to any legal fees or other costs associated with the mortgagee herein asserting its rights under this mortgage upon any default by the mortgagor. The Mortgagor shall also be liable for the mortgagee’s legal fees, disbursements and GST on a solicitor-client basis for any steps taken after the issuing of the Notice of Sale including but not limited to any negotiations, court applications, eviction proceedings, listing and sale of the property.

(Emphasis added)

GA Mortgage, Appendix B, Eighth Report

8. The “interest” clause in the GA Mortgage reads:

PROVIDED that the monthly interest payment shall be due on the 1st day of each month. Interest shall be calculated on a monthly basis, not in advance and shall be payable at the rate as set out in this mortgage before and after maturity until the principal is paid in full.

(Emphasis added)

GA Mortgage, Appendix B, Eighth Report

9. The “Late Payment Charge” clause in the GA Mortgage reads:

\$350.00 N.S.F. and LATE PAYMENT CHARGE

PROVIDED further that there will be a Three Hundred and Fifty Dollar (\$350.00) charge to the Mortgagors for each Mortgage payment that is missed or any payment that is not honoured by the Mortgagors bank or any post-dated cheques not deposited at the request of the Mortgagors on the day the said post-dated cheques are due or any payment not delivered to the Mortgagee on the date it is due before or after maturity of the mortgage.

(Emphasis added)

GA Mortgage, Appendix B, Eighth Report

PART II – ISSUES

- A. **Does the Additional Interest Clause Violate the Provisions of s.8 of the *Interest Act*, and therefore Unenforceable?**

PART III – LAW

10. S.8 of the *Interest Act*, R.S.C. 1985 C. I-15 reads:

S.8 (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 or hypothec on immovables that has the effect of increasing the charge on the arrears beyond the rate of interest 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 principal money not in arrears. (emphasis added)

a) What is a “penalty”?

11. The British Columbia Court of Appeal in *Reliant Capital Ltd. v. Silverdale Development Corp.* conducted an extensive review of the historical basis of s.8 of the *Interest Act* and concluded that:

- 1) from the earliest cases, even predating the codification of the provisions of the predecessor section to s.8 in 1880, the Courts have refused to enforce interest charges that were in the nature of a penalty (para. 45).

- 2) The essence of a penalty is a payment of money stipulated *in terrorem* of the party in default rather than a genuine pre-estimate of the damage suffered, and, in equity, a lender who increased the rate of interest upon default was held to be imposing a penalty (para. 45-46).
- 3) The “legitimate commercial purpose” test in construing s.8 is not a useful test because it gives rise to commercial uncertainty, and leads to arbitrary application, and is unnecessary and unhelpful gloss on s.8 (para. 87,89).
- 4) The purpose of s.8 is to protect borrowers against penalties (para. 89).

Reliant Capital Ltd. v. Silverdale Development Corp. (2006) 270 D.L.R. (4th) 717 (B.C.C.A.) Interim Receiver’s Book of Authorities, Tab 1

12. In *Mastercraft Properties Ltd. v. EL EF Investments Inc.* the Ontario Court of Appeal held that in order to contravene s.8 of the *Interest Act* a mortgage must both stipulate for a fine, penalty or rate of interest, and have the prohibited effect of increasing the interest rate. The Court held that:

- a) A “fine” or “penalty” was defined Court as a form of monetary punishment for breach of the repayment terms of the mortgage contract (para 4);
- b) Mortgagees cannot escape the operation of s.8 by using the word “bonus” to describe something which is in substance a “fine” or “penalty” (para 4);
- c) Where a mortgage contains a covenant that exacts a bonus of interest payable upon default, in addition to any other interest payable under a mortgage, it is in clear contravention of s.8 (para 7);
- d) The maturity of a mortgage does not eliminate the application of s.8 if the effect of the terms of the mortgage is to impose a penalty that had the effect of imposing a higher rate of interest in arrears (para 24);

The Court expressly declined to decide whether the pre-payment penalty provisions of paragraph 16(1) of the *Mortgages Act* (now 17(1)) applies only to situations where the mortgagor is attempting to redeem a mortgage in default, and not to situations where the mortgagee is taking action to recover monies owing (para 25).

Mastercraft Properties Ltd. v. EL EF Investments Inc. (1993) 14 O.R. (3d) 519 (C.A.), Interim Receiver's Book of Authorities, Tab 2

13. The words "fine" and "penalty" in s.8 of the *Interest Act* must be construed widely to prohibit recovery of any form of additional payment that increases the rate of interest charged. A stipulation in the mortgage requiring the debtor to pay 15% "indemnity" if there is a default, and if the creditor institutes legal proceedings, is prohibited by s.8 of the *Interest Act* and unenforceable.

Immeubles Fournier Inc. v. Construction St. Hilaire Ltée [1975] 2 S.C.R. 2, Interim Receiver's Book of Authorities, Tab 3, para 12

14. Even if s.8(1) is inapplicable, equity would produce the same result. A mortgagee cannot recover a charge that would be a penalty or a rate of interest that would have the effect of increasing the charge on arrears beyond the rate of interest payable on the interest money not in arrears. The payment would not be compensation for loss of interest resulting from a voluntary early discharge, but would be related or tied to default, notwithstanding the subsequent change in label by the mortgagee. Even if the *Interest Act* did not apply, equity should produce the same result.

Citizens Trust v. Vyas (1996) 2 R.P.R. (3d) 30 (B.C.S.C.), Interim Receiver's Book of Authorities, Tab 4, para 37-38

15. In *Tapio v. Kajander*, a mortgage contained a clause which read:

"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."

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 the maturity thereof without notice and without bonus.

(Emphasis added)

The Court held that this clause was invalid as it violated s.8 of the *Interest Act*. The Court held that the only way to impose a penalty for failure to make prompt payments without falling foul of the *Interest Act* was to stipulate for a greater rate, and provide for a

lower rate if payments are made promptly. The Court noted that this is an artificial approach, but it also appears to be the only means by which a mortgager can exact a penalty for late payment.

Tapio v. Kajander [1965] 1 O.R. 431, Interim Receiver's Book of Authorities
Tab 5

16. Any clause, whether worded as a "penalty" or a "bonus", that has the effect of increasing the charge on the arrears beyond the rate of interest payable on the principal money not in arrears, is prohibited by s.8 of the *Interest Act*.

Levy v. Booksban [1931] 2 D.L.R. 1007 (Ont. S.C.), Interim Receiver's Book of
Authorities, Tab 6, page 1009

17. Interest is money paid for the use of money. If upon default of payment for the period of one day, the terms of the mortgage require payment of three months' interest, notwithstanding that the loan continues and interest at normal rates is also thereafter earned, this so-called additional "interest" is clearly in the nature of a penalty.

Schwartz v. Williams (1915) 27 D.L.R. 733 (Ont. S.C.), Interim Receiver's Book
of Authorities, Tab 7, page 734-735

18. A provision of a mortgage that has the effect of imposing a payment of a set amount on each occasion on which proceedings are taken, regardless of the nature or extent or costs of the proceeding or occasion of default, is a penalty, and not enforceable.

1259121 Ontario Inc. v. Canada Trust Company (2007) 30 B.L.R. (4th) 193
(Ont. S.C.), Interim Receiver's Book of Authorities, Tab 8, para 19-20

19. The use of the words "...that has the effect..." of incurring the charge or the arrears beyond the rate of interest payable on principal money not in arrears in s.8(1) of the *Interest Act* is deliberate. The purpose of this wording is to discourage creative drafting of mortgages to get around s.8(1). A clause that had the effect of compensating a mortgagee for the time and trouble of collecting an overdue mortgage, by having the effect of increasing the interest rate after default, is prohibited under s.8(1).

Raintree Financial Ltd. v. Bell (1993) 82 B.C.L.R. (2d) 28, Interim Receiver's
Book of Authorities, Tab 9, para 7, 14-15

20. As noted in the Notice of Sale issued by Graphic Arts, upon the issuance of the Notice of Sale, Graphic Arts claimed the amount of three months' interest totalling \$236,250.00 as a "pre-payment penalty", in addition to the interest ordinarily chargeable under the GA Mortgage. This imposition of an additional "penalty" of \$236,250.00, upon the issuance of a notice of sale, cannot have any other purpose than to be held *in terrorem* over the Applicant. The entire amount of three months' interest is payable upon the issuance of a notice of sale, notwithstanding the actual costs of enforcement, and therefore cannot be a genuine pre-estimate of loss. Consequently, it is the position of the Interim Receiver that the Penalty Interest Clause violates the provisions of s.8 of the *Interest Act* and is therefore unenforceable.
21. Even if s.8 was inapplicable, the GA Mortgage unambiguously characterizes the requirement to pay the additional three months' interest upon the issuance of a Notice of Sale as a "penalty", and therefore the Penalty Interest Clause is also not enforceable in equity.

b) Is s.8 effective with respect to mortgages that have matured?

22. Section 8(1) was intended to provide a remedy against provisions in a mortgage which have the effect of directly, by way of increased interest charges, or indirectly, by way of penalty, increasing the rate of interest charged on payments in default over that which is chargeable pursuant to the terms of the mortgage on principal money which is not in default. On a fair and liberal construction of s.8(1), there is no justification for not providing the protection of s.8(1) for payments in default after maturity of a mortgage. It would require clear and compelling language in the Statute to make a distinction between defaults occurring before maturity and defaults occurring after maturity.

Beauchamp v. Timberland Investments Ltd. (1983) 44 O.R. (2d) 512 at 517,
Interim Receiver's Book of Authorities, Tab 10, para 12, 15

Mastercraft Properties Ltd. v. EL EF Investments Inc. (Supra), Interim
Receiver's Book of Authorities, Tab 2, para 24

23. In *Parkhill v. Moher* the mortgage contained a clause which read:

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 his mortgage without such payment.

(Emphasis added)

The Court followed *Tapio, Supra*, and held that the clause was unenforceable as it violated s.8 of the *Interest Act*. On the facts of *Parkhill*, the mortgage being interpreted by the Court had matured and the mortgagor had failed to pay the amounts owing to the mortgagee on maturity. The Court held that despite the fact that the mortgage had matured, s.8 of the *Interest Act* was still applicable and that the mortgagee was not entitled to the additional interest.

Parkhill v. Moher (1977) 17 O.R. (2d) 543, Interim Receiver's Book of Authorities Tab 11, para 9, 10, 12

24. Consequently it is the position of the Interim Receiver that the fact that the GA Mortgage had matured is irrelevant to the application of s.8 of the *Interest Act*. The jurisprudence sets out that if a matured mortgage contains a clause that imposes a penalty payment after default that violates s.8, it is unenforceable.

c) **Is s.17 of the *Mortgages Act*, R.S.O. 1990 c.M.40 and the *O'Shanter Development* line of cases applicable to these facts?**

25. Section 17(1) of the *Mortgages Act* R.S.O. 1990 c.M.40 reads:

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. R.S.O. 1990, c. M.40, s. 17.

26. In *O'Shanter Development Co. Ltd. v. Gentra Canada Investments Inc.* the Ontario Divisional Court held that a prepayment provision in a first mortgage that read:

5.1 Prepayment of the whole or any part of the principal sum is permitted commencing 24 hours after the advance hereunder, subject to compliance with applicable prepayment conditions as set out in sub-paragraph 5.2 hereof.

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 mortgagor agrees to indemnify and save harmless the mortgagee from all costs and losses resulting therefrom and to pay to the mortgagee the greater of:

- (a) three months' 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.

did not stipulate for a fine or penalty that violated s.8 of the *Interest Act*. Therefore payment of the interest penalty in clause 5.2 was enforceable against a second mortgagee selling the property under power of sale that had attempted to redeem the first mortgage, as s.17 of the *Mortgages Act* permits the defaulting mortgagor the opportunity to redeem his property upon giving three months' notice, or paying interest in lieu of notice. The Court held that the rationale for the wording of clause 5.2 was not punishment for default, but, rather was compensation to the mortgagee for redemption of the mortgage prior to maturity.

O'Shanter Development Co. v. Gentra Canada Investments (1995) 25 O.R. (3d) 188 (Ont. Div. Ct.), Interim Receiver's Book of Authorities, Tab 12, para 23

27. It is the position of the Interim Receiver that *O'Shanter* is distinguishable for the following reasons:
- (i) The GA Mortgage had matured and therefore “prepayment penalties” are moot;
 - (ii) The wording of the Penalty Interest Clause is entirely different from the wording of the prepayment provision being interpreted in *O'Shanter*;
 - (iii) *Mastercraft, Supra*, which *O'Shanter* follows (para. 20-21 *O'Shanter*) declined to rule as to whether (then) s.16(1) of the *Mortgages Act* applied to situations where the mortgagee is taking action to recover monies owing;
 - (iv) The Applicant in this case never made, or attempted to make, any payment to Graphic Arts in accordance with s.17 of the *Mortgages Act*, in order to redeem the mortgage;
 - (v) The GA Mortgage is a vendor take back mortgage to secure the full payment of the purchase price of the Property rather than a true term mortgage.
28. The Ontario Superior Court recently attempted to reconcile the reasoning in *O'Shanter* and *Mastercraft* in the context of a claim for interest arising upon the commencement of enforcement by a mortgagee. The Court held that the reasoning in *O'Shanter Development* is consistent with the view expressed by the Court of Appeal in *Mastercraft*, that the rights afforded by s.17 of the *Mortgages Act* are options available to the mortgagor on default, namely:
- (i) the mortgagor can give three months' notice of early redemption; or
 - (ii) the mortgagor can redeem by paying the interest bonus prior to the expiry of the notice period.

However, the Court held that once the mortgagee takes steps to realize on the mortgage by issuing a notice of sale, it cannot convert the rights of the mortgagor under s.17 of the *Mortgages Act* to prepay the mortgage, into obligations of the mortgagor to pay the three months prepayment penalty upon the realization of the security. Once a mortgagee issues a notice of sale, the mortgagee is no longer entitled to demand payment of three months' interest under s.17 of the *Mortgages Act*.

Ialango v. Term Investments Ltd. (2007) 54 R.P.R. (4th) 310, Interim Receiver's Book of Authorities, Tab 13, para 30-31

29. In this case, to the knowledge of the Interim Receiver Sapphire never requested the prepayment of the GA Mortgage. Applying the reasoning in *Ialango* to these facts, it is the position of the Interim Receiver that s.17 of the *Mortgages Act*, and, therefore, the O'Shanter line of cases, are inapplicable because:

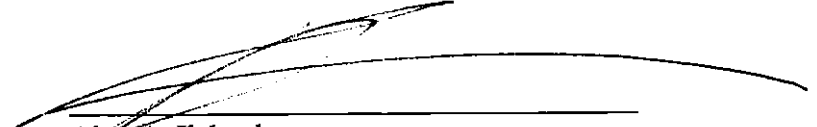
- (i) the GA Mortgage matured on December 1, 2006;
- (ii) Graphic Arts commenced enforcement proceedings by issuing a notice of sale on June 12th, 2007;
- (iii) the Interim Receiver was appointed by the Court on behalf of all of the creditors of the Applicant, including Graphic Arts, to continue enforcement proceedings by marketing the Property, selling it, and distributing the proceeds to the stakeholders;
- (iv) the Interim Receiver has completed the sale, and Graphic Arts has received the amounts owing to it under the GA Mortgage, except for the Penalty Interest;
- (v) the Penalty Interest Clause was triggered by the issuance of the Notice of Sale.

Accordingly, the payment of the Penalty Interest cannot be characterized as a payment of a "pre-payment penalty" by Graphic Arts, s.17 of the *Mortgages Act* does not apply, and s.8 of the *Interest Act* is applicable to the provisions of the Penalty Interest Clause.

PART IV - CONCLUSION

30. The Penalty Interest Clause cannot be characterized by Graphic Arts as an additional fee, the payment of which allows the Applicant the privilege of making a “pre-payment” of the amounts owing under the GA Mortgage prior to the maturity date. The assessment of the “penalty” was purely for the purpose of receiving greater interest after default rather than before default, and was only operative upon the issuance of a Notice of Sale. Therefore it is the position of the Interim Receiver that the Penalty Interest Clause is unenforceable under the provisions of s.8 of the Interest Act.

**ALL OF WHICH IS RESPECTFULLY SUBMITTED THIS 8TH DAY OF MAY,
2008.**



Alex A. Ilchenko
Fraser Milner Casgrain LLP