

Section 10 of the *Canada Interest Act* and Over Five-Year Closed Mortgage Loans: Making Sense of Outdated Legislation

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Introduction

The *Interest Act*¹ (Canada) (“Act”) is federal legislation that applies across Canada. Section 10 of the Act reads as follows:

(1) Whenever any principal money or interest secured by mortgage on real property is not, under the terms of the mortgage, payable until a time more than five years after the date of the mortgage, then, if at any time after the expiration of the five years, any person liable to pay or entitled to redeem the mortgage tenders or pays, to the person entitled to receive the money, the amount due for principal money and interest to the time of payment, as calculated under Sections 6 to 9, together with three months further interest in lieu of notice, no further interest shall be chargeable, payable or recoverable at any time thereafter on the principal money or interest due under the mortgage.

(2) Nothing in this section applies to any mortgage on real property given by a joint stock company or other corporation, nor to any debenture issued by any such company or corporation, for the payment of which security has been given by way of mortgage on real property. R.S., c. I-18, s. 10

Therefore, mortgage loans beyond five (5) years, even if not prepayable, or if prepayable with yield maintenance, may be prepaid with three (3) months’ interest, unless the borrower qualifies for an exemption under Section 10(2).

For income tax, capital tax and other valid considerations, holders of Canadian commercial real estate frequently structure themselves as limited partnerships or trusts. Also, real estate investment trusts represent a significant component of today’s ownership segment. Yet, neither limited partnerships nor trusts qualify for the exemption in Section 10(2).

Legislative History

The legislative history of these provisions is best explained by Mr. Justice Robins of the Ontario Court of Appeal, in the frequently cited *Litowitz* decision,² as follows:

The Section 10 right of prepayment was first enacted by Parliament in 1880. [...] Subsection 1, as the Parliamentary debates reveal (House of Common Debates, March 31, 1880, p. 954), was intended to remedy the problem of farmers being locked into long-term mortgages at high interest rates and being subjected to large bonuses or penalties when they sought prepayment. The exemption clause was enacted some ten years later in response to problems that s.-s. 1 had created for corporations, particularly railway companies, in obtaining long-term *financing* by way of loans secured by mortgages of real property. Lenders were understandably reluctant to provide long-term money when it was open to borrowers to repay the loan after five years even though the mortgage was closed on its terms. *Subsection 2 was added to remedy this problem and facilitate long-term commercial borrowing by exempting any mortgage “given by a joint stock company or other corporation” from the operation of s.-s. 1. As a result, the application of s.-s. 1 is restricted to non-corporate mortgagors.* [emphasis added]

As mentioned above, structurings today are frequently effected through limited partnership or trust vehicles, neither of which are corporations. When discussing this problem recently with representatives of the federal Department of Finance, the writer was asked the following question: “This problem has been around for a long time. Why all the sudden interest?” The answer lies in today’s commercial real estate economic environment, in which interest rates are at historic lows, lenders possess an abundance of available funds to lend long term, and competition among buyers of quality products is so fierce that capitalization (“cap”) rates are being driven down to very aggressive levels.

Therefore, for the current owner looking at refinancing it is logical to want to take advantage of low interest rates at a longer term; for the purchaser pricing the income stream at a low cap rate where the margin of error is oftentimes razor thin, longer-term stabilized debt often helps rationalize the *pro forma*.

“Longer term” today generally means longer than five (5) years; hence, the Section 10 problem. At least one major institutional lender writes 10-year commitment letters on the following basis:

Term: 120 months, provided that the lender obtains an acceptable legal opinion that none of the borrowing entities will benefit from the right to pre-pay the loan prior to maturity pursuant to the *Interest Act*, failing which the loan will be made for a term not exceeding 5 years.

Structuring Around the Problem

Section 10(2) creates three categories of exemptions:

1. the joint stock company which, if still in existence, is rarely used, as it is a non-incorporated association with shareholders and is not nearly as regulated as a corporation itself;
2. the corporation; and
3. the debenture issued by any such company or corporation.

Being exceptions to the general rule, courts will interpret these restrictively. Also, Section 10 is of public order and, therefore, cannot be derogated from contractually. Therefore, techniques have been devised to circumvent the problem, with relative strengths and weaknesses.

Corporation as Borrower

Common Law Position

The most frequently utilized technique is to have a corporation hold legal title to the property, with the non-corporate entity (individual, limited partnership or trust) retaining the beneficial ownership.

Certain provinces, such as Ontario, have legislation similar to the Act, which has led to some interesting litigation—e.g., the 1998 decision of the Ontario Court of Appeal in the case of *Kukor Construction & Developments & Associates v. Canada Life Assurance Co.*,³ where the issue of structuring via a limited partnership in the context of a mortgage loan of more than five (5) years was scrutinized. This decision is often cited as authority for the premise that a structure in which the beneficial owner of the property is a limited partnership whose general partner is a corporation (and appears on the title as such) will satisfy Section 10 of the Act. *Litowitz*⁴ also concluded that prepayment was precluded under Section 18(2) of the *Mortgages Act* (Ontario)—which is substantively the same as Section 10(2) of the Act—where individual purchasers of units in a multiple-unit residential apartment building organized as a corporation that sold the units and granted the mortgage.

The Quebec Civil Law Position

In the Province of Quebec, we encounter more difficult concerns, in large part stemming from the fact that the common law distinction between legal and beneficial ownership does not exist in Quebec. While the *Quebec Civil Code* permits what are known as dismemberments of ownership (usufruct, servitude and emphyteusis), it does not divide or “fragment” ownership between legal and equitable title as does the common. Therefore, in a structure whereby a corporation acquires title to a property on behalf of another, it is doing so at what is known in the civil as a *prête-nom* or mandatary (the civil law equivalent of an agent) and the *prête-nom* has no rights of any nature whatsoever. The *prête-nom* will usually sign a *prête-nom* agreement with the owner, disclaiming any rights whatsoever and agreeing not to do anything without the owner’s permission. Thus, the grantor of a conventional (i.e., contractual) hypothec (the civil law equivalent of the common law mortgage) must have the legal capacity to alienate.⁵ Even if the *prête-nom* is described as the grantor of the hypothecary security, it could only be doing so on behalf of the real owner.

With this in mind, when we structure ownership of Quebec properties by way of a *prête-nom* on title on behalf of a non-corporate entity such as a limited partnership or a trust, it is really the same as if the non-corporate entity, being the true owner, had bought the property in its own right, borrowed the money on its own behalf, and hypothecated or mortgaged the property on its own behalf. Some practitioners take the view that *Kukor* and *Litowitz* are perfectly and validly applicable to Quebec, although I am aware of no case law that either supports or refutes this position.

Drop-Down

Certainly, the more conservative approach favours what is known as a “drop-down,” which is used frequently in conjunction with acquisitions being financed through new mortgage financing of longer than five years. The transaction is effected in two steps: (1) purchase of the property by a corporation that owns the property outright and not as a *prête-nom* and (2) after some agreed-upon delay, transfer of the beneficial ownership to a limited partnership or trust. The legal rationale behind this is that the courts have concluded that the moment in time in which Section 10(2) is judged is the date the hypothec is granted.⁶

The drop-down works for acquisition financing, where the acquirer can plan the structure with the lender in a manner that will satisfy each party’s requirements. It does not work for new financing or refinancing of a property in which the trust or the limited partnership is already the owner, unless the *Kukor* and *Litowitz* reasoning is applied and accepted. To reverse the ownership structure to a corporation is an expensive process and often carries with it adverse income tax and capital tax consequences.

Finally, even the lenders voice some concern over the drop-down. Being aware of the situation, they often wonder to themselves if this knowledge may come back to haunt them five years later. Yet, when they oblige borrowers to represent and warrant the ownership, what choice is there?

All of this just adds to the need for legislative reform.

Debenture Issuance

This technique, permitted by Section 10(2) of the Act, is accomplished by the corporation borrowing the funds and issuing a debenture for the indebtedness. The trust or limited partnership that owns the property would then guarantee the debt obligations and would secure these guarantee obligations by means of a collateral hypothec of the property.

This is a highly paper-intensive and expensive process, which most borrowers would prefer to avoid. Furthermore, since the borrower must be a corporation that issues the debenture, capital tax issues must be considered and addressed. In transactions involving multiple owners, the lenders generally will insist upon the identical process for each co-owner/borrower. Where each is not a corporation, each faces the Section 10 issue. Where one or more borrowers are corporations and qualify under Section 10(2), it would not be surprising if these other co-owners refuse to embark upon the debenture process, merely to satisfy the concerns of a co-owner structured as a limited partnership or a trust. The reasons can include internal prohibitions or restrictions upon issuing debentures, which cannot be overcome, or simply a refusal to embark upon a complicated and expensive process that is only necessary because a co-owner is not a corporation. Either explanation is perfectly legitimate in today's fast-moving commercial world.

Legislative Reform

The *status quo* and the uncertainty resulting from this situation do not serve the interests of anyone involved in the commercial mortgage lending process. Lenders anxious to "park" funds long term do not want borrowers prepaying before maturity and disturbing the yield. Borrowers want to be able to structure their ownership interests in the most advantageous manner they can create, and borrow long term without undue complication and added expense. Attorneys required to render enforceability opinions wish to do so with professional confidence. There is no reason why a borrower that is a general partnership of corporations encounters no problems under this section, while a limited partnership or trust is very problematic.

If Section 10(2) were added to the Act toward the end of the 19th Century to facilitate long-term commercial borrowings of corporations in vogue at that time, Section 10(2) would very easily be amended by adding limited partnership and trusts to the permitted exemptions. This would easily solve the problem, and put an end to all of the uncertainty and complications discussed above.

Discussions have been held with the federal Department of Finance to amend Section 10(2). A preliminary meeting was held in Ottawa in June 2006, and the submissions received a positive reaction. The process will now continue in full force and, hopefully, Section 10(2) will be amended in the near future to add limited partnerships and trusts to the list of permitted exceptions.

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¹1985 R.S., c.1-18.

²*Litowitz v. Standard Life Assurance Co. (Trustees of)* (1996), 30 O.R. (3d) 579, [1996] O.J. No. 3816 (Ont. C.A.), motion for permission to appeal to the Supreme Court of Canada denied.

³11 O.R. (3d) 577

⁴Op. cit., note 3

⁵Article 2681 of the Civil Code of Quebec: "A conventional hypothec may be granted only by a person having the capacity to alienate the property hypothecated."

⁶See, for example, *Laberge v. Caisse de dépôt et placement du Québec*, [1998] R.J.Q. 1956, where individuals assuming a mortgage debt that had originally been granted by a corporation could not then use Section 10(1) to prepay the debt after five years.