NEITHER A BORROWER NOR A LENDER BE: THE PROBLEM WITH SALES OF REAL PROPERTY SUBJECT TO EXISTING MORTGAGES

Joseph T. Robertson*

I. Introduction

Sales of real property financed by the purchaser agreeing to assume the vendor's obligations under an existing mortgage occur more frequently during periods of economic instability.[1] In inflationary times, when market rates of interest exceed those specified in existing mortgages, sales of the so-called "equity of redemption" are attractive to potential purchasers and to vendors tempted to capitalize on interest rate fluctuations.[2] At the same time, this financing technique attracts either legal or financial implications for: (a) vendors, (b) their guarantors, (c) their secured lenders, (d) purchasers, (e) those who provide mortgage loan insurance, and ultimately (f) realtors intent on effecting a sale.[3] Although the category of interested persons is wide-ranging, attention will focus on those directly affected by this financing technique; vendors and their secured lenders.

For vendors their folly may lie in the possibility of continuing liability under the mortgage. That is, if a purchaser subsequently places the mortgage loan in default the vendor may remain responsible for the debt or for any deficiency resulting from a forced sale of the property.[4] The legal issue for judicial determination focuses on the moment when the original mortgagor (hereinafter the 'vendor') is

---

*Faculty of Law, University of New Brunswick, Fredericton. This article was originally published by the Real Estate Institute of Canada and received the 1988 Morguard Literary Award. It has been updated to reflect recent legislative amendments in certain provinces.

[1] The analysis provided is restricted to the situation in which the vendor has granted previously a purchase money mortgage to a lender and is now attempting to find a purchaser willing to assume the former's obligations. Little is to be gained from surveying the diversity of possible fact situations in which vendor financed sales may occur and be structured. For the most part, the issues and the solutions remain unchanged.

[2] Interest rate capitalization is not the sole stimulus for vendor financed sales. Should the outstanding indebtedness exceed the value of the property and the vendor have insufficient funds to discharge the mortgage, the purchaser may be prepared to accept the former's promise to pay the difference. However, the issues discussed in this essay and, in particular, those relating to the interests of lenders are not materially affected by this motivational consideration; see *infra*, note 31.

[3] Persons who have guaranteed mortgage loans of vendors are vitally interested in the effect which a sale has on their continuing liability under the contract of guarantee. Purchasers entering into agreements of purchase and sale need to be apprised of the possibility that under the mortgage contract the loan may be called as a result of the sale of the equity of redemption: see *EPC Industries Ltd* v. *Union Electric Supplies Co. and Union Properties Western Ltd* (1985), 55 Nfld. & P.E.I.R. 186 (Nfld. S.C.T.D.). Correlatively, realtors acting on behalf of vendors must determine initially the vendor's right to offer this type of financing and be in a position to point out its disadvantages, see *infra*, note 84. Finally, Canada's public and private mortgage loan insurers, MICC and CMHC, should be concerned with the potential for sales to uncreditworthy purchasers and the need for lenders to invoke a contractual provision to block unacceptable sales. Within the last ten years their loss experience approaches the billion dollar mark, with the public insurer bearing the brunt of the loss.

[4] The inability to maintain an action for the debt, in defined circumstances, in the provinces of Alberta and Saskatchewan requires separate analysis; see text infra, note 66.

or should be released from liability. Therein lies the potential risk for vendors offering this type of financing. From the perspective of mortgagees (hereinafter 'lenders'), there is a valid concern as to the suitability of the purchaser and, correlatively, the potential for greater exposure to risk of default and financial loss. In response to these risks, Canadian lenders have introduced into mortgage contracts what are termed "due-on-sale" clauses. To the extent that these clauses are enforceable at law, lenders are clothed with an unfettered right to prohibit sales of the equity by electing to call the loan. On the other hand, there is no guarantee that lenders will exercise their discretion in a reasonable manner and hence the clauses are open to abuse.

This essay examines the common law as it relates to both continuing liability of vendors and the validity and exercise of "due-on-sale" clauses by lenders. The analysis is supplemented by reference to the treatment accorded these issues by American courts. Critiques of recent proposals by the British Columbia and Ontario Law Reform Commissions and of reform legislation in both Prince Edward Island and British Columbia lead to a suggested framework for resolving the legal issues raised. While any reform model must seek to balance the legitimate interests of those affected by this mode of financing, I argue that a proper balance cannot be achieved unless the issue of continuing liability is addressed and resolved at the time of the sale. The presence of a "due-on-sale" clause in the mortgage contract may achieve that result should the lender be permitted to call the loan.

II. "Due-on-Sale" Clauses

A survey of Canadian case law reveals that lenders have not settled on a typical or standard "due-on-sale" clause. While its contents and scope vary among mortgage documents, it typically provides the lender with the right to call the loan if the secured property is sold to a purchaser not approved by the lender. [5] The majority of cases decided in Canada and the United States have been litigated on such a clause.[6] Within this definitional framework, the legal effect of a "due-on-sale" clause involves two distinct questions. First, is the clause valid or is it void ab initio, such that it is of no binding force whatever? In this regard, antagonists of the clause attack its validity on the ground that it offends the proprietary rule against restraints on alienation. Second, even if the clause is valid *per se* is there a

---

[5]For example, in *Royal Bank of Canada v. Freeborn* (1974), 22 Alta L.R. (2d) 279 (S.C.T.D.) the following clause was in issue:

> In the event of the Mortgagor selling, conveying, transferring, or entering into any agreement of sale or transfer of the title of the property hereby mortgaged to a purchaser,grantee or transferee not approved by the Mortgagee thenat the option of the Mortgagee, all moneys hereby secured with accrued interest thereon shall forthwith become due and payable. Further, should a purchaser, grantee or transferee fail to (l) apply for and receive the Mortgagee's written consent, (2) personally assume all the obligations of the Mortgagor, and (3) sign the Assumption Agreement of the Mortgagee then the Mortgagee may at its option demand repayment of the principal amount of the mortgage with accrued interest thereon.

[6]So far as Canadian law is concerned, cases in which the drafting deviates from the typical clause are identified.

legal basis or a willingness on the part of the courts to deny enforcement where the refusal to approve the purchaser is unwarranted? In other words, are courts prepared to intercede on behalf of vendors by requiring lenders to prove the reasonableness of a particular refusal? Each of these questions requires analysis.

(a) Void as a Restraint on Alienation

There are few precedents in Anglo/Canadian mortgage law which can be invoked to declare the "due-on-sale" clause void. Although the law of mortgages is founded on principles of equity, its doctrines are not boundless in application. Thus, for example, legal arguments based on the concepts of unconscionability or duress are of little utility except in the most extreme situations.[7] Accordingly, those wishing to attack the validity of such clauses have had to turn to the law of real property. Under the rule against restraints on alienation, a contract term which purports to prevent an owner from disposing of property is void.

The restraint rule has been advanced in both Canada and the United States, but the majority American position is that the clause does not amount to an invalid restraint.[8] Enforcement is automatic unless the vendor is able to prove that the lender is engaged in unconscionable conduct.[9] With the one exception examined below, Canadian courts have upheld consistently the validity of the clause and rejected the restraint argument.[10] Strictly speaking, it is obvious that the typical clause does not prohibit the vendor from selling the property. It only prohibits a sale of property in which the purchaser is to take advantage of pre-existing financing. Should a lender withhold approval, vendors are entitled to pay out the mortgage loan and effect a conventional sale. There is, however, one reported Canadian decision which detracts from this line of reasoning.

In *Re Bahnsen and Hazelwood*[11] the Ontario Court of Appeal held void, as a restraint on alienation, a clause which simply required lender approval.[12] Though

---

[7]Mortgage law remains wedded to fundamental contractual principles which restrain courts from questioning the subjective reasonableness of an unambiguous provision. In accordance with classical contract doctrine, what is or is not reasonable is an issue to be decided at the time of the making of the contract.

[8]With respect to the American positions see generally, Report of the Subcommittee on Real Estate Financing, "Enforcement of Due-On-Transfer Clauses," (1978) 13 Real Prop., Prob. & Tr. J. 891 (updated W.B. Dunn and T.S. Nowinski (1981) 16 Real Prop., Prob. & Tr. J. 291) and, in particular, G.S. Nelson and D.A. Whitman, Real Estate Finance Law (St. Paul, Minn.: West Publishing Co., 1985) at 324.

[9]It would appear that the vendor must show that the lender is calling the loan for purposes unrelated to interest rate capitalization and the creditworthiness of the purchaser; see *Tierce* v. *APS Co.*, 382 So. 2d. 485, 487 (Ala. 1979).

[10]Though the legal reasoning employed to uphold the validity of the clause varies, the result is the same; see *Briar Building Holdings Ltd* v. *Bow West Holdings Ltd et al.* (1981), 16 Alta L.R. (2d) 42 (Q.B.), 126 D.L.R. (3d) 566; *Marine Water Wells Ltd* v. *Dobson & Co. Refrigeration & Air Conditioning Ltd et al.* (1982), 25 R.P.R. 240 (Sask. Q.B.); *Canada Permanent Trust Company* v. *King's Bridge Apartments Limited et al.*, (1984), 48 Nfld. & P.E.I.R. 345 (Nfld. C.A.), 8 D.L.R. (4th) 152; *Weeks et al.* v. Rosocha (1982), 36 O.R. (2d) 379 (Co. Ct.), rev'd on other grounds (1983), 41 O.R. 787(C.A.); 28 R.P.R. 126.

[11](1960), 23 D.L.R. (2d) 76 (Ont. C.A.).

[12]The clause reads: "In the event of sale before the herein mortgage has been discharged the said mortgagor must pay an amount agreeable to both parties of the existing mortgage and the new purchaser must be approved by the mortgagee herein." *Quaere*--is not the clause void for uncertainty in light of the requirement to pay an un-

the judgment cannot be considered a seminal one, given the cursory treatment accorded the issue, it is apparent that the court was not concerned with the possibility that alienation could be prohibited completely. Rather the court focused on the possibility that the discretionary power could be exercised on discriminatory grounds of "the purchaser's creed, race, color or religion."[13] That possibility did not, however, deter the Newfoundland Court of Appeal[14] from upholding the validity of a similarly worded clause. In contrast to *Re Bahnsen*, an Ontario trial court[15] upheld a "due-on-sale" clause (termed in that case an "optional maturity clause"). The judge distinguished *Re Bahnsen* on the basis that the clause there under consideration "was not one which provided for the mortgage to fall due on a sale thereby permitting the vendors to discharge the mortgage."[16] The fact that the clause in *Re Bahnsen* did not require the lender to call the loan if approval was refused should not be overlooked. Theoretically, the lender in *Re Bahnsen* might have sought a mandatory injunction to prohibit the sale, in which case the restraint argument is more appealing. It is even more persuasive where there is a 'closed mortgage' by which the vendor has no right of early repayment. The failure of the vendor to bargain for this right coupled with a clause prohibiting outright a sale of the equity may well influence a court to conclude that such clauses constitute a direct restraint on alienation. The vendor has neither the right to sell the property free of the mortgage nor the freedom to effect a sale to a purchaser willing to assume the vendor's obligations.[17] Accordingly, lenders are better served by the typical due-on-sale/optional maturity clause if only because it weakens the restraint argument.[18]

Although the typical clause may not be looked on as direct restraint on alienation, it has been suggested that the clause operates as an indirect or practical restraint. In the United States that argument cannot be ignored because of the nature of that jurisdiction's money mortgage markets. Occasionally, the lack of available mortgage funds has impeded the possibility of creditworthy purchasers

---

determined price for approval, which of itself suggests that the clause is penal in nature?

[13] *Supra*, note 11 at 77.

[14] *Canada Permanent Trust Company* v. *Kings Bridge Apartments Limited et al.*, *supra*, note 10. The Newfoundland Court of Appeal was able to distinguish *Re Bahnsen* on the basis of the 'general' acceleration clause which can be invoked in the event of a breach of any obligation and not merely one contained in a "due-on-sale" clause.

[15] *Weeks et al.* v. *Rosocha*, *supra*, note 10.

[16] *Ibid.* at 382.

[17] Even under our "due-on-sale" clause, it is conceivable that the lender could refuse approval and refuse to elect to call the loan. While the restraint argument would undoubtedly be given greater weight in this circumstance, there is one instance where the lender would be justified in refusing tocall the loan. In cases where interest rates have declined since the mortgage was granted, the vendor under a closed mortgage might attempt a sale of the equity solely for the purpose of having the lender call the loan. However, the vendor cannot take advantage of the clause for this purpose; see *Valley Vu Realty (Ottawa) Ltd et al.* v. *Victoria & Grey Trust Co.* (1984), 44 O.R. (2d) 256 (H.C.), 30 R.P.R. 90. As well, consideration must be given to the interests of lenders under participation mortgages in which they are to share in the revenues derived from the mortgaged premises; see text *infra*.

[18] It is weakened further if the clause simply states that the lender has the right to elect to call the loan in the event of a sale, but omitting any reference to an approval requirement. Nonetheless, there is no substantive difference between this clause and our typical "due-on-sale" clause. In either case the vendor is forced to seek the lender's approval in order to avoid the possibility of the loan being called.

obtaining their own financing.[19] Thus sales of the equity of redemption remain as the only practical means of effecting a sale. But one cannot transpose this economic rationale to the Canadian marketplace. Here the problem has not been the lack of funds as such, but at times the lack of funds at acceptable interest rates.[20] While vendors might wish to persist in attacking the validity of the clause, their arguments ignore the lender's legitimate concern that if the clause is declared invalid the vendor is free to sell to the most financially irresponsible purchaser that can be found.

(b) Justifying the Refusal

The reluctance of Canadian courts to declare "due-on-sale" clauses void, forces a second question. Are courts prepared to intercede on behalf of vendors by requiring lenders to prove the reasonableness of a particular refusal? A minority of American courts have imposed a reasonableness requirement. In Canada there is only one reported decision in which the court has exercised a judicial discretion with the effect of prohibiting enforcement of the clause. In *Royal Bank v. Freeborn*[21] the lender denied consent to a sale of the property, which had already been affected, sought a declaration as to the outstanding indebtedness, and in default an order for sale or foreclosure. The Alberta trial judge refused to grant the declaration but granted an order under the *Judicature Act*[22] which gives a court discretion to order a stay of proceedings in regard to enforcement of security on land. The effect of that 'staying' order left the lender with no alternative but to accept the new owner since the lender could not proceed with a foreclosure action. Though the Court did not declare the "due-on-sale" clause invalid, it felt that the purchasers deserved relief as there was no evidence that they would "commit waste or cause the premises to fall into disrepair."[23] While Freeborn stands alone in Canadian jurisprudence, it is proper to ask whether there is any other legal basis on which courts could interfere with a lender's exercise of a "due-on-sale" clause.

Once again there are few precedents in Anglo/Canadian law which, by analogy, could be invoked to undermine the notion of judicial deference in regard to the validity of the lender's reasons for refusing approval. With respect to the com-

---

[19]See Nelson and Whitman, *supra*, note 8 at 317 and note 10.

[20]During our recessionary period mortgage interest rates rose to a high of 22% as of September 1981. No one would deny that this created a buyers' market, yet buyers were simply not willing to enter into contractual obligations at such rates of interest. But, of course, that problem may have been common to all vendors including those with no mortgages or those who had accumulated a substantial equity in the property and thus not able to offer realistically a vendor financed sale.

[21]*Supra*, note 5.

[22]R.S.A. 1980, c.J-1, s. 32(e).

[23]*Supra*, note 5 at 287. The court also inferred that the clause presented an indirect restraint on alienation in view of the fact that "the average homeowner or purchaser of a home does not have $30,000 readily available to pay off a mortgage of this size"; *ibid.* at 286. The simple response to that reasoning is that the vendor may apply the purchase monies against the mortgage obligation once the purchaser arranges his or her own financing. With respect to the argument that the property may be worth less than the indebtedness, see *supra*, note 2 and *infra*, note 31.

mon law regulating landlords and tenants, a covenant on the part of a tenant not to assign or sublet without the consent of the landlord does not permit judicial interference in the exercise of that discretion.[24] Admittedly, under provincial statutes governing commercial tenancies, it is an implied term of the covenant that consent will not be unreasonably withheld. On the basis of that implication (or an express one) and on application by the tenant, courts have required landlands to prove the reasonableness of a refusal.[25] However, that legislation also provides that the landlord can contract out of the obligation to offer valid reasons.[26] By comparison what is to be noted is that the typical "due-on-sale" clause omits any stipulation that approval will not be unreasonably withheld.[27] Hence, the issue turns on whether courts are prepared to imply such a term, thereby clothing the vendor with the right to challenge the grounds of refusal.

In this regard, the Supreme Court[28] recently dealt with the issue of when a contractual term can be implied (here it was in the context of a banking relationship) and concluded that it must meet the test of necessity.[29] While cogent arguments might be advanced in support of an implied term because of its reasonableness, the test of necessity renders the possibility of judicial interference in the lender's exercise of a "due-on-sale" clause a non-issue. The manner in which that test has been applied in other contractual settings indicates that the law would not support an implied term in the present context. In the absence of reform legislation, or a statutory provision such as that found in Alberta, Canadian courts are restrained from interfering with the lender's exercise of this discretionary right. Yet, some American courts have assumed a judicially active role by imposing a reasonableness requirement. Their treatment of what constitutes a reasonable refusal is instructive and assists in the development of a reform model.

A review of American case law brings forward a number of bases on which a minority of courts have prohibited the lender from enforcing the clause.[30] That most relevant to this inquiry focuses on the reasons offered by the lender in refusing to grant approval.[31] Judicial intrusion on a case-by-case approach places the

---

[24] See generally Williams and Rhodes, *Canadian Law of Landlord and Tenant* (Carswell: Toronto, 5th ed., 1983), vol. 2 at 15-36 *et seq.*

[25] *E.g.*, *Landlord and Tenant Act*, R.S.N.B. 1973, c.L-1, s. 11. At law an assignor may seek a declaration but most statutes provide for a summary procedure; see Williams and Rhodes, *ibid.* at 15-53.

[26] *E.g.*, *Landlord and Tenant Act*, *ibid.*, s. 11(1).

[27] See *supra*, note 5.

[28] *Canadian Pacific Hotels Ltd* v. *Bank of Montreal* (1987), 77 N.R. 161.

[29] The Supreme Court set out three bases on which a term could be implied: a presumed intention derived from custom or usage or, one necessary to promote business efficacy or; one necessary as a legal incident of a particular class or kind of contract. In the present context it would be futile to argue for an implied term that consent will not be unreasonably withheld.

[30] See "Enforcement of Due-On-Transfer Clauses," *supra*, note 8 at 909 et seq.

[31] California courts have been persuaded to refuse enforcement because of money-market conditions; see *ibid.* at 914 et seq. and text *supra*, note 19. Another ground stems from a sale where the property is worth less than the outstanding indebtedness and the vendor is not in a financial position to discharge the mortgage if the loan were called; see *ibid.* at 912 to 914. The writer is of the opinion that this circumstance does not justify non-enforcement of the clause. The interests of the lender remain paramount so far as it can be shown that the purchaser poses a

onus on the lender to prove "factual justification," that is, the reasonableness of the refusal in the circumstances. By this means lenders are required to prove that their legitimate interests are threatened by the sale of the equity to the prospective purchaser. If the onus of proof is not met, enforcement is deemed inequitable and the vendor is left free to transfer the property. Refusal is deemed justifiable on three grounds. The first applies to sales to high risk purchasers. Clearly proven credit risks enhance the chances of default and expose the lender to a greater risk of financial loss. Opponents of the "due-on-sale" may argue that as long as the vendor remains liable the lender's interests are not jeopardized.[32] However, that position is untenable in reality. Fleeing vendors, even if they remain liable, render the task of debt realization difficult. Moreover, in the residential situation it is most likely that the vendor will have purchased another home and thus be saddled with an additional mortgage obligation. In real terms the capacity of the residential vendor to satisfy both obligations, in whole or in part, must be regarded as limited. Finally, the traditional acceptance of the notion that the vendor is or should remain liable requires re-examination.[33] The second factual ground of justification relates to the possible exposure of the secured property to waste or depreciation. For example, the purchaser's contemplated use of the property may have a detrimental effect on its realizable value. It is not difficult to accept this ground of refusal. The secured property represents the principal means of debt realization. Everyone appreciates the fact that the continued solvency of the vendor and purchaser is a matter of speculation and one often beyond their control.

The third ground on which American lenders have satisfied the onus of proof arises from a refusal by the purchaser to enter into an assumption agreement.[34] This contract enables the lender to proceed against the purchaser in the event of default. Without it there could be no recourse against the purchaser because of the absence of privity of contract.[35] While there is good reason to believe that lenders should be permitted to withhold approval in these circumstances, the true issue is whether the vendor should be relieved of liability if the purchaser enters into an assumption agreement with the lender? That question is dealt with below in the context of continuing liability.[36]

The obligation imposed on lenders to justify their refusal to approve the purchaser and their demand for immediate payment of the outstanding indebtedness on what are considered legitimate grounds, leads one to ask what are considered illegitimate grounds of refusal. American litigation has focused primarily on the issue of interest rate capitalization. Under the majority position of automatic en-

---

threat to the former's interests.

[32] That argument has been accepted by American courts; see *ibid.* at 917.

[33] See text, *infra* note 46.

[34] Note that under our typical clause this requirement is a condition precedent to approval; see *supra*, note 5.

[35] In some provinces privity is created by statute where the purchaser has agreed with the vendor to assume the mortgage obligations; see text *infra*, note 44.

[36] See text commencing *infra*, note 40.

forcement, the American lender is permitted to capitalize on interest rate fluctuations in one of two ways.[37] First, by calling the loan and lending out at a higher rate and second, by negotiating for a higher interest rate with the purchaser. At the same time, the minority position acknowledges that a refusal based on the economic motive of capitalization is irrelevant.[38] The lender must still prove the reasonableness of the refusal on the grounds outlined previously. Indeed, the issue as to which of the parties should be permitted to capitalize on interest rate fluctuations has dominated American jurisprudence. As a general proposition it can be said that American courts have been persuaded that the lender's pursuit of economic advantage should not undermine either the validity or exercise of the clause. The following analysis seeks to demonstrate that the underlying basis for that approach is inapplicable in a Canadian context.

Today the typical American mortgage is one in which the amortization period of the loan and its fixed term coincide. Consequently, fixed terms of 15 to 30 years are commonplace. Only recently have American lenders offered shorter periods and resorted to variable rate mortgages in which periodic adjustment to market rates of interest is required. Nonetheless, consumer preferences and a reluctance to seek financing on these terms have resulted in the perpetuation of long-term fixed mortgage loans. American borrowers are protected against increased interest rate fluctuations, thereby insulated against the risk of unwieldy rates which would dramatically increase monthly payments. Their lenders, however, are exposed to a greater risk of loss which in some cases has been insurmountable. Fluctuations in economic activity and its causal effect on interest rate markets render mortgage lenders more vulnerable to collapse where their mortgage portfolios consist of low yielding interest rate loans.[39] Admittedly, the financial stability of American mortgage lenders, and in particular savings and loan institutions, may be considered a legitimate concern which supersedes the borrower's/vendor's interest in capitalizing on interest rates. But regardless of the validity of that economic argument, it is inapplicable to the Canadian mortgage market of today. By the 1970s the availability of long-term fixed mortgages had become an anomaly at some distance from what borrowers in this country can ever envisage as a realistic option. The typical purchase money mortgage obtained in respect of residential property is for a period rarely exceeding five years. Commercial lending practices are such that in exceptional circumstances that time period may be greater, but demand loans providing for periodic adjustment of interest are common. Of all the arguments that might be advanced by lenders withholding approval, the need to capitalize on interest rates is the least tenable. It would leave vendors with the *prima facie* right to take advantage of interest rate disparities. Under Canadian law that right is short lived once a "due-on-sale" clause forms part of the mortgage contract, in which case lenders may exercise their discretion reasonably or capriciously and without fear of challenge. The

---

[37]See Nelson and Whitman, *supra*, note 8 at 325.

[38]*Ibid.*

[39]*Ibid.* at 318 and notes 12 to 14. See also R.L. Cohen, "Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability," (1975) 27 Stan. L.R. 1109.

presence of a "due-on-sale" clause and an arbitrary refusal to approve the purchaser may, however, be more of a blessing to vendors once the law regarding their continuing liability is explained.

III. Vendor's Continuing Liability

Many a vendor has suffered under the mistaken notion that liability ceases once the property has been transferred to a purchaser willing to undertake the mortgage obligations. Many a solicitor has laboured under the same mistake.[40] This is not to suggest that under no circumstances will a vendor be relieved of liability should the purchaser subsequently place the mortgage loan in default. However, Canadian courts have not been consistent in determining the precise moment vendors are deemed to be relieved of liability. These inconsistencies are revealed in the following analysis structured according to three time frames when liability could cease: (1) at the time of sale; (2) at the time the fixed term of the loan expires; and (3) when the mortgage is repaid in due course. Separate treatment is accorded the law of Alberta and Saskatchewan in light of statutory provisions unique to those provinces.

(a) At the Time of Sale

The only 'sure fire' method by which vendors can be absolved of the risk of continuing liability is by having the lender agree to it, preferably in writing, with the purchaser entering into an assumption agreement with the lender.[41] The latter contract is necessary in order to establish privity of contract between the lender and the purchaser, thereby clothing the lender with the right to proceed against the purchaser in the event of default. A tripartite arrangement of this nature is termed an 'express novation.' It requires consent of all three parties and, in particular, the lender, who agrees to release the vendor of liability and accept the purchaser as the sole debtor. Whether a lender, on request, is prepared to release a vendor of liability is matter of speculation. But one should not readily presume that lenders will respond on the basis of altruistic considerations. The commercial reality is that lenders are not prepared, without more, to relinquish a right of recourse when no such obligation is imposed by law or contract. It is clear at law that simply because property has been transferred subject to an existing mortgage, the vendor is not to be released of liability.[42] Since there is no privity of contract between purchaser and lender, the latter is unable to sue the purchaser for the indebtedness or for a deficiency in the event of a forced sale. To hold both vendor and purchaser immune from liability would restrict the lender's debt realization options to the land itself and negate the effect of the vendors con-

---

[40] See Ontario Law Reform Commission, *Law of Mortgages Report, Director's Report on Issues and Agenda*, March 1982 at 61.

[41] The assumption agreement, as between lender and purchaser, is an enforceable contract. The consideration required at law stems from the lender's approval and in releasing the vendor of further liability.

[42] The "leading" case is *Forster v. Ivey* (1901), 2 O.L.R. 480 (C.A.). One must also bear in mind that a purchaser who buys subject to an existing mortgage may not have agreed with the vendor to assume the mortgage obligations.

tractual obligation to repay the loan. In terms of theory and practicality, this rule of law is not susceptible to criticism. But the continuing liability issue does not end here. If privity of contract between the purchaser and lender is established, such that the former assumes liability for the debt, then it is proper to ask whether the vendor is or should be released of liability.

Privity of contract between lender and purchaser may be established in two ways: by agreement and by legislation. An assumption agreement is often extracted by the lender without objection by the purchaser and without the lender agreeing to release the vendor of liability.[43] More importantly, there is no Canadian case which has relieved the vendor of its continuing obligation simply because the purchaser has entered into an assumption agreement. The same is also true should privity of contract be imposed by legislation. For example, the *Mortgages Act*[44] of Ontario permits the lender to sue either the vendor or the purchaser, but not both. While other provinces have adopted similar legislation, it differs only in that lenders are not required to make an election.[45] They can sue either party or both. But should the vendor be released in these circumstances? A negative response is easily justified. The lender having neither the right nor possibly the opportunity to determine the suitability of the purchaser should not be exposed to unknown risks. The decision to grant the mortgage loan was based initially on lending criteria applied in regard to the vendor, not the purchaser. The lack of a sound policy reason to support the negation of vendor liability should curtail further debate. But the presence of a "due-on-sale" clause invites further analysis.

Armed with a "due-on-sale" clause, lenders who after due consideration grant approval are no longer in a position to argue as convincingly that the sale poses a threat to their legitimate interests.[46] It is at this point that the vendor could be presumed to be released from future liability, provided the lender has obtained an assumption agreement from the purchaser or, alternatively, one is implied by statute.[47] Henceforth the purchaser could be regarded as the sole debtor. The validity of that argument does not rest exclusively on notions of policy. The legal basis for the argument is founded on the principle of 'implied novation.'

English law recognizes the possibility of an implied novation where it can be inferred from the creditor's conduct: "whether this inference is justifiable

---

[43] At law, and in the absence of a "due-on-sale" clause, this contract may wellbe considered a gratuitous promise unsupported by consideration and therefore unenforceable unless made under seal. However, that argument has not been subjected to judicial scrutiny and is irrelevant should privity of contract be imposed by statute.

[44] R.S.O. 1980, c. 296, s. 19.

[45] *E.g.*, *Land Titles Act*, R.S.A. 1980, c.L-5, s. 62(1).

[46] Lenders may be quick to point out that in cases where the purchaser's solvency is questionable, approval is being granted on the understanding that the vendor remains liable: That argument is addressed, *infra*, note 49 and text, *infra*.

[47] Admittedly the express assumption agreement is more attractive than that implied by statute. Invariably the latter refers only to the obligation to answer for the debt, whereas under the former the purchaser must answer for breaches of all obligations.

depends, of course, upon the circumstances."[48] The approval granted by a lender pursuant to a "due-on-sale" clause, coupled with the purchaser undertaking personal liability, may to some warrant the inference and finding of implied novation so as to release the vendor of future liability. Of course, it would be open for the lender to rebut that inference, for example, by expressly stating at the time approval is sought that it is conditioned on the vendor remaining liable.[49] Though no Canadian court has held a vendor to be released from liability at the time of the sale by expressly adopting the principle of implied novation, *Saskatchewan Trust Company v. Ross*[50] reached this result without using that legal justification. Regrettably, it did not distinguish between implied and express novation. The approval of the purchaser pursuant to a "due-on-sale" clause and the purchaser's willingness to assume liability simply amounted to a novation and hence the vendor was relieved of liability. Admittedly, even if Canadian courts were prepared to relieve vendors of liability, by an express finding of implied novation, that determination surely masks the policy rationale underlying its application. Implied novation represents the legal justification for allocating certain financial risks to lenders. The policy justification lies in the notion that users of "due-on-sale" clauses are better able and vested with the right to evaluate risks inherent in vendor financed sales. Vendors should not be exposed to future liability occasioned by the default of purchasers whom the lender has deemed earlier to be creditworthy. To maintain that both vendor and purchaser should remain liabile undermines the lender's legitimate reasons for extracting a "due-on-sale" clause in the first instance. Nonetheless, *Ross* stands alone in Canadian jurisprudence. In part this can be explained by the fact that in many instances the mortgage contract subject to litigation, and on which the vendor's continuing liability is premised, did not contain a "due-on-sale" clause. Accordingly, the lender had neither the right nor possibly the opportunity to adjudicate on the suitability of the purchaser. Hence, the novation argument is necessarily restricted to situations where the mortgage term expired and had been renewed with the purchaser but without the vendor's concurrence.

(b) Expiration of Fixed Term

Invariably, on expiration of the fixed term of the loan the lender extracts a renewal agreement (often referred to as a modification agreement) from the purchaser.[51] Under these contracts purchasers agree to assume the mortgage obligations, to renew the mortgage term for a further fixed period and, in many instances, to pay interest at a rate exceeding that specified in the mortgage. During the renewal term, the purchaser defaults. Canadian courts are divided as to whether the vendor's liability should cease at the moment of renewal. One group

---

[48]Cheshire, Fifoot and Furston's *Law of Contract* (London: Butterworths, 11th ed., 1986) at 510.

[49]*Quaere*--is not the lender in a better position to alert the vendor to the issue of continuing liability? In which case, both vendor and lender may be prepared to negotiate the issue of continuing liability.

[50](1985), 40 R.P.R. 213 (Sask. Q.B.).

[51]The following analysis is applicable equally to situations in which the terms of the mortgage contract are amended by the purchaser and lender, prior to the expiration of the fixed term of the loan.

refuses to recognize the principle of implied novation maintaining that if the vendor is to be released of liability the express consent of the lender is required and despite the fact that the lender had the opportunity to reject the purchaser and call the loan. As well, these courts have refused to accept an alternative argument derived from suretyship law, which requires explanation. Vendors have argued that once the property is sold they should no longer be regarded as principal debtors, but rather as quasi-sureties or guarantors. If the purchaser defaults during the original term, the vendor accepts liability. But once the mortgage is renewed and at a higher rate of interest, then on principles of suretyship law, the vendor/guarantor is released of liability unless the vendor has consented to any detrimental change in the underlying mortgage contract.[52]

In Nova Scotia the failure to obtain the vendor's consent with respect to the renewal agreement has not prejudiced lenders. In that province an express novation is required to relieve the vendor of liability. The implied novation and suretyship arguments have been rejected outright.[53] In Ontario, one trial court has upheld vendor liability after rejecting the suretyship argument despite detrimental changes in the renewal agreement as effected by the lender and purchaser.[54] And the Court of Appeal has effectively ruled that the vendor is not to be released unless there has been an express novation.[55] By contrast the appellate courts of British Columbia and Prince Edward Island have resolved the issue of continuing liability in favour of vendors where a renewal of the mortgage term has been effected at an increased rate of interest rate and without obtaining the concurrence of the vendor. The Prince Edward Island Court of Appeal has accepted the suretyship argument as a basis for eliminating vendor liability.[56] (More recently, the legislature of that province has enacted reform provisions which are discussed below.) The same result has been achieved by the British Columbia Court of Appeal. In three instances, the Court of Appeal applied the principle of novation but refrained from making any formal distinction between express and implied novation.[57] In New Brunswick, the law relating to continuing liability has yet to be

[52]The classic rule is: "that any alteration of the contract guaranteed, without the assent of the surety discharges him absolutely unless it be without inquiry evident that the alteration is unsubstantial," per Meridith C.J., *Farmers Loan and Savings Company* v. *Patchett* (1903), 6 O.L.R. 255 (Comm. Pl.) at 256, aff'd 8 O.L.R. 569 (C.A.). The mere extension of time is sufficient to discharge the guarantor unless there is a "reservation of rights" clause. That clause states that notwithstanding the agreement between the mortgagor and mortgagee to extend the term of the loan, it may be called if the guarantor requests the lender to do so; *Bristol & West of England Land Co.* v. *Taylor* (1893), 24 O.R. 286 (Q.B.). However, a "reservation of rights" clause does not protect the mortgagee when the rate of interest has been increased. In that cirucmstance the guarantors are released of liability unless their consent has been sought and obtained.

[53]*Central Trust Co.* v. *Bartlett* (1983), 30 R.P.R. 267 (N.S.C.A.).

[54]*Financeamerica Realty Ltd* v. *Holloway et al.* (1985), 53 O.R. (2d) 3 (H.C.).

[55]*Malaviya* v. *Lankin et al.* (1985), 53 O.R. (2d) 1 (C.A.); but note that the rate of interest was not altered, nor was a binding extension agreement concluded.

[56]*Royal Trust Corporation of Canada* v. *Reid et al.* (1985), 54 Nfld. & P.E.I.R. 201 (P.E.I.C.A.); 20 D.L.R. (4th) 223.

[57]In British Columbia the courts do not speak in terms of implied novation. Consequently, they have difficulty in reconciling the notion that on renewal a novation occurs, when in fact the vendor has not been consulted. Nonetheless, the same result is achieved regardless of the legal reasoning employed; *Bank of British Columbia* v. *Firm Holdings Ltd* (1984), 57 B.C.L.R. 1 (C.A.); *Canada Permanent Trust Company* v. *Neumann and Neumann* (1986), 8 B.C.L.R. (2d) 318 (C.A.) and *Bank of Nova Scotia* v. *Vancouver Island Renovating Inc. et al.*(1986), 6 B.C.L.R. (2d)

determined definitively. However, there are two appellate decisions which suggest that either the implied novation or suretyship defences may be available in certain instances.

In *Central & Eastern Trust Company v. Rosebowl Holdings Ltd*[58] the Court of Appeal upheld the liability of the vendor on the ground there had not been an express novation. The Court, however, left open the possibility of finding an implied novation: "There was no evidence of an express agreement between [the vendor and lender] nor do I think the evidence supports such an inference."[59] Indeed the facts of *Rosebowl* do not support such an inference. Though it appears that the purchaser entered into an assumption agreement with the lender, default occurred during the fixed term of the loan and there had been no modification of the original terms of the mortgage contract. Further, there was no evidence that the lender had the opportunity to approve the purchaser. Hence, the finding that the vendor remained liable cannot be faulted, leaving intact the possibility of releasing a vendor of liability on the principle of implied novation should the required facts be present.

Correlatively, the suretyship defence remains as an alternative ground for eliminating vendor liability. In a subsequent case,[60] the Court of Appeal held that a vendor was not liable for a deficiency arising from the forced sale of a property. Though the purchaser had agreed with the lender to assume the mortgage obligations, the mortgage had not been renewed with the purchaser. The lender did, however, provide the purchaser with a partial discharge with respect to part of the lands covered by the security document during the original term of the mortgage loan. The failure of the lender to obtain the consent of the vendor at the time the partial discharge was granted was a sufficient ground for holding that the vendor was to be relieved of liability in respect to the deficiency. It is true that the court did not characterize the vendor as a quasi-surety, nor expressly invoke suretyship principles but the analogy is obvious. In this regard it is to be noted that in the United States the suretyship rules are applied when resolving the issue of continuing liability.[61]

Canadian lenders have not been content to leave the continuing liability issue solely to judicial resolution. Recently drafted mortgage contracts contain a clause negating any existing or potential rule of law eliminating vendor liability. While the drafting varies, the clause provides in essence that where the property is sold any dealings between purchaser and lender, including renewal and alteration of the interest rate, will not in any way affect or prejudice the rights of the lender against the vendor. On the basis of such clauses vendors in Ontario and British

---

250 (C.A.).

[58](1981), 34 N.B.R. (2d) 308 (C.A.); app'd. *La Caisse Populaire De Saint-Jacques Ltee. v. Belanger et al.* (1986), 41 R.P.R. 216 (N.B.Q.B.).

[59]*Ibid.* at 315.

[60]*Traders Realty Ltd v. Dion et al.* (1986), 38 R.P.R. 195 (N.B.C.A.).

[61]See Nelson and Whitman, *supra*, note 8 at 305 et seq.

Columbia have remained liable.[62] A clause of this nature should deter any vendor from selling the equity of redemption and act as a catalyst for dormant law reform agencies.

(c) Discharge in Due Course

In those provinces where vendors are not released from liability at the time of renewal (Nova Scotia and Ontario), the obligation to pay continues until the mortgage has been discharged in due course.[63] In theory that period could encompass twenty years.[64] The only mitigating factor is that even where liability continues, the vendor is bound only to pay at the rate of interest originally agreed to in the mortgage contract. Undoubtedly vendors derive little consultation from that concession.[65]

(d) Alberta and Saskatchewan

The issue of continuing liability in Alberta and Saskatchewan attracts different considerations due to certain legislative provisions. In defined circumstances lenders are unable to maintain an action for the debt or for a deficiency in the event of a forced sale. In Alberta any mortgage granted by an individual on real property is subject to this legislated rule.[66] The Saskatchewan legislation differs to the extent that the mortgage loan must be for the purpose of purchasing the property.[67] Though, as a general proposition, non-corporate vendors are immune from liability, the position of lenders is all the more precarious should the purchaser pose a threat to their legitimate interests. Since lenders are restricted to realizing on the debt through foreclosure or sale of the property, they are vitally affected by improvident sales to high risk purchasers who increase the likelihood of default. Once it is recognized that land values may drop drastically, as happened in Alberta during the recent recession, it is not difficult to appreciate lenders' concerns over the financial ability of the purchaser to prevent the loan from going into default.[68] Hence the employment of "due-on-sale" clauses in these provinces assumes even greater relevancy. However, should the vendor be

---

[62] See *Malaviya* v. *Lankin et al., supra*, note 55 and *Eaton Bay Trust Co.* v. *King* (1987), 19 B.C.L.R. (2d) 245 (C.A.).

[63] *Supra*, notes 53 and 54.

[64] This is true of provinces in which the limitation period for a document under seal is twenty years. In theoretical terms it could even be longer once it is recognized that a cause of action does not arise until there has been default under the mortgage.

[65] This is not to suggest that the difference between interest accruing at the old rate and that under the renewed mortgage cannot be significant.

[66] *Law of Property Act*, R.S.A. 1980, c.L-8, as amended S.A. 1984, c.24, s. 41. The relevant provisions do not apply to a mortgage given under the National Housing Act (s.43(2)) and have been extended to security taken by approved lenders and insured under that Act: see Thijssen v. Galusha (1985), 59 A.R. 138 (Alta. Q.B.) and *Re Royal Trust Corp. of Canada and Vollan* (1985), 18 D.L.R. (4th) 312 (Alta. Q.B.).

[67] *The Limitation of Civil Rights Act*, R.S.S. 1978, c.L-16, s. 2(1).

[68] Property values in Calgary dropped by as much as 40%. As well, it must be recognized that some individual borrowers, with the financial capacity to honour the mortgage obligation, simply walked away knowing that they could not be sued.

outside the statutory protections, case law in Alberta does not provide a ready answer to the issue of continuing liability.[69] Recent cases have upheld liability on the part of the vendor because of the lack of express novation.[70] In Saskatchewan it is reasonably clear that the vendor will be released of liability at the time of renewal.[71]

IV. Reform Solutions

The disparate and unsatisfactory treatment accorded vendors under Canadian law demands legislative intervention which will balance the legitimate interests of vendors and lenders. Two provincial law reform agencies have responded to the inequities highlighted in the law reports--namely Ontario and British Columbia. Most recently, the British Columbia legislature has proclaimed into force statutory amendments which do not follow precisely the recommendations of its own law reform commission. As well, the government of Prince Edward Island has adopted reform legislation . The reform proposals and legislation must now be analyzed; thereafter, the framework for an alternative reform model is offered.

(a) Present Law Reform Solutions

The Law Reform Commission of British Columbia[72] released its proposal in 1985. While the Commission recognized the problem stemming from sales to uncreditworthy purchasers, no mention was made of the use nor effect of "due-on-sale" clauses. Hence, its proposal focused solely on the issue of continuing liability and one which was adopted subsequently by Prince Edward Island in the form of legislative amendments. The reform proposal and legislation provides:[73]

> A person who transfers land subject to a mortgage . . . ceases to be liable under the personal covenant in the mortgage . . . unless the mortgagee . . . makes a demand for payment for the sum secured on all persons who are personally liable for payment of the mortgage, within 3 months after the term of the mortgage . . . has expired.

The primary objection to this solution must be self-evident.[74] It leaves the vendor in the unenviable position of being called on to repay the loan at any time

---

[69] See generally E. Mirth, Mortgage Renewals in Alberta (1985), 23 Alta L.R. 405 at 414 to 426.

[70] See *Canada Trust Co. Mortgage Co.* v. *Stonewood Developments Ltd et al.* (1983), 29 R.P.R. 260 (Alta. Q.B.-M.C.) and *Paramount Life Insurance and Rocky Mountain Life Insurance Company* v. *Torgersen Development Corp. (Alberta) Ltd et al.* (1987), 51 Alta, L.R. (2d) 59 (Q.B.). The latter case rejects both the implied novation and suretyship arguments.

[71] See *Saskatchewan Trsut Company* v. Ross, *supra*, note 50. Note that at the time the mortgage in Ross was granted the anti-deficiency legislation did not apply to third party purchase money loans,but was restricted to loans in which the vendor had sold the property to the purchser who granted back a mortgage. This accounts for the fact that the original mortgagor/vendor in Ross was an individual, rather than a corporate vendor.

[72] Report on Personal Liability Under a Mortgage or Agreement for Sale (1985), L.R.C. 84.

[73] *Ibid.* at 36 and *Real Property Act*, S.P.E.I. 1987, c.R-4, s. 80.

[74] There is at least one positive feature of the proposals--lenders cannot require the borrower to waive the benefit

during the remaining term of the loan and up to three months thereafter. It falls short of balancing the interests of those affected by the issues, because it fails to pursue the possibility of eliminating vendor liability at the time of the sale and, in particular, when a lender is armed with a "due-on-sale" clause. Notwithstanding the recommendation of the British Columbia Law Reform Commission, the legislature of that province has recently enacted reform measures which modify and extend the Commission's solution. Moreover, some of those reform measures have been acted on by the Ontario Law Reform Commission. However, the Ontario proposals are broader in scope and provide a convenient backdrop for evaluation of the solutions ultimately adopted in British Columbia.

In the fall of 1987 the Ontario Law Reform Commission[75] published a comprehensive report on mortgage law in which the issues of continuing liability and those respecting the validity and exercise of the "due-on-sale" clause (referred to as an optional maturity clause) were addressed separately. The reform proposals were restricted to a class of borrowers deemed by the Ontario Commission to be in need of legislated protection. The proposals benefit the 'consumer,' now defined as the "protected borrower."[76] Though this class of borrower includes those who have given security on their single family residences, the definition is much broader in application. While a comprehensive analysis of the pervasiveness of status as "protected borrower" is beyond the scope of this essay, suffice it to say that the concept of protected borrower as defined by the proposals extends, for example, to certain small business loans secured by real property.[77] The rights of non-protected borrowers and their lenders will continue to be governed by the terms of the mortgage contract and the existing law of Ontario.

In the case of "protected borrowers," the Ontario proposals respecting the right to effect or prohibit a vendor financed sale are no more than a codification of the present law. In the absence of a "due-on-sale" clause the protected borrower retains the unfettered right to advance this type of financing.[78] On the other hand, lenders may bargain for such a clause in which case they retain the unfettered right to call the loan.[79] While the Commission did not address the possibility of imposing a reasonableness requirement with respect to approval, it did recognize that lenders could resort to the clause for the purpose of interest rate

---

of the proposals. That restriction eliminates the possibility of the lender requiring the vendor to remain liable even after the expiration of the prescribed limitation period.

[75]Report On the Law of Mortgages; Minister of the Attorney General (1987), hereinafter the "Ontario Report." With respect to the Commissions's recommendations, reference is made to the relevant sections of the "Model Act" provided therein.

[76]Defined *ibid.*, s. 1.1(13).

[77]Any mortgage (defined as a 'security agreement') granted or guaranteed by an individual to secure an amount which does not exceed that to be prescribed by regulation will qualify that individual as a protected borrower, irrespective of the purpose of the loan and whether the secured property is occupied by the borrower: see Model Act, *ibid.*

[78]See 'Ontario Report,' *supra*, note 75 at 87.

[79]*Ibid.*

capitalization. In an effort to balance the interests of the parties,the Commission decided to impose a 'down-side' risk on lenders who employ that clause.

Lenders who extract a "due-on-sale" clause will find that vendors wishing to effect a conventional sale of their property can prepay the loan in full and without offering prepayment compensation.[80] Hence in those instances where the mortgage is fully closed (no right of prepayment) and whereinterest rates have declined since the mortgage was granted, vendors need not compensate lenders for the financial loss arising from early repayment. In other words, a "due-on-sale" clause transforms a 'closed mortgage' into an open one. Under the proposed scheme lenders are damned if they do and damned if they don't bargain for a "due-on-sale" clause.

Should this proposal become law, one must ask whether lenders will respond by requiring protected borrowers to pay the increased price of an open mortgage in the event the lender insists on the insertion of a "due-on-sale" clause. In turn, will lenders be prepared to offer, open mortgages for a five year term? One has only to look at the financial section of our national newspaper to appreciate the fact that the notion of a five-year open mortgage is pure fantacy. At present, Canada's national lending institutions are unwilling to grant that privilege unless the mortgage term is for a period not exceeding one year. In the circumstances, it is unlikely that the Commission's recommendations will be readily embraced by either "protected borrowers" or their lenders. Of course borrowers who do not come within the protected category will remain subject to the common law which is clearly lender-oriented.

The manner in which the issue of continuing liability is attacked by the Commission is more defensible. Under the proposals protected borrowers wishing to be relieved of liability, at the time of sale, must seek the lender's consent to the assumption of the mortgage by the purchaser. The issue of continuing liability is then resolved in the following manner.[81]

> (1) If the lender does not respond to the request within the allotted time, consent is deemed to have been granted and the protected borrower is relieved of future liability.
>
> (2) If the lender consents, the protected borrower is relieved of future liability.
>
> (3) If the lender refuses consent, the protected borrower or lender may apply to the court for a determination regarding the reasonableness of the refusal. The lender is obligated to satisfy the court that the refusal is based on commercially reasonable grounds materially affecting the

---

[80] Model Act, *supra*, note 75, s. 5.3. The borrower must be selling the property in good faith to an unrelated purchaser, see s. 5.3(2).

[81] Model Act, *ibid.*, s. 5.5.

lender's risk under the mortgage. If the lender fails to meet the onus of proof, the protected borrower is relieved of liability. If, however, the lender meets the onus of proof, a sale may proceed but the protected borrower remains liable.

(4) If the lender refuses consent and the protected borrower does not apply to the court for a determination, and proceeds with the sale, the vendor remains liable unless it can be proven in any subsequent action brought by the lender that consent ought to have been granted. However,that defence is unavailable if the protected borrower has failed to seek consent in the first instance.

(5) In cases where the protected borrower remains liable, liability ceases within six months of the expiration of the mortgage term (e.g., when the purchaser renews the mortgage loan) unless the lender demands payment from the protected borrower within that time period.

Despite the fact that the proposed scheme provides a means by which the protected borrower can be relieved of liability, it is contingent on the protected borrower seeking the lender's consent in the first instance. Had the Commission required that consent be sought in all cases, the reasonableness requirement could have been imposed for the purpose of determining whether the lender's objections to the purchaser are valid, whether the lender should have the right to call the loan or alternatively whether the vendor should be released of future liability. Under the Commission's scheme, lenders must realize that sales to financially irresponsible purchasers are permitted, notwithstanding the fact that protected borrowers should be reticent in persisting with a sale which exposes them to continuing liability. To avoid sales to high risk purchasers and a debate as to the reasonableness of a refusal, lenders must bargain for a "due-on-sale" clause. Those who do must bear the risk of a vendor prepaying a closed mortgage at a time when market rates of interest are lower than that found in the mortgage. It would appear that under the Commission's proposals, neither protected borrower/vendor nor lender will be placated.

In 1986, prior to the release of the Ontario Report the British Columbia government introduced reform legislation which did not come into effect until December 1, 1988. Though the relevant amendments to the *Law and Equity Act*[82] reflect the Commission's earlier recommendation to extinguish vendor liability, if demand for payment has not been made within three months after the expiration of the fixed term, that recommnendation has been qualified so that it applies only in the case of sales of the equity involving "residential mortgages." While that restrictive criterion may be regarded as one means for determining the sophistication of vendors, it lacks the clarity of the Ontario proposal which distinguishes between the protected and non-protected borrower by offering an exhaustive definition of those who fall within the former category. By comparison,

[82] R.S.B.C. 1979, c.224, s. 20.2.

the legislation of British Columbia prescribes no meaning for the term "residential mortgage." Can one assume that the amendments are applicable only if the property is owner-occupied? Alternatively, are they applicable to multi-unit dwellings, none of which is occupied by the mortgagor/vendor? Moreover, the fact that the amendment dictates that a "person ceases to be liable" leads one to conclude that corporate borrowers of residential buildings may come within the protection of the reform legislation. In certain respects the government of British Columbia would have been better advised to follow the recommendation of its own Law Reform Commission.

At the same time, reform in British Columbia is not restricted to the elimination of vendor liability three months after the mortgage has been renewed. Future liability may, in the case of "residential mortgages," cease at the time of the sale should the vendor seek and obtain the approval of the lender with respect to the assumption of the mortgage by the purchaser.[83] If approval is refused, the vendor may apply to the court and be relieved of liability providing that it can be shown that approval had been unreasonably withheld. Though the relevant provision of the *Law and Equity Act* lacks the sophistication of the Ontario proposal outlined above, it seeks to achieve the same objective, albeit generating the very criticism levelled at the Ontario proposal. However, the British Columbia legislation does not address the issue in the context of lenders who have bargained for a "due-on-sale" clause. In this regard, it remains to be determined whether a lender will be able to elect to call a loan secured by a residential mortgage, by invoking the "due-on-sale" clause, should the vendor persist with an application to the court for a determination with respect to the suitability of the purchaser. It is arguable whether the statutory right to challenge the lender's reasons for withholding approval should, as a matter of policy, be available even where the lender elects to call the loan on the basis of a "due-on-sale" clause. Admittedly, the Ontario proposals undermine the validity of such an argument but only because separate treatment is accorded "due-on-sale" clauses in that province. In regard to the British Columbia legislation, one must ask whether lenders should be able to undermine a consumer protection scheme by resorting to "due-on-sale" clauses. If lenders in British Columbia are concerned with the possibility of the foregoing argument finding judicial acceptance, consolation may be found in the knowledge that there is no impediment to the insertion of a clause in the mortgage contract by which the borrower waives the right to pursue a court challenge to the lender's refusal to approve a purchaser. That conclusion derives from the fact that the Act expressly excludes the possibility of the vendor granting a waiver, at the time the mortgage is granted, with respect to liability ceasing three months after the expiration of the mortgage term.[84] However, the Act is silent with respect to the possibility of obtaining a waiver of the vendor's right to have a court adjudicate on the reasonableness of a refusal to approve. In such circumstances, it is not unreasonable to speculate that lenders will resort to a boilerplate waiver clause for

---

[83] *Ibid.*, s. 20.3.

[84] See *ibid.*, s. 20.2(4), but note that waiver is possible if entered into by the original parties to the mortgage after the sale of the equity.

the purpose of negating the right of a vendor to resort to a statutory scheme by which personal liability may be eliminated at the time of the sale.

(b) Towards a Reform Model

One of the major obstacles to effective law reform is prescribing a scheme which protects the interests of both parties, without restricting the freedom of those able to determine their own solutions. That obstacle is one which must be overcome, but the specific manner in which it is to be achieved is the principal source of controversy. To date, law reform proposals and reforming legislation have focused on the following problems; the validity and exercise of "due-on-sale" clauses, the moment vendor liability should cease in the absence of an agreement and a mechanism by which vendors can have the issue resolved at the time of the sale. However, the panaceae offered fail to recognize that the issues generated by this method of sale financing might not arise if vendors were apprised of the potential risks prior to entering into an agreement for sale of the equity. Indeed, one may speculate that many a vendor would have abandoned the opportunity to capitalize on interest rate disparities had they appreciated the financial risks embodied in the notion of continuing liability. For the unsophisticated vendor, these risks are simply too great and cannot be measured in terms of who has the better right to capitalize on interest rates. Hence, any reform model should seek to ensure that vendors do not resort to a sale of the equity unless cognizant of its legal implications, including continuing liability, before entering into a binding agreement for the sale of the equity.

During the last two decades, law reformers have endorsed a requirement that one party to a contract disclose certain information which is deemed of fundamental significance to the other party. In the present context, such a requirement is warranted except to the extent that the disclosure responsibility be imposed on lenders. The express duty to advise vendors of the possibility of future liability should lie with those who undertake the drafting of an agreement for the sale of the equity, that is, either real estate licensees or the vendor's solicitor. Moreover, a breach of that statutory duty should entitle vendors to claim indemnification in the event they are called on to compensate the lender with respect to any loss arising after the default of the purchaser. The right to indemnification should, however, be denied where it can be shown that, notwithstanding the breach of the statutory duty, the vendor was aware of the risks inherent in this method of real estate finance prior to entering into the contract of sale.

The immediate objective of this reform proposal is to enable vendors to make informed decisions even if it has the effect of discouraging sales of the equity. The fact that this proposal seeks to place liability on those who fail to fulfill the statutory duty may to some require justification. In response, one must ask whether such a duty already exists at law. In the case of solicitors and real estate licensees, a failure on their part to advise a client of the potential risks inherent in vendor financed sales, can be viewed as an omission giving rise to liability in the event a vendor is called on to compensate a lender. Certainly members of the medical profession remain exposed to liability for failing to explain fully the risks

inherent in pursuing a medical procedure or when prescribing a medication. Why should the vendor's advisor be treated in law any differently? Once an express duty to advise is imposed, and assuming that the obligation is honoured, any sympathy that one might have for vendors is diminished by the fact that those who proceed with such sales do so in the knowledge of their potential for liability. Nonetheless, this proposal does not dispense with the need to determine the moment vendor liability should cease regardless of the knowledge possessed by the vendor at the time of the sale. Present law reform solutions dictate that liability should cease at the time of renewal if demand for payment is not made within a specified number of months after that date. The writer agrees with this proposal. But the true debate will focus on whether relief should apply only to unsophisticated vendors, be they defined as "protected borrowers" or those who have granted "residential mortgages." The politics of law reform and the problem of formulating a definition which is neither over nor under-inclusive require that this policy debate be resolved elsewhere. At the same time, it must be recognized that the possibility of eliminating vendor liability at the time of the sale must be pursued.

The presence of a "due-on-sale" clause serves as a further means of bringing the issue of continuing liability to the attention of the vendor, assuming that the purchaser's solicitor discover its presence prior to the closing of the transaction. From the lender's perspective, it serves as a means for eliminating sales to uncreditworthy purchasers. In developing a reform model, the validity of the clause must be addressed. There is little doubt that it serves a legitimate purpose; avoidance of greater risk exposure. As well, the American notion that the clause constitutes an indirect restraint in light of restricted mortgage money markets is, at the moment, irrelevant in the Canadian context. Accordingly, we must accept the validity of the clause and under the reform model go so far as to deem the parties to have agreed to such a clause in the event the lender has failed to include one in the mortgage contract.

The next issue is whether courts should be permitted to adjudicate on the reasonableness of a refusal. Though the majority of American courts have rejected this possibility, the economic rationale underlying judicial deference, that is, the need for lenders to capitalize on interest rates must be ignored when developing a Canadian reform model. There are other arguments to be advanced in support of a legislative solution which invites judicial scrutiny with respect to the reasons offered by lenders refusing approval. In part they address the issue of continuing liability.

Vendors might argue that without legislative protection, lenders will simply withhold approval unless vendors agree to remain liable even though the proposed purchaser poses less risk than does the vendor. Alternatively, lenders will be predisposed to capitalize on interest rates. After all, lenders are profit motivated, why would they not wish to take advantage of the opportunity of capitalization when the law does not prohibit such? More importantly, the possibility that lenders will discriminate against members of a class of purchasers persists. Furthermore, any notion that borrowers are in a position to negotiate at the time

of the loan application, with respect to these issues, is misconceived. Institutional lenders are not prepared to deviate from 'boilerplate' clauses which serve their interests. The borrower's option is to accept or reject the loan on the terms offered. Ultimately the reform model must either reject or accept the notion that lenders should possess the unilateral right to either approve the purchaser or call the loan. In reaching a decision the possible policy arguments to be advanced by lenders in support of that right must be outlined. Lenders may argue, as some have, that they have no desire to capitalize on interest rates.[85] Their concerns must stem from a proposal which enables the court to "second guess" a financial decision made in a responsible manner. Moreover, there will be instances where approval is being granted on the basis that the vendor remains liable; a right which may be expressly provided for in the mortgage contract or, alternatively, one that the vendor bestows willingly on the lender at the time of sale in order to obtain approval. The issue is complicated further should the loan be guaranteed by a third party. Should the reform model relieve the vendor of liability, guarantors would undoubtedly be accorded similar treatment. In situations where the purchaser's solvency remains a matter of speculation, parties should be able to reach a compromise which includes the vendor's and guarantor's agreement to remain liable. Certain lenders might argue that there are secured lending transactions in which they should have not only the contractual right to refuse approval, but also the right to prohibit a sale. Participation mortgages, in which the lender shares in the revenues derived from the mortgaged premises, should not be subject to a scheme which restricts the lenders right to insist that the vendor retain ownership.[86] In the alternative, the lender should at least retain an unfettered discretion to determine the suitability of the purchaser. Finally, consideration must be given to the fact that not all lenders are as sophisticated as those who fall within the 'institutional' category. There are private lenders engaged in isolated security transactions who possess neither the acumen nor the means for determining the suitability of the purchaser.[87] Finally, it could be argued that no lender should be subjected to risks imposed by courts which do not have to answer for their errors other than by appellate review. Of course, court supervision of the lender's exercise of the "due-on-sale" clause is both time consuming and costly. The manner in which the policy debate may be resolved encompasses at least two options.

A reasonableness requirement could be imposed subject to certain guidelines. For example, if there is a reasonable doubt with respect to whether the lender's interests are threatened, the court must decide in favour of the lender and permit the lender to call the loan. Alternatively, the court could permit a sale provided that the vendor and guarantors agree to remain liable and the sale does not expose the lender to a greater risk of loss. Liability would continue up until

---

[85] See Ontario Report, *supra*, note 77 at 85.

[86] Participation mortgages should be excluded from any reform proposals except to the extent that they may presently offend the equitable rules relating to 'cloggs and fetters' on the equity of redemption. Such rules should play no part in the determination as to the validity of such mortgage contracts.

[87] Of particular concern are secured loans between family members.

the time the debt obligation was fully paid. In the event the lender's refusal was deemed unreasonable, the vendor would be permitted to sell and freed of the risk of potential liability. Pursuant to this scheme, private lenders could be deemed 'exempt' provided that a workable definition for 'private lender' can be circumscribed. Similar treatment would be accorded sales which involve participation mortgages. Second, the reform model could adopt the Ontario proposal to the extent that it distinguishes between consumer and commercial transactions. The rights of the so-called "protected borrower" would be governed in the manner outlined above. The major difference between this proposal and that offered by the Ontario Law Reform Commission lies to the fact that lenders with a "due-on-sale" clause would not retain the unilateral right to decide whether a sale of the equity will be permitted. Commercial borrowers would remain subject to the terms of the contract and the common law. Whether or not this option is preferable to the first is dependent on the validity of a policy which denies commercial borrowers the benefit of the legislation. As noted earlier that policy debate must be resolved elsewhere. But lenders should have no objection to a scheme which would relieve, for example, residential vendors of liability and impose liability on creditworthy purchasers. In the residential situation, it is most likely that vendors will have purchased another home secured by a mortgage. In real terms their capacity to satisfy both obligations, in whole or in part, must be regarded as limited. Obviously, the diversity and complexity of interests which must be balanced renders the task of reform difficult. Moreover, the realization of law reform objectives is ascerbated by the presence of corrolary issues. This essay has examined the issues in the context of a voluntary sale to a purchaser at "arm's length." But what of involuntary transfers including the death of the vendor, a sale to a subsequent mortgagee, a sale under a power of sale conducted by a second mortgagee, a transfer stemming from the dissolution of a marriage or one arising from the granting of a subsequent mortgage. While these possibilities cannot be ignored, they should not undermine the need to search for the appropriate solution to the issues raised initially.

V. Conclusion

With the approbation of the courts lenders have been able to diminish or eliminate the potential risks arising from sales of property subject to existing mortgages. Correlatively, their ability to discriminate against classes of purchasers remains, as does the right to capitalize on interest rate fluctuations. On the other hand, vendors who have the right or are granted approval to effect a sale of the equity face the continuing threat of being called on to answer for the debt. At most vendors in some provinces can expect to be relieved of liability at the time the purchaser renews the mortgage. But that possibility is short lived in the event the mortgage contract dictates otherwise. For many liability will continue until the loan has been repaid, regardless of the number of times the original term has been renewed. Acknowledging that the present law is distinctly one-sided only the most astute of vendors should be prepared to offer this method of finance. Though the need for law reform is evident, the reform proposals to date fail to properly balance the legitimate interests of those affected, including lenders. Despite the inherent difficulties of devising an acceptable solution, they are not

insurmountable. Eliminating the possibility of lender abuse of the "due-on-sale" clause remains as one objective as does the need to ensure that the issue of continuing liability is at the outset brought to the attention of vendors, and resolved at the time of the sale.