

## COMMERCIAL

### The Building I Rent for Business is Being Foreclosed On. Do I Have to Leave?

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#### 1. Introduction: Research Materials

Undoubtedly because of the length of the present recession, the above question has become an increasingly important one for lawyers. In legal terms, the question may be characterized as one touching upon both landlord and tenant law and mortgages law. My starting point was to review the two best known Canadian textbooks in both these areas: *Falconbridge on Mortgages*<sup>1</sup> and Williams and Rhodes, *Canadian Law of Landlord and Tenant*.<sup>2</sup> These texts provide a good general outline of the applicable law.<sup>3</sup> Because these texts are primarily concerned with the law of Ontario, I then turned to the legislation of Nova Scotia that might be applicable to this question. That research identified the *Registry Act*<sup>4</sup> and *Real Property Act*<sup>5</sup> as

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<sup>1</sup> Canada Law Book, 4th ed., 1977. See in particular Chapters 15 and 25 which address the questions of leaseholds and parties to foreclosure. See also, pp. 522-523 which address the law of Nova Scotia with respect to foreclosure proceedings.

<sup>2</sup> Carswell, 6th ed. 1988. See Chapter 5.

<sup>3</sup> See also Fordham, A.G.H., "Foreclosure and Sale in Nova Scotia" (Address to the Real Property Conference, Continuing Legal Education Society of Nova Scotia 1982); MacIntosh, Charles W., *Nova Scotia Real Property Practice Manual* (Toronto: Butterworths, 1988)

<sup>4</sup> R.S.N.S., 1989, c. 392, ss. 18, 25.

<sup>5</sup> R.S.N.S. 1989, c. 385, s.25.

well as the Rules of Civil Procedure<sup>6</sup> as having some bearing. Finally, I reviewed applicable case law through a review of the Canadian Abridgment, the Real Property Reports Index and The Nova Scotia Reports Index. That review disclosed a number of relevant cases. Of special interest in this province, however, is the Nova Scotia Court of Appeal decision of *Devan Properties Limited v. Metropolitan Stores of Canada Limited*<sup>7</sup>.

In responding to the question posed, the first matter to be addressed is whether the tenant's lease preceded or followed the mortgagee's interest in the land. The applicable law differs depending upon the response to this matter. We begin with a consideration of the common law position in the event that the lease precedes the mortgagee's interest in the premises. That position is affected by the probable application of sections 18 and 25 of the *Registry Act*.

## 2. Lease Precedes the Mortgagee's Interest in the Land.

In entering into a mortgage, the mortgagor conveys their interest in the real property at issue to the mortgagee, retaining possession and the equity of redemption. If the mortgagor has leased the relevant property to a tenant prior to entering into the mortgage, the mortgagor is only able to convey to the mortgagee an interest that is subject to that leasehold arrangement; i.e., the mortgagor may only convey a reversion to the mortgagee. In practical terms, the tenant's right to possess the land is paramount to that of the mortgagee such that if there is foreclosure, the mortgagee will be subject to the terms of the lease. As expressed in *Falconbridge on Mortgages*, the point is made as follows:

If the owner of land free from encumbrance grants a lease of the land, and afterwards mortgages it, the mortgage affects merely the reversion retained by the mortgagor. The right of the lessee to possession in such case is paramount, and the rights of the

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<sup>6</sup> See in particular, R. 5.13(4).

<sup>7</sup> *Devan Properties Limited v. Metropolitan Stores of Canada Ltd.* (1988), 1 R.P.R.(2d) 244, 88 N.S.R.(2d) 129 (C.A.); affirming (1988), 87 N.S.R. (2d) 43. In this paper, reference is made to the R.P.R. cite.

mortgagee to possession and to have recourse to the land for recovery of the mortgage money are subject to the right of the lessee.<sup>8</sup>

Despite foreclosure proceedings, the mortgagee will remain subject to the lease where it precedes the mortgage. Absent considerations of the *Registry Act*<sup>9</sup> then, it is clear that the tenant is not required to leave the property so long as acting in accordance with the terms of the lease. It may be, of course, that the mortgagee can require that the rent payments be directed to the mortgagee rather than the mortgagor, but that is another matter.<sup>10</sup>

The *Registry Act* changes the common law priorities of time as between the tenant and the mortgagee in cases where the lease is for a term longer than a three years. The effect of this Act is likely to be significant since many, if not most, commercial leases will exceed such a term. Sections 18 and 25 of the Act provide as follows:

s. 18. Every instrument shall, as against any persons claiming for valuable consideration and without notice under any subsequent instrument affecting the title to the same land, be ineffective unless the instrument is registered in the manner provided by this Act before the registering of such subsequent instrument.

s. 25. Every lease of land for any term exceeding three years shall, as against any person claiming under any subsequent instrument, be ineffective unless registered in the manner provided in this Act previous to the registering of such subsequent instrument.

In short, if a lease of three years or more is unregistered, it will be ineffective as against the mortgagee who enters into and registers a

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<sup>8</sup> *Supra*, footnote 1 at p. 320. See also p. 465 for a similar statement in the context of foreclosure.

<sup>9</sup> *Supra*, footnote 4.

<sup>10</sup> For a discussion of this question, see *Falconbridge on Mortgages, supra*, footnote 1, a pp. 322-24.

mortgage.<sup>11</sup> The common law described above will only be applicable in the event that the lease is registered prior to the mortgage agreement. An interesting case involving the application of the *Registry Act* in this context is the British Columbia case of *Canada Trustco Mortgage Co. v. Park Plaza County Club Holdings Inc.*<sup>12</sup> In that case, the plaintiff mortgagees had registered their mortgage prior to the defendant's lease. At a date following the registration of the lease, the plaintiff entered into modifications of the mortgage agreement. Changes were made to the interest rate and the due date. Additional security was required and one of the parties to the mortgage was replaced. The plaintiffs argued that the mortgage took priority over the defendant's lease because it was registered first. The defendant in turn argued that the changes to the mortgage constituted a novation and as such, the mortgage was subject to the now prior lease. In the result, the terms of the mortgage which were unaffected by the modifications continued to have priority over the lease while the lease took precedence over new terms of the mortgage.

### 3. Mortgagee's Interest in Land Precedes the Leasehold.<sup>13</sup>

Where the mortgagee's interest in the land precedes the lease, the mortgagor has only a portion of the equity of redemption. As such, the lease is not generally binding upon the mortgagee. Williams and Rhodes, *The Canadian Law of Landlord and Tenant* puts the matter as follows:

If the land is already mortgaged at the time the lease is made, the lease will be subject to the rights of the parties to the mortgage

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<sup>11</sup> For a case involving the matter of notice, see *Alberta Agricultural Development Corp. v. Martin* (1990), 104 A.R. 238 (Master).

<sup>12</sup> (1988), 28 B.C.L.R.(2d) 98 (B.C.S.C.). Another case involving the application of the *Registry Act* is *Walker v. Cote* (1932), 41 O.W.N. 313 (H.C.). It might also be suggested that the case of *Devan Properties Limited*, *supra*, footnote 7, addresses problems associated with the failure to register. The case is discussed in the next section of this paper.

<sup>13</sup> It is presumed in this portion of the paper that the mortgage is properly registered and that there are no priority issues of this kind.

unless all such parties join in the lease, but this statement may call for variation by reference to the statutory or contractual powers of of the mortgagor and mortgagee. In the case of a lease made by a mortgagor after a mortgage, the mortgagee being assignee not of the reversion but of the whole estate of the mortgagor, may treat the tenant as a trespasser and eject him without notice.<sup>14</sup>

The above commentary is, however, deceptively simple in suggesting that a mortgage preceding the lease will have paramountcy over the lease in all circumstances and that the mortgagee may force the tenant to leave. In fact, in some circumstances, the tenant may not be required to leave. Three further matters must be considered.

(a) Foreclosure and the Tenant's Right to Redeem

As noted, because the mortgagor has the equity of redemption in the mortgaged property, upon entering into a lease with the tenant, the tenant acquires a partial transfer of the equity of redemption. That has significant consequences in terms of the exercise of foreclosure by the mortgagee. In general terms, the equity of redemption allows the mortgagor to recover the land upon payment in accordance with the terms of the mortgage and this right continues even after there has been a default under the mortgage and foreclosure proceedings commenced. Describing the specific case of Ontario, *Falconbridge on Mortgages* states the rights of the *lessee* as follows:

The lessee is a purchaser of the equity of redemption *pro tanto* and is entitled to redeem. He is therefore a necessary party to an action for foreclosure or sale...It is necessary to make the tenant a party no matter how long or short his term may be, if the

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<sup>14</sup> *Supra*, footnote 2, para. 5:1. See also *Falconbridge on Mortgages*, *supra* footnote 1 at pp. 320 and 326. Cases supportive of this general proposition include *Devan Properties Limited v. Metropolitan Stores of Canada Ltd.*, *supra*, footnote 7, *Dudley and District Benefit Society v. Emerson*, [1949] Ch. 707 and *Aitkenhead v. Spivak*, [1931] 4 D.L.R. 174 (Man. C.A.).

mortgagee desires to affect him by the proceedings and to compel him to give up possession of the mortgaged lands.<sup>15</sup>

The situation is somewhat different procedurally in the province of Nova Scotia in that the lessee need not be made a party to the foreclosure proceedings. Nonetheless, notice must be given and the lessee would seem to have a right to apply to the court to redeem the mortgage. Reference must, in this regard, be made to R. 5.13(4) of the Rules of Civil Procedure:

R. 5.13(4) It shall not be necessary to make beneficiaries or subsequent encumbrancers defendants in a proceeding for foreclosure or foreclosure and sale, but the court may direct notice to be given to the beneficiaries or subsequent incumbrancers by mailing by ordinary mail a copy of the order and advertisement of sale, and after making of the copies any beneficiary or subsequent incumbrancer shall be bound by the proceedings in the same manner as if he had originally been made a party, and any person may within one month thereafter apply to the court to discharge, vary, add to the order, or for such other relief in the proceeding as he is entitled to, and the court may make such order as is just.

Thus, the lessee would seem to be able to redeem the mortgage in Nova Scotia even after the commencement of foreclosure proceedings. In practical terms, however, that means that, subject to any defences under the mortgage itself, the tenant must pay the amounts owing under the mortgage in order to "step into the shoes" of the mortgagee and retain the possession of the land. As such, the right to redeem is of limited use unless the commercial lease is a very valuable one.<sup>16</sup>

The discussion in *Falconbridge on Mortgages* continues by noting that in Ontario, the right to redeem is such that if the tenant is not made a party to the proceedings, the tenant may be able to reopen the proceedings and

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<sup>15</sup> *Falconbridge on Mortgages*, *supra* footnote 1, p.465. Cases cited for this proposition include *Collins v. Cunningham* (1892), 21 S.C.R. 139 and *Capital Trust Corp. Ltd. v. McGuigan*, [1934] O.W.N. 656 (H.C.J.).

<sup>16</sup> *Ibid.*

redeem.<sup>17</sup> In Ontario, however, the original foreclosure proceeding operates by way of an *order nisi* or interlocutory judgment and allows redemption within a certain period of time mentioned in the order. A further order is then required to make foreclosure absolute. The situation in Nova Scotia is somewhat different and is described by *Falconbridge on Mortgages* as follows:

The adjudication of foreclosure under the Nova Scotia order is, however, subject in effect, if not in terms, to the provisions which the order also contains directing, *inter alia*, a sale by the sheriff, unless in the meantime the party entitled to do so pays the amount due with costs; so that the order may be said to be *nisi* only, and not absolute, because the right to redeem exists until the sale under the decree.<sup>18</sup>

Reference in this regard must be made to R. 5.13(4) of the Rules of Civil Procedure (already cited) and s. 25 of the *Real Property Act*<sup>19</sup>:

s. 25 (1) Where by reason of any of the rules of the Supreme Court, providing that it shall not be necessary in certain cases to make encumbrancers, beneficiaries, widows, devisees or heirs parties to actions for foreclosure and sale of mortgaged lands, such persons are not made parties, such lands are sold in any such action, and a deed thereof executed, the deed shall be effective to convey to the grantee all the interest in the land so sold of all such encumbrancers, beneficiaries, widows, devisees and heirs at law as if they had been parties to the action.

(2) No sale or deed of land heretofore made shall be deemed invalid by reason only that any such person mentioned in this section was not made a party to the action, and every such deed shall be deemed to have vested in the grantee all the interest of any such person in the land.

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<sup>17</sup> *Ibid.* The case cited for this proposition is *Martin v. Miles* (1883), 5 O.R. 404 (Ch.D.).

<sup>18</sup> *Ibid.*, pp.522-523, citing *Pew v. Zinck and Lobster Point Realty Corp.* [1953] 2 D.L.R. 337 (S.C.C.). See also *Devan Properties Limited*, *supra*, footnote 7 at p. 257. In his reasons, Matthews, J.A. refers to a 1982 paper given at the C.L.E. entitled "Foreclosure and Sale in Nova Scotia" by Fordham, *supra*, footnote 3. The reader might also wish to refer to this more general paper on this issue.

<sup>19</sup> R.S.N.S. 1989, c. 385.

In essence, it was this particular point that was at issue in the case of *Devan Properties Limited v. Metropolitan Stores of Canada Limited*.<sup>20</sup> It is perhaps worth setting out a substantial portion of the head note of that decision:

In February 1973 the appellant entered into an offer to lease retail space in a shopping centre for a term of 25 years from the owner of the space, N.Ltd. That offer was never recorded. In July 1974, N.Ltd. granted a mortgage to N.Co. and E.Co. The mortgage was recorded the same month. The appellant and N.Ltd. entered into a written lease for a term of 25 years from February 1, 1975, in August 1974. N.Co. and E.Co. were not parties to the lease, which was not recorded until May 1983. In May 1987, foreclosure proceedings were commenced by N. Co. and E.Co. against N.Ltd. In July 1987 an order for foreclosure and sale was granted. The order did not make the sale subject to the lease. Notice of sale was mailed to the appellant as a subsequent encumbrancer and the appellant decided not to intervene in the foreclosure proceedings, believing its lease would be protected by a non-disturbance agreement which they entered into with N.Co. and E.co. in July 1975, which agreement was not recorded.

The mortgaged property was sold to a numbered company in September 1987 and that sale was ratified and confirmed in December 1987. The respondent entered into an agreement to purchase the shopping centre in March 1988 and informed the appellant that it considered the lease no longer enforceable. The appellant refused to surrender its tenancy and the respondent sought a declaration that the lease between N.Ltd. and the appellant was void as against the respondent. The respondent argued that through the numbered company it could rely upon the sheriff's deed to obtain title, which was not subject to any leases entered into or recorded after the mortgage or to the unrecorded non-disturbance agreement. The appellant claimed lease protection not only through the mortgagor but also through the mortgagees, who allegedly desired and authorized the lease. The order desired by the respondent was granted, and the appellant appealed.

**Held** - The appeal was dismissed.

The effect of the foreclosure order was to extinguish the equity of redemption in the property held by the mortgagor. Neither the foreclosure order nor the sheriff's deed made the sale subject to the lease or the unrecorded non-disturbance agreement and there was no evidence that the numbered company had actual notice of the appellant's lease. The appellant had notice of the foreclosure and sale proceeding and failed to apply within

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<sup>20</sup> *Supra*, footnote 7.



the one month provided by Civil Procedure R. 5.13(4) to discharge, vary, or add to the order. The combined effect of (now s. 25) of the Real Property Act...and R. 5.13(4) is that the sheriff's sale and confirmatory order will extinguish the right of all subsequent encumbrancers in the equity of redemption. In Nova Scotia, once a property has been foreclosed, the mortgagor, absent gross irregularity in the sale or fraud, has no right to redeem the property following the foreclosure sale.<sup>21</sup>

By way of a conclusion to this section, it may be said that a tenant may well have a right to redeem the mortgage as part of the foreclosure proceedings and if this option is pursued, the tenant may not have to leave the leasehold premises. That being said, the right is subject to two significant limitations, one practical, the other legal. The practical shortcoming of redemption is that unless the lease is a very valuable one, it is unlikely that the tenant will want to satisfy the terms of the mortgage so as to result in a reconveyance of the property. The legal shortcoming is that the tenant must act within the time frame provided by R. 5.13(4). Failure to do so will result in the mortgagee's being able to extinguish the equity of redemption and the sale will pass good title to a purchaser free of encumbrances subsequent to the mortgage including, of course, the tenant's lease.

(b) Did the Mortgagee Accept the Terms of the Lease?

There is authority for the proposition that if the mortgagee accepts the lease, or, if the terms of the mortgage permit the mortgagor to lease the premises, either generally, or on specific terms, the mortgagee is in much the same position as though the lease preceded the mortgage.<sup>22</sup> In effect by consenting to the lease, the mortgagee has agreed that the tenant will have quiet possession as long as the terms of the lease are fulfilled. Having made

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<sup>21</sup> *Ibid.* pp. 244-245.

<sup>22</sup> *Falconbridge on Mortgages*, p. 465. It might also be noted in passing that if the mortgage contains a provision requiring consent to a lease by the mortgagor and a lease is obtained without that consent, the lease is not binding upon the mortgagee: 433414 *Ontario Ltd. v. Lehdorff Property Management Ltd.* (1981), 31 O.R. (2d) 769 (H.C.).

this point, the case of *Devan Properties Limited*<sup>23</sup> places some limitation upon this point in the context of foreclosure. As has been noted, in that case the mortgage involved a shopping centre and it was clear that the mortgagor would be entering into leasing arrangements. Further, some time after the mortgagor entered into the lease with the appellant, the mortgagee signed a non-disturbance agreement with the appellant which included provisions such as the following:

2. If the Leased Premises should during the term of the Lease or any renewal thereof come under the Mortgagee's management or control,

(a) the Mortgagee will allow the Lessee to continue in occupation of the leased premises in accordance with and subject to the terms of the lease.<sup>24</sup>

It was because of this non-disturbance agreement that the appellant did not participate in the foreclosure proceedings, believing that its right to continue the tenancy would flow through the mortgagee's rather than through the mortgagor's interest in the property and that the foreclosure would only affect the latter. It is worth noting that the mortgagees were not parties to the lease, nor was the non-disturbance agreement registered, nor did the respondent purchaser have actual notice of the lease at the time of purchase under the foreclosure order.<sup>25</sup> The court determined that the

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<sup>23</sup> *Supra*, footnote 7.

<sup>24</sup> *Ibid.*, p.p.248-249.

<sup>25</sup> I mention these facts because a review of this case would suggest that it was fairly decided given the equities of the case. In particular, the respondent had no notice of the lease while the appellant had notice of the foreclosure proceedings and thus the ability to make the foreclosure order subject to the lease by presentation of its position at that time. Note for example the following statement of the court at p. 270 of the case, *supra*, footnote 7:" The appellant is a lessee of the mortgagor under a lease subsequent to the mortgage. By resisting a separate demand for possession by the respondent, the appellant is attempting to attack obliquely the orders of the Court in the foreclosure and sale proceeding". If the circumstances were otherwise, the decision might have been different.

interest of the appellant was extinguished by the foreclosure and that the proper time to raise the matter was during the foreclosure proceedings; the implication in the decision is the foreclosure order might, in such circumstances have been made subject to the lease:

Simply because the mortgagee knew that the mortgagor intended to enter into lease of the premises or that, indeed, the success of the shopping centre depended upon reliable lessees or the mortgagees desired those lease and, in particular that of the appellant, does not result in the mortgagee's interest being made subject to the leases. Further, and in particular, those leases do not gain priority over the respondent which purchased from the numbered company

Due to the provisions in R. 5.13(4), the orders and the deed, the respondent's rights are paramount to those of the appellant and the appellant's rights are subject to the respondent's right to take possession...Simply because the tenancies were envisioned at the time of the granting of the mortgage, that does not result in the mortgage being subservient to the lease. The lease here was subsequent to the mortgage. Should such a lessee seek to argue special status, as was done here, then appropriate proceedings must be taken prior to the order for foreclosure and sale, or without deciding the issue of status, in accordance with R. 5.13(4) within the 1-month period prior to the confirmatory order. After that time the interest of such lessees in the land is extinguished.<sup>26</sup>

In terms of the question posed then, it may be that if the mortgagee has consented to the lease or if the terms of the mortgage provide for the lease, the tenant may not be forced to leave. However, as a procedural matter, this kind of argument must be raised prior to the confirmatory order of foreclosure and sale. Again, it might also be reiterated that the respondent purchaser did not, in the *Devan Properties Limited* case, have actual notice of the lease nor was the mortgagee a party to the lease. The decision might have been otherwise in such circumstances. In the decision, the Court stated as follows: "[The orders and the deed] results in the mortgagor's equity of

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<sup>26</sup> *Supra*, footnote 7, at p. 270.

redemption being extinguished, subject only to prior recorded encumbrances and those of which the purchaser at the sheriff's sale had actual notice". Presumably, if the mortgagee is a party to the lease, it can be argued that the mortgagee's interest, a prior encumbrance, is subject to the lease.<sup>27</sup>

(c) A "New" Tenancy

Just as a final comment, it might well be that the tenant can enter into a new lease arrangement. *Falconbridge on Mortgages* has a good discussion of this point in respect of the mortgagee in possession.<sup>28</sup>

4. Conclusion

As the above discussion makes clear, the question whether the tenant will be required to leave the leasehold premises when the landlord is being foreclosed upon is one that will require a close review of the surrounding circumstances. Assuming that the requirements of the *Registry Act*<sup>29</sup> are fulfilled, the tenant whose lease precedes the mortgage will not be required to leave the premises. As a prior encumbrance, the mortgagee's interest is subject to the terms of the lease. Where the lease follows the mortgage, the situation is more complex but, until the equity of redemption is extinguished by foreclosure in accordance with R. 5.13(4) of the Rules of Civil Procedure and s. 25 of the *Real Property Act*<sup>30</sup>, the tenant may redeem the lease and remain on the premises. Further, where the mortgagee has consented to the lease or where the mortgage allows for leasehold arrangements, the order of foreclosure may be made subject to the lease under the procedure of R. 5.13(4). Indeed, if the mortgagee is a party to the lease, there may be an argument that

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<sup>27</sup> *Ibid.*, p. 271.

<sup>28</sup> *Supra*, footnote 1 at p.327. In that discussion, it is noted that such an agreement may arise either expressly or by implication. See also the case of *Freeborn v. Goodman*, [1969] S.C.R. 923.

<sup>29</sup> R.S.N.S. 1989, c. 392.

<sup>30</sup> R.S.N.S. 1989, c. 385.

the tenant's claim runs through the mortgagee's interest. Finally, it might well be that the tenant will be able to enter into a new lease.