

## Litigation - Canada

### Subsequent mortgagee loses priority for fraudulent prior discharge

Contributed by **Dentons**

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In *CIBC Mortgages Inc v Computershare Trust Co of Canada*<sup>(1)</sup> the Ontario Superior Court of Justice considered applications from competing mortgagees to a property where the first charge had been discharged by fraud and subsequent mortgages were obtained. The court decided that although the subsequent mortgagees were innocent parties, unaware of the fraudulent discharge on the first mortgage, the first mortgagee was entitled to retain priority.

#### Facts

In 2008 homeowners Dhanraj and Sumatie Lowtan applied for a loan from Computershare Trust Company of Canada secured by a first charge on the property. In 2009, unbeknown to Computershare, its mortgage was discharged by someone fraudulently claiming to have authority to bind the company. In March 2011 the owners granted a mortgage to Maria Giovanni and Darlene Geraci. Meanwhile, the owners continued to make payments to Computershare.

In July 2011 the owners approached CIBC to obtain a new mortgage. Despite the fact that they were still making monthly payments to Computershare, they told CIBC that the only charge they had was the mortgage with Giovanni and Geraci. CIBC granted a 'first' mortgage on the condition of pay-out and discharge of the Giovanni/Geraci mortgage. In December 2012 the owners then approached Secure Capital MIC Inc to register a 'second' mortgage. This time the owners told Secure Capital about the CIBC 'first' mortgage, but still did not disclose the original mortgage with Computershare.

Payments on the Computershare mortgage continued until January 4 2013, after which time the mortgage went into default. Less than one month later, the owners defaulted on both the CIBC and Secure Capital mortgages. On April 9 2013 Secure Capital issued a notice of sale.

On April 12 2013 Computershare discovered that its mortgage had been fraudulently discharged. Shortly thereafter, the owners filed for bankruptcy and vacated the property. Towards the end of May 2013 a caution was registered against the property, indicating that the discharge of the Computershare mortgage may be fraudulent.

While CIBC sold the property with all parties' consent, the proceeds were insufficient to satisfy all three debts. As a result, CIBC and Computershare each brought an application seeking a declaration that it had first charge on the property. Computershare also applied to have the discharge declared void. Secure Capital sought a declaration that its mortgage ranked second behind CIBC.

#### Decision

The court made a factual finding that the owners knew about the fraudulent discharge.<sup>(2)</sup>

In the circumstances, CIBC and Secure Capital unsuccessfully attempted to argue that the charges granted by the owners to them were not fraudulent within the meaning of Section 78 of the Land Titles Act, which confirms that an instrument is effective according to its nature and intent once it is registered. However, Section 78(4.1) excludes fraudulent instruments and Section 78(4.2) preserves non-fraudulent instruments, including those registered subsequent to a fraudulent one.<sup>(3)</sup>

The court found that since the owners knew about the fraudulent discharge, they did not own the interest in the property which they purported to have secured to the benefit of CIBC and Secure Capital. The subsequent mortgages were therefore fraudulent instruments under Section 78 (4.2) of the act, and their priority had to give way to Computershare's prior (though 'discharged') security.<sup>(4)</sup>

#### Legal principles

Although the purpose of the Land Titles Act is to save those dealing with registered properties from

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having to check behind the register to investigate the title,<sup>(5)</sup> that reliance on the registry is "not a one-way street".<sup>(6)</sup> In this case, Computershare legitimately expected that it was enough to register its charge on title, which would act as notice to anyone who obtained charge on title in the future.<sup>(7)</sup>

The court was ultimately guided by the 'deferred indefeasibility' theory, citing the decision in *Lawrence v Wright*.<sup>(8)</sup> *Lawrence* effectively did away with the 'immediate indefeasibility' theory, which held that the fact that a transfer has been obtained by fraud is irrelevant and the subsequent party is entitled to rely on the register.<sup>(9)</sup> In contrast, the theory of deferred indefeasibility sets out three types of party for the purpose of determining title when there has been fraud on a property: the original owner, the intermediate owner (which deals with the fraudster) and the deferred owner (a *bona fide* purchaser or encumbrance for value without notice which takes from the intermediate owner). Recognising that the intermediate owner has the opportunity to avoid the fraud, only a deferred owner can defeat the original owner's title.<sup>(10)</sup> In this case, CIBC was the intermediate owner since it acquired an interest from a fraudster and had the opportunity to investigate the transaction and avoid the fraud. There was no deferred owner, which left Computershare with priority.

## Comment

This decision arguably places the burden of guarding against fraud on the mortgagee closest to the act of fraud itself. Here, the court suggested that CIBC could have found out by asking the right questions, such as how the homeowners were able to pay off the Computershare mortgage despite their financial difficulties.<sup>(11)</sup> Therefore, mortgagees should be mindful of the need to make inquiries to ensure that their priority is not negatively impacted by fraud perpetrated on an earlier mortgagee where circumstances (eg, the prior discharge of a significant mortgage) suggest that it is reasonable to do so.

Mortgagees must also be diligent in following up on any information they receive after granting a loan to a party, even if secured by a first charge. In this case, the evidence did not suggest that Computershare should have been aware of the fraudulent discharge.<sup>(12)</sup> However, the fact that payments were continuing would not have been enough to relieve Computershare of its obligation to be vigilant. As the court observed, a party's willingness to continue mortgage payments may be a part of the fraudulent scheme itself.<sup>(13)</sup>

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## Endnotes

(1) 2015 ONSC 543.

(2) *Ibid* at paras 30-36.

(3) Land Titles Act, RSO 1990 c L.5, s 78.

(4) *Computershare*, *supra* note 1 at paras 51, 62.

(5) *Ibid* at para 53.

(6) *Ibid* at para 43.

(7) *Ibid*.

(8) 2007 ONCA 74.

(9) *Ibid* at para 36.

(10) *Ibid* at para 21; *Computershare*, *supra* note 1 at para 58.

(11) *Computershare*, *supra* note 1 at para 58.

(12) *Ibid* at paras 25-29.

(13) *Ibid* at para 35.

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