

# KEEPING CURRENT

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## Impact of Unsecured Debt on a Mortgage Lender's Security

By Zev Zlotnick

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In the context of commercial lending, the priority of claims is a critical aspect of risk management. A common concern for commercial mortgage lenders is how a borrower's unsecured debt, such as debt arising from promissory notes, can impact the lender's security interest in the mortgaged property. This article outlines how unsecured debt affects the mortgage lender's security and emphasizes that, under most legal frameworks, a mortgage lender's registered security generally maintains its priority over unsecured debts.

### Priority of Secured vs. Unsecured Debt

The distinction between secured and unsecured debt is fundamental in understanding the impact on a commercial mortgage lender's security. Secured debt, such as a mortgage, is backed by a specific asset, real property in this case. The lender has a security interest that is registered and perfected, giving it a priority claim over that property in the event of default or bankruptcy. In contrast, unsecured debt, like that from a promissory note, is not tied to any specific asset and, therefore, does not provide the creditor with a direct claim to specific property.

### The Effect of Unsecured Debt on a Mortgage Lender's Security

Unsecured promissory note debt does not directly impact the mortgage lender's security interest because unsecured creditors do not have a lien or claim against the mortgaged property. Under most jurisdictions, as long as the mortgage lender's security interest is properly registered and perfected, it retains priority over any subsequent unsecured debt. The principle of "first in time, first in right" generally governs priority rules, meaning that the mortgage lender's claim will be senior to any unsecured creditors that later assert claims against the borrower's assets.

### Risk of Indirect Impacts

However, while unsecured debt does not affect the priority of the mortgage lender's security, it can indirectly influence the lender's position. For instance, if the borrower accumulates substantial unsecured debt, this may indicate financial distress, increasing the risk of default on the mortgage. Furthermore, in insolvency or bankruptcy proceedings, while secured creditors generally have priority over unsecured creditors, the presence of significant unsecured debt may affect the debtor's ability to service all obligations, including the secured debt.

### Enforcement and Bankruptcy Considerations

In a bankruptcy scenario, the mortgage lender's priority over the secured property is maintained, but it might face practical challenges in recovering the debt. Secured creditors can enforce their claims against the specific collateral while unsecured creditors have to share the remaining assets, if any, after the secured debts are satisfied. However, the existence of substantial unsecured debt could result in a more complex and prolonged bankruptcy proceeding, potentially delaying the lender's ability to realize on its security.

### Legal Protections for Mortgage Lenders

To mitigate risks, mortgage lenders should ensure that their security interests are properly registered and perfected by registering their mortgage and filing in accordance with the applicable *Personal Property Security Act* (Ontario). Additionally, lenders may consider including covenants in their loan agreements that restrict the borrower's ability to incur further unsecured debt or require notification of any material changes in the borrower's financial condition.

As such, while unsecured debt, such as promissory note debt, does not directly affect the priority of a commercial mortgage lender's registered security interest, it may have indirect implications, especially in cases of borrower financial distress or insolvency. Ensuring the proper perfection and registration of the mortgage lender's security interest remains essential to maintain priority over unsecured debts. However, lenders should also monitor the borrower's overall financial health and manage potential risks through covenants and diligent oversight.

Special thank you to TJ Kaloti of Peakhill Capital for raising the issue contained in this 1-Minute Read.

For any related questions, please contact the writer. To see my previous 1-Minute Reads for Commercial Mortgage Lenders, please visit the Blog portion of my profile at <https://www.grllp.com/profile/zevzlotnick>

### Contact Us

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