

What's Old is New Again - Interest Rate Decision in Ontario is What Lenders Expect

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Commercial Reality in Finance Contracts Prevail

In January 2018 the Ontario Superior Court of Justice released a decision, *Solar Power Network Inc. v. ClearFlow Energy*¹, which raised concern for lenders regarding interest payable by Borrowers that is not expressed on an annualized basis. However, lenders can rest easy now that the Ontario Court of Appeal (ONCA) has released its decision reversing, in part, the lower court.²

The issues in this case focused on Section 4 of the *Interest Act*³ which states that if interest is payable at a rate or percentage per day, week, month, or at any rate or percentage for any period less than a year, such interest shall be limited to five percent per annum unless the contract contains an express statement of the yearly rate or percentage of interest to which the other rate or percentage is equivalent.

The loans between the parties in this case each had a base rate of interest specified per annum, a one-time administrative fee, and a discount fee of 0.003% of the principal amount of the loan payable on the due date of the loan and every day thereafter until the loan was repaid. The base rate of interest was not an issue in this case.

What Constitutes “Interest” Under the *Interest Act*?

Ultimately, the ONCA confirmed that a one-time administrative fee, payable at the start of the term or renewal for the work needed to enter into and administer a loan does not constitute interest and therefore does not need to comply with Section 4 of the *Interest Act*. In contrast the Court confirmed the lower court’s ruling that the “discount fee” did constitute interest as this fee was not linked to the creation or renewal of a loan, the amount of the fee did not vary according to the administrative work required and the fee was charged at a daily fixed rate. Therefore, such fee was required to comply with Section 4 of the *Interest Act*. It should be remembered however, that an administrative fee would constitute interest under Section 347 of the *Criminal Code* (Usury laws).

Takeaway: To ensure that an administrative fee does not constitute interest and therefore does not need to comply with the *Interest Act* ensure that the nature and purpose of the fee are to compensate for the administrative work necessary to perform, setup and administer the loans.

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Does the Discount Fee Satisfy Section 4 of the *Interest Act*?

When interest is payable at a rate or percentage for any period that is less than a year Section 4 of the *Interest Act* requires “an express statement of the yearly rate or percentage of interest to which the other rate or percentage is equivalent.” This requirement can be broken up into two issues (1) whether there is an express statement of the yearly rate or percentage of interest and (2) whether the other rate or percentage is equivalent.

Issue 1: Does the Discount Fee Include an Express Statement of the Yearly Rate or Percentage of Interest?

The ONCA held that the discount fee formula provided in the agreement constituted a “rate” for the purposes of Section 4. This finding reconfirms that interest does not need to be expressed as a numerical percentage and that a formula will satisfy Section 4.

The Court also took note that common commercial practice is for interest provisions to specify that interest is to be calculated on the basis of 12 months of thirty days each or 360 days. In more complex agreements, there is an annualizing formula stating that the yearly rate is to be calculated on the basis of the specified rate of interest, multiplied by the number of days in the year⁴. Less complex agreements often do not set out the formula. The ONCA relying partially on common commercial practice accepted that the inclusion of the formula was sufficient and noted that in discussing these types of commercial loans, an annualizing formula may not even be required for such agreements to comply with Section 4.

Issue 2: Does the Discount Fee Formula set out the Equivalent Rate or Percentage of Interest?

One of the issues raised in the lower court was that the formulas utilized did not set out the equivalent rate or percentage of interest and as such, were in violation of the *Interest Act*. The matter revolved around how compounding would work when utilizing the discount fee formula. If the loan were paid when due, then there would be no compounding but if not, then there would be compounding. The lower court struck the discount fee formula as it did not express an equivalent rate. The ONCA reversed this decision and noted that since the discount fee was dependent on the future activities of the borrower, it would have been impossible for the lender to state an equivalent rate or percentage of interest. The Court again focused on interpreting this issue in light of common sense, and commercial reality and held that it cannot be the case that Section 4 is engaged where lenders fail to provide information that is impossible to provide.

Takeaways:

- Section 4 of the *Interest Act* will be satisfied when an annualizing formula is included in the loan agreement.
- If the agreement is a commercial loan agreement consistent with modern commercial reality it may not need to provide an annualizing formula to comply with Section 4 of the *Interest Act*.

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- Always provide an annualized rate when there is no formula. Even though the Court took a commercial reality test into account, it still held that if interest were set out only on a monthly basis, it needed to be annualized. Section 4 of the *Interest Act* will not be satisfied if the agreement, for example, provides for interest at 2% per month calculated monthly but which is payable on the due date of the loan or promissory note. In such a scenario an annualized rate must be provided to comply with Section 4. This is likely one of the most common mistakes made by non-Canadian lenders.

For further information regarding this matter, please contact Jonathan Fleisher, Amanda Scolieri or any other member of the Banking, Lending & Specialty Finance Group.

¹ 2018 ONSC 7286 (the "*Interest Act*").

² *Solar Power Network Inc. v. ClearFlow Energy*, 2018 ONCA 727.

³ RSC, 1985, c I-15.

⁴ The decision quotes *Canada-U.S. Commercial Law Guide* (Toronto: Thomson Reuters, 2017) loose-leaf authored by Cassels partners Alison Manzer and Peter Sullivan.

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