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Recent "Interest" in Annual Rates

Mar 01, 2018

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In a recent and surprising decision, *Solar Power Network Inc. v. ClearFlow Energy Finance Corp.*,[1] the borrower, Solar Power Network Inc., successfully attacked loan agreement interest rate provisions on the basis that the provisions did not comply with Section 4 of the *Interest Act* (Canada).[2] Despite the inclusion of a conversion provision, commonly included in loan documents to avoid inadvertently tripping a borrower's right to attack interest provisions, the Ontario Superior Court of Justice held that the interest rates did not comply with Section 4, and ultimately capped the total loan interest rate at a maximum of 5% *per annum*.

Section 4 provides,

Except as to mortgages on real property or hypothecs on immovables, whenever any interest is, by the terms of any written or printed contract, whether under seal or not, made payable at a rate or percentage per day, week, month, or at any rate or percentage for any period less than a year, no interest exceeding the rate or percentage of five per cent per annum shall be chargeable, payable or recoverable on any part of the principal money unless the contract contains an express statement of the yearly rate or percentage of interest to which the other rate or percentage is equivalent.[3]

The Decision

In *ClearFlow*, the loan arrangement had three repayment components (in addition to repaying the principal). These included an interest rate at 12% *per annum* and a daily discount fee of .003% of the principal amount payable quarterly. At issue in this decision was: (i) whether the discount fee should be properly characterized as interest within the meaning of the *Interest Act*; and (ii) whether the interest provisions complied with Section 4.

The loan agreement attempted to comply with Section 4 by providing explanatory language and a formula for calculating the annual rate for the administration fee and discount fee as follows:

Unless otherwise stated, in this Agreement if reference is made to a rate of interest, discount rate, fee or other amount "per annum" or a similar expression is used, such interest, fee or other amount shall be calculated on the basis of a year of 365 or 366 days, as the case may be. If the amount of any interest, fee or other amount is determined or expressed on the basis of a period of less than one year of 365 or 366 days, as the case may be, the equivalent yearly rate is equal to the rate so determined or expressed, divided by the number of days in the said period, and multiplied by the actual number of days in that calendar year.[4]

The court held that the discount fee, for the purposes of Section 4, should be properly characterized as interest. The court further held that the inclusion of the conversion formula did not satisfy the requirement in Section 4 for an "express statement of the yearly rate or percentage of interest to which the other rate or percentage is equivalent" required by Section 4.[5] The interest rate payable under the loan documents was reduced from 12%, plus the discount fee, to 5%.

The court reasoned that expressing interest in this manner was misleading and that the use of a formula did not meet the Section 4 statutory requirement of an express statement of the annual interest rate. The court further noted that, in the alternative, if the use of a formula does comply with Section 4, there was an expectation that the discount fees would not be paid, but accrue. In this case, the annualized formula failed to take into account the effect of compounding, and thus did not comply with Section 4.

Effectively Stating the Interest Rate

The purpose of Section 4 is to protect consumers from misleadingly-stated interest rates. It does so by standardizing the expression of interest in annual terms. **As we have previously discussed**, running afoul Section 4 is very easy to avoid for fixed-rate agreements. However, for loan agreements that use floating or variable adjustment rates, Section 4 can create drafting challenges. Conversion provisions, which include interest rate annualization formulas such as in *ClearFlow*, are commonly included in loan documents, on the understanding of lenders and their counsel that such provisions comply with the *Interest Act*.

While an appeal of the decision in *ClearFlow* is certain, lenders should take note. The *ClearFlow* decision suggests that the use of formulas to express the annual interest rate will not comply with Section 4. In order to adhere to the *ClearFlow* interpretation of Section 4, lenders should consider including both the equivalent nominal and effective rate of interest whenever possible, as well as provide further explanatory language, beyond standard conversion provisions, to ensure that the borrower's obligations are clearly understood.

The attitude to Section 4 expressed by McEwen J. would suggest that there is a risk that, in any action in Canada against a Canadian borrower, regardless of the choice of a foreign law in the loan documents, Section 4 could be regarded as a law of mandatory application. Canada could look like a difficult place to do business.

The Financial Services Group at Aird & Berlis can help advise lenders on the implications of the *ClearFlow* decision. Details can be found on our **Financial Services web page**.

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[1] 2018 ONSC 7286.
[2] R.S.C., 1985, c. I-15 (the "*Interest Act*")
[3] *Ibid*, section 4.
[4] *Supra* note 1, at para 48.
[5] *Supra* note 2, section 4.

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