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Back to Normal? Ontario Court of Appeal Overturns *ClearFlow* Decision on Interest Disclosure under Section 4 of *Interest Act*

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Early in 2018, lenders and their counsel were surprised and alarmed by the Ontario Superior Court of Justice decision in *Solar Power Network Inc. v ClearFlow Energy Finance Corp.*, which threatened to disrupt a long-established consensus that section 4 of the Canadian federal *Interest Act* no longer posed any difficulties in sophisticated lending transactions: see our Interest Disclosure under Section 4 of the Interest Act: The Ghost Is Clanking Its Chains Again, bulletin on the *ClearFlow* decision.

The decision was quickly appealed and heard on an expedited basis by the Ontario Court of Appeal. The Canadian Bankers' Association was given leave to intervene. It supported the appellant lender's submissions that the decision had misinterpreted section 4 of the *Interest Act*. The Court of Appeal, in reasons released on September 4, 2018, agreed and allowed the appeal.

To recap, in the *ClearFlow* case, the borrower, Solar Power Network Inc. (Solar), an installer of solar panels, which obtained short-term financing from the lender, ClearFlow Energy Finance Corp. (ClearFlow), brought an application asserting that the loan documents did not comply with section 4 of the *Interest Act* and, as a result, ClearFlow could only recover interest at 5% on the principal advanced to Solar.

Section 4 of the *Interest Act* reads as follows:

> 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.

The loans made by ClearFlow to Solar bore interest at 12% per annum, compounded and calculated monthly, with a step-up to 24% per annum on default. In addition, they provided for two "fees" payable by Solar to ClearFlow. The judge who decided the application found that one of the fees – an "administration fee" calculated as a percentage of the principal advanced and payable at the date of advance – was properly characterized as a fee and was not interest for purposes of section 4 of the *Interest Act*.

However, the loan agreement also provided for a "discount fee," as follows:

> Each Borrower further agrees to pay to the Lender:...iii) on the date of repayment of such Loan...a discount fee of 0.003% of the outstanding balance of such Loan for every day such Loan remains outstanding until such Loan is repaid in full.

The application judge held that the "discount fee" was really interest for purposes of section 4, since it satisfied the three essential elements of interest: it was compensation for the use or retention of money that was owed to another person, it related to a principal amount or an obligation to pay money, and it accrued over time.

The loan agreement attempted to comply with section 4 of the *Interest Act* by including a typical "conversion" provision, which set out a formula to convert any interest rate not expressed as an annual rate, such as the daily rate of the discount fee, into an equivalent nominal annual rate (this provision was apparently not included, however, in promissory notes given by Solar in respect of certain of its loans):

> 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.

ClearFlow argued that by using the formula in the conversion provision, Solar could easily determine the nominal annual rate to which the discount fee was equivalent: "[T]his is a simple calculation since it is only necessary to multiply 0.003 by 365 or 366 days as the case may be." However, the application judge held that providing a conversion formula was not an "express statement" of the annual rate, as required by section 4, observing that section 4 "is designed to avoid the exact type of mischief that can occur when rates are not annualized and the borrower, therefore, does not have a clear understanding of its obligation to pay interest. A formula does not necessarily allow for this clear understanding to occur. Formulas can be confusing and even misleading."

The application judge also held that section 4 of the *Interest Act* required disclosure of the effective annual rate to which the "discount fee" was equivalent, taking into account interest compounding, which occurred if Solar did not repay a loan at maturity and ClearFlow agreed to "roll it over" (including the accrued "discount fee") into a new loan. In the result, the application judge held that ClearFlow was entitled only to interest at 5% per annum, as provided in section 4. ClearFlow was thus denied approximately $10 million in accrued interest (on loans exceeding $40 million in total).

In reasons given by Justice Sharpe, the Court of Appeal agreed with the application judge that the administration fee was properly characterized as a fee, but that the "discount fee" was really interest. However, the Court rejected the application judge's interpretation of section 4 of the *Interest Act*. First, the Court found that by referring to an equivalent "rate or percentage," the statute contemplated not only a "numerical percentage" but also a "rate" expressed by a "mathematical formula." The Court noted that formulas to calculate a floating interest rate had been consistently held to comply with other provisions of the *Interest Act*.

The Court of Appeal further held that section 4 "must be interpreted in the light of modern commercial reality," in particular the common practice of calculating interest on the basis of a 360-day year of 12 months each of 30 days, with a formula in the loan documents (similar to the formula used by ClearFlow) to convert such rate into an annual rate based on a calendar year.

The Court of Appeal also rejected the second conclusion reached by the application judge. It observed that the loan documents could not have set out an effective rate of interest reflecting compounding of the discount fee, because such compounding would occur only if the parties agreed to "roll over" loans at maturity, which could not be known with certainty when the loan documents were entered into. The Court said that "it cannot be the case that s. 4 is engaged when a lender fails to provide information that it is impossible to provide" and that "to interpret s. 4 otherwise would be contrary to common sense, commercial reality and established principles of statutory interpretation."

Finally, the Court of Appeal agreed with the application judge that section 4 of the *Interest Act* applied to the promissory notes, because they did not contain a conversion formula. However, it found that to reduce to 5% the interest rate payable in respect of the whole transaction was not an appropriate remedy:

> This case involved a commercial transaction between parties of equal bargaining power who inadvertently and only marginally ran afoul of s. 4. There was no evidence of intention to break the law, of any unfairness in the agreement, or of one party taking advantage of another. To secure the funds it required, Solar Power knew that it had to pay a high rate of interest. The discount fee represents a tiny fraction of the interest that is otherwise payable and falls well below the 5% maximum interest allowed by s. 4. To limit all interest payable to 5% would…result in a substantial windfall to Solar Power.

The Court of Appeal thus "read down" the literal wording of section 4 so that only interest not stated as a "yearly rate or percentage" would be reduced to 5%:

> Reducing only the non-compliant rate to 5% takes into account, rather than defeats, the lender's legitimate expectations… Reducing only the non-compliant rate to 5% appropriately interprets the dated text of s. 4 in accordance with contemporary commercial realities.

In conclusion, the Court of Appeal decision is comprehensive and well-reasoned. It seems likely that it will be the last word on Solar's attempt to revive section 4 of the *Interest Act* as a powerful weapon in the hands of borrowers. It also provides a welcome reaffirmation that the *Interest Act*, which contains several other provisions just as problematic as section 4, should be interpreted so as to achieve a commercially reasonable result.

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