Goodmans LLP Update

Ontario Court of Appeal Holds Use of Formula is Sufficient to Satisfy Annual Rate of Interest Disclosure Under Section 4 of *Interest Act* (Canada)

The Ontario Court of Appeal has issued its judgment in *Solar Power Network Inc. v. ClearFlow Energy Finance Corp.*, finding that the use of a formula in loan documentation is sufficient to satisfy the requirement of Section 4 of the *Interest Act* (Canada) (the "**Act**") to express an annual rate of interest. It is now clear Section 4 does not require there to be an expressed numerical percentage in the lending document.

Background

The Court of Appeal considered a January 2018 judgment of Justice Thomas McEwen of the Ontario Superior Court of Justice, which cast doubt on the typical disclosure language used by lenders to address Section 4 of the Act and concluded the inclusion of a formula for calculating the equivalent annual rate of interest where such rate is stated to be calculated for a period of less than a year is not sufficient to comply with Section 4 because a formula can never be sufficient for such purpose or, alternatively, because the particular formula resulted in a nominal but not effective annual rate of interest. This decision understandably raised concerns within the lending community as to the scope of the required disclosure of an annual rate of interest, especially in the context of loans made to sophisticated borrowers and with variable rates of interest including compounding features.

As a policy matter, Section 4 is meant to ensure borrowers have adequate disclosure as to the cost of borrowing. In particular, the basic requirement is that whenever interest is made payable at a rate or percentage per day, week, month, or any period less than a year, no interest exceeding the rate or percentage of five percent per annum shall be chargeable, payable or recoverable on any part of the principal debt unless the lending document contains an express statement of the yearly rate or percentage of interest to which such other rate or percentage is equivalent.

Since Section 4 was first enacted, financing vehicles have evolved with far more options available to lenders and borrowers, some with a high degree of complexity. Nonetheless, before the January 2018 decision, and as a result of earlier jurisprudence as to the meaning of Section 4, lenders and practitioners had come to a common understanding as to what was required for lenders to comply with Section 4 even in the era of modern financing vehicles.

As a practical matter, this case raised two issues: (1) The adequacy of any formula that is expressed with a view to disclosing the annual rate of interest required by Section 4; and (2) How compound interest is treated for this purpose and whether compounding requires special disclosure of the "effective" rate of interest.

Court of Appeal Decision

The Court of Appeal concluded that the use of a formula is sufficient to satisfy the requirement of Section 4 to express an annual rate of interest. It is clear that Section 4 does not require there to be an expressed numerical percentage. The Court of Appeal appears to have reached this conclusion in part due to its interpretation of the wording in Section 4 and in part due to its recognition of the prevalence of formulae in this context and its desire to be aligned with commercial reality which precludes the ability to determine an expressed numerical percentage in many circumstances.

The Court of Appeal also concluded that the compounding of interest involved in the applicable credit facilities did not run afoul of Section 4. There were multiple reasons given for this conclusion, but most notable is the rationale that, as a practical matter, the formula provided allowed the borrower to determine the equivalent annual interest rate such that it was not misled.

The case also contains some language which lenders may find helpful to the effect that a court should, consistent with prior Supreme Court decisions, take account of the "entire context" of a transaction and not focus only on what appears to be the plain meaning of a legislative provision viewed in isolation. The Court of Appeal noted that the lender and borrower were of equal sophistication and of equal bargaining power. It was mindful that a "windfall" would benefit the borrower should a technical breach of Section 4 free the borrower of its agreed obligation to pay a higher rate of interest. While Section 4 is founded in the rationale of consumer protection and the fairness that comes from adequate disclosure of the cost of borrowing, in this case the Court of Appeal concluded that a sophisticated commercial borrower is not the same as an unsophisticated consumer signing a pre-printed standard form and that lenders are also entitled to fairness in interpretation and to have contemporary commercial practices respected.

Implications

In light of this decision, lenders should have renewed confidence that complex negotiated interest provisions drafted with the intent of complying with Section 4 will be upheld. Such provisions should always be drafted with Section 4 in mind, but lenders will not be required to disclose the impossible and borrowers should not rely on the possibility that agreed interest provisions will be disregarded based on a mere technicality. In our view, absent a further appeal in this case, the traditional disclosure language contained in most loan agreements should be sufficient going forward absent unusual fees or calculation methods.

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