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BRINGING CLARITY TO THE INTEREST ACT: THE CLEARFLOW DECISION

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OVERVIEW

On September 4, 2018 the Ontario Court of Appeal released its much anticipated decision in *Solar Power Network Inc. v ClearFlow Energy Finance Corp.*[1] The decision is significant for lenders and their counsel as it overturned a decision from the Ontario Superior Court of Justice, which held that formulas used to determine annual rates of interest violated section 4 of the *Interest Act*.[2]

In overturning the Superior Court decision, the Court of Appeal held that such formulas can satisfy section 4 of the Act.[3] In doing so, the Court of Appeal added some much-needed clarity to the Act.

BACKGROUND

Solar Power Network Inc. ("**SPN**") and ClearFlow Energy Finance Corp. ("**ClearFlow**") entered into a series of loan documents.

In the loan documents, ClearFlow used a common annualized formula to calculate interest rates. Specifically, ClearFlow charged a "Discount Fee" of .003% of the outstanding principal of the applicable loan. If the principal was not paid when the term of the loan expired, the outstanding balance would roll-over into a new loan with the Discount Fee being calculated on a daily basis.

SPN claimed that the Discount Fee was an interest charge, and not a fee. SPN also claimed that because the Discount Fee was not expressed as a yearly rate of interest, it violated section 4 of the Act. That section states:

> ...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

[1] 2018 ONCA 727 [*ClearFlow*].
[2] *Solar Power Network Inc. v ClearFlow Energy Corp.*, 2018 ONSC 7286 at para 53.
[3] RSC 1985, c-1-15.

percentage of interest to which the other rate or percentage is equivalent.[4]

The Superior Court's Decision

The Application Judge, Justice McEwen, found that the Discount Fee was an interest charge and that it violated section 4 of the Act. The effective rate of interest under the Discount Fee depended on several potential compound periods of interest and made it difficult for SPN to understand its obligations under the loan documents. According to Justice McEwen, SPN's confusion confirmed that section 4 demands clearer language.[5]

To remedy this breach, Justice McEwen held that the purpose of section 4 could only be achieved if the total interest payable in the loan documents was reduced to 5%. That is, even non-offending interest rates in the loan documents were reduced to 5%. While His Honour acknowledged that the remedy could seem "draconian", he found that to do otherwise would only encourage the kind of misleading lending behaviour that Parliament intended to protect consumers from when it drafted section 4.

The Court of Appeal's Decision

In overturning Justice McEwen's application of section 4, the Court of Appeal centered its analysis on "modern commercial reality" and the expectations of commercial arrangements.[6] The court also noted that many commercial parties include a simple formula to calculate the yearly interest rate on a loan and that case law has already accepted the use of such formulas in more complex, and less certain circumstances.[7]

Further, the court addressed whether the formula used for the Discount Fee accurately disclosed the effective rate of interest. The court pointed out that the Discount Fee was only added to the principal on the due date and would only start accruing if the loan was not paid. As a result, neither ClearFlow nor SPN could determine if the Discount Fee would ever be compounded. The court found that ClearFlow's formula did not violate the Act, stating that "it cannot be the case that s.4 is engaged when a lender fails to provide information that it is impossible to provide".[8]

With respect to the remedy that Justice McEwen had imposed, the Court of Appeal held that, absent evidence of lenders trying to avoid the protections of section 4, only the offending interest rates should be reduced to 5%. This prevents any "draconian" results caused by reducing interest rates

[4] *Ibid*.
[5] *Supra* note 2 at para 53.
[6] *ClearFlow, supra* note 1 paras 53, 81.
[7] *Ibid* at para 50.
[8] *Ibid* at para 61.

across an entire lending relationship.[9] According to the court, this interpretation not only upholds the "lenders legitimate expectations" but also prevents the borrower from gaining a substantial windfall.[10]

WHAT DOES THIS MEAN FOR LENDERS?

In our previous comment we cautioned lenders and their counsel to pay attention to the Act in light of Justice McEwen's decision. While the Court of Appeal's decision in ClearFlow lessens the uncertainty surrounding annualized interest rates, it's still beneficial to pay attention to the Act. Lenders and their counsel should ensure that when formulas are used to calculate annualized interest rates, the borrower's obligations are clearly set out. Lenders may also want to include examples of how yearly interest rates would be calculated so as to help prevent against allegations of confusion or misleading lending practices.

[9] *Ibid* at para 81.
[10] *Ibid* at paras 78, 81.