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Interest Disclosure under Section 4 of the *Interest Act:* The Ghost Is Clanking Its Chains Again

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Section 4 of the Canadian federal *Interest Act*, an interest disclosure provision first enacted in 1897 and surviving almost unchanged today, has been of little concern to lenders for the past quarter-century. A series of judicial decisions in the early 1990s seemed to have limited its scope so that it posed few problems in practice. However, the recent Ontario Superior Court of Justice decision in *Solar Power Network Inc. v. ClearFlow Energy Finance Corp.*, unless it is reversed on appeal, may have breathed new life into section 4. Lenders may need to rethink disclosure in loan documents of both nominal and effective annual rates of interest in order to comply with section 4 as the Court in *ClearFlow* has interpreted it.

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), successfully argued 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:

> 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 Court 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 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 Court held that the discount fee was really interest for purposes of section 4. This conclusion seems reasonable, since the "fee" accrued on a daily basis like interest.

The loan documents attempted to comply with section 4 of the *Interest Act* by including a "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 a nominal annual rate:

> 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.

Provisions like this have been commonly included in loan agreements, so that interest calculated, for example, on the basis of a 360-day year, could be converted into a nominal annual rate for purposes of section 4 of the *Interest Act*. Although no previous Canadian judicial decision had considered whether such conversion provisions complied with section 4, lenders and their counsel generally believed that they were sufficient for that purpose.

ClearFlow argued that using the formula in the conversion provision, Solar could easily determine the nominal annual rate to which the discount fee was equivalent: "this 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 Court held that providing a conversion formula was not an "express statement" of the annual rate, as required by section 4:

> In my view, the statutory requirement for an express statement 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 requirement for an express statement of the annual interest rate, to my mind, is designed to avoid exactly the type of situation that has arisen in this case. [Solar] is claiming that it cannot understand its interest obligations, while ClearFlow is claiming that the obligations are well set out and [Solar] could simply do the interest calculation. The requirement of an express statement does away with this type of dispute and uncertainty, particularly where in this case there are multiple loans, which may roll-over [emphasis added].

The Court also held in the alternative 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:

> Even if the formula in the Loan Agreement with respect to the Discount Fee is viable, I do not accept that the formula complies with s. 4 by providing an "equivalent" annual rate of interest.
>
> The case law accepts that there are two potential methods of expressing the equivalent rate of interest. The first is the "nominal interest rate". This is expressed by simply multiplying the monthly interest rate by the number of compounding periods (i.e. 2% per month x 12 months is "equivalent" to 24% per annum). The second is the "effective annual interest rate". This rate factors in the effect that compounding has on the overall interest rate (i.e. 2% per month, when factoring in yearly compounding is "equivalent" to 26.8% per annum). ...
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> I do not accept ClearFlow's position that the Discount Fee is easily calculable by multiplying 0.003% into an annualized rate which in a typical year would be 1.095%. The actual interest rate pursuant to the Discount Fee could be dependent on a number of compound periods of interest since interest on the Discount Fee is compounded each time the Loan rolled-over. As noted above, if the Loan was not paid off in the requisite time, the Discount Fee (and the Administration Fee if it too was outstanding) would be added to the principal amount owing and a new Loan created. ...
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> Since I have found that the Discount Fee is in fact interest we are left with the situation where interest was being paid on outstanding interest when a Loan rolled-over. It is therefore not accurate to say that by simply multiplying 0.003% x 365 that the Discount Rate could be annualized so that the borrower's obligation could clearly be understood. Confusion over interest calculations did arise. *The nature of the Discount Fee, which was understood by both parties, required that an "effective annual rate" be disclosed. I find that the formula provided in the Loan Agreement does not produce a sufficient and equivalent rate for the purposes of satisfying s. 4 of the* Act. Further explanatory language ought to have been used by ClearFlow [emphasis added].

The Court does not discuss in *ClearFlow* two appellate decisions from 1991 that explicitly considered and rejected arguments that section 4 of the *Interest Act* required disclosure of effective annual rates: *McHugh v. Forbes*, decided by the Ontario Court of Appeal; and *Bank of Nova Scotia v. Dunphy Leasing Enterprises Ltd.*, an Alberta Court of Appeal decision later affirmed by the Supreme Court of Canada. The

Court cites some later lower-court decisions following *Dunphy Leasing*, but purports to distinguish them on the basis that in those cases an equivalent annual nominal rate was set out in the loan documents. However, that distinction would be valid only if the Court in *ClearFlow* is right in its other conclusion – that a conversion formula is not a sufficient statement of an equivalent annual rate for purposes of section 4.

The Court's interpretation of section 4 in *ClearFlow* would in some situations make compliance impossible. When interest calculations involve floating rates, it is hard to see how the loan agreement could "state" the equivalent effective annual rate other than by a formula, which the Court seems to suggest will never be sufficiently clear. The Court also seems to expect that the calculation must always be easily understandable by the borrower, which may be a tall order to satisfy. Other judicial decisions on section 4 of the *Interest Act* have explicitly accepted that a sophisticated borrower may be assumed to have sufficient skills to make interest calculations.

We hope that the *ClearFlow* decision will be reversed on appeal or corrected in later cases. In the meantime, what should lenders do?

A possible approach would be to provide disclosure of both equivalent nominal annual rates and equivalent effective annual rates, to address both the *ClearFlow* interpretation of section 4 and what we believe is the correct interpretation. In addition, the borrower could expressly acknowledge in the loan agreement that it understands the conversion formulas and how to calculate annual rates of interest by using them. While section 4 refers to the disclosure being "contained" in the loan agreement, even the Court in *ClearFlow* might well have accepted disclosure incorporated by reference – for example, if the borrower had been able to consult a website where the lender posted updates of the current effective rates payable by the borrower, or even if the lender had provided such updates on request from the borrower. It is difficult to imagine that a court would not find sufficient a combination of a conversion formula in the loan agreement itself with such a back-up whereby the borrower could obtain the actual current rate if it couldn't or didn't want to work through the formula.

One factor that limits the potential impact of the *ClearFlow* decision is that, in our view, it is unlikely that section 4 would be applied by a Canadian court to a loan agreement governed by foreign law, even if the borrower is in Canada.

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