The Sun Shines for Lenders - Solar Power in the Court of Appeal

September 06, 2018

Peter E. Hamilton, Daphne J. MacKenzie, Kelly Niebergall

The Ontario Court of Appeal has rendered its decision in *Solar Power Network Inc*. v. ClearFlow Energy Finance Corp., 2018 ONCA 727, validating the use of a formula to comply with the requirement in section 4 of the *Interest Act* for an equivalent annual rate - at least as long as the formula is the most meaningful way of expressing the equivalent annual rate.

The Superior Court Decision: A Formula Doesn't Work

Earlier this year, the Superior Court rendered a decision to the effect that:

- a discount fee of 0.003% per day charged by ClearFlow Energy Finance Corp. on loans it made to Solar Power Network Inc. and its affiliates was interest
- the inclusion of a formula for calculating the equivalent annual rate for the fee was not sufficient to comply with section 4 of the *Interest Act*, either because a formula could never suffice for such purpose or because the formula only produced a nominal rather than an effective rate
- the result of non-compliance was that all interest charged on the loans, including interest that accrued at the base interest rate of 12% per annum and 24% per annum in the event of a default, was limited to 5%.

For a more detailed discussion of the relevant facts and the Superior Court's decision, see our client update on the decision.

Many lenders and their counsel were alarmed by the Superior Court's holding that the formula in the ClearFlow loan documents was insufficient, because it commonly appears in commercial loan agreements that provide for interest rates calculated based on a period shorter than a year and because the remedy of capping all the interest at 5% was so draconian in its effect. ClearFlow appealed the decision and The Canadian Bankers' Association intervened to make submissions on the issue.

The Court of Appeal's Analysis: A Formula Can Work

The Court of Appeal took a contextual approach. It looked at case law accepting the use of formulas in the context of other sections of the *Interest Act*, as well as other commercial statutes. It noted too the "modern commercial reality" of commercial loans commonly bearing interest calculated on the basis of a 360-day year or 12 months of 30 days and including an annualizing formula to calculate the equivalent

annual rate. It actually left open the issue of whether section 4 would even apply to such an expressed rate. The court concluded that the mathematical formula in the ClearFlow loan documents was sufficient to express a "rate" for the purposes of section 4.

The court then went on to consider whether the formula produced an "equivalent rate" given it produced a nominal rate rather than an effective rate taking into account the effects of compounding. The court held that a nominal rate was sufficient in the circumstances since it was "impossible for the Loan Agreement to state an equivalent rate or percentage of interest that took into account compounding of the discount fee." It was important to this determination that it was not possible for the parties to know the existence and extent of compounding of the discount fee until after the due date.

This leaves open the possibility that, where an effectual annual rate can be determined at the inception of a loan – if, for instance, interest at a fixed rate on a sum certain compounds at specified periods during the term of the loan - the equivalent annual rate may be an effective rate.

The Consequences of Non-Compliance

On the facts in *Solar Power*, some of the loans were made under a loan agreement that contained the formula for calculating an equivalent annual rate, and some were made under promissory notes, which contained no such formula. The expression of the discount fee on the promissory note loans, therefore, did not satisfy section 4. ClearFlow appealed the lower court's ruling that all interest under such loans should be restricted to 5%. The Court of Appeal agreed that the limitation to 5% should be restricted to the discount fee on the promissory note loans.

The court considered the circumstances at issue and said:

"[t]his 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."

The court interpreted section 4 in light of "modern commercial reality and the expectations of the parties" to find that only the interest expressed in a manner that didn't comply with section 4 should be subject to the 5% cap. Solar Power did not expect to receive the windfall that would result if the entire amount of interest was capped at 5%. Its expectation given its risk profile was that it would have to pay a high rate of interest for these loans. The lender's expectation was that it would recover the interest bargained for.

Presumably, if the agreement was unfair or if the parties did not have equal bargaining power, the court might have given less weight to the expectations of the parties in its interpretation of the remedy provided by section 4.

Going Forward

The Ontario Court of Appeal's validation of the practice of lenders and their counsel in including a formula for the purposes of satisfying the requirement of an equivalent annual rate in section 4 is welcome, as is the guidance on when a nominal rate of interest may constitute an equivalent annual rate. After the confusion and uncertainty that followed the Superior Court's decision, the Court of Appeal's focus on commercial realities and interpreting section 4 in light of current practice was yet another ray of sunshine in this beautiful Ontario summer.

Update: Solar Power Network has applied to the Supreme Court of Canada for leave to appeal this decision