The Boundaries of the Interest Act

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In foreclosure proceedings, we are often asked by lenders why certain default fees, other charges or interest rate changes that are clearly chargeable based upon the terms of the mortgage are not collectable through the Court proceedings. Our answer has been that in part it is because some Masters or Justices feel that such fees, charges or interest rate changes are a "penalty" under the *Interest Act.*[1] The Supreme Court of Canada recently released its decision confirming what fees and interest can and cannot be charged in mortgages.

In *Krayzel Corp. v. Equitable Trust Co.,*[2] which is commonly referred to by the Calgary Bar as the "Lougheed Block" case, Lougheed Block Inc. ("Lougheed") granted a mortgage to Equitable Trust Company ("Equitable") to secure a $27 million loan. The initial interest rate in the mortgage was 2.875% per annum. When the mortgage matured, Lougheed and Equitable agreed to a renewal for a 7 month term. The interest rate in the renewal was prime plus 3.125% for the first 6 months and then 25% for the 7th month. The term of the first renewal expired on March 1, 2009.

On April 28, 2009, the parties entered into a second renewal agreement which was made effective as of February 1, 2009 (a month before the expiration of the first renewal period). Under the second renewal agreement, the interest rate was 25% per annum. Lougheed was required to make monthly interest payments. However, the monthly "pay rate" was not at the 25% rate of interest. Rather, the "pay rate" was set at 7.5%, or prime plus 5.25%, whichever was greater. The difference between the stated rate of 25% and the "pay rate" was to accrue to the loan, and if Lougheed did not default then the accrued interest would be forgiven.

As one might guess, since the matter was being litigated, Lougheed defaulted (in its first payment) under the second renewal agreement and Equitable sought payment at the 25% interest rate. Lougheed claimed that the interest rate changes infringed the *Interest Act*.

Section 2 of the *Interest Act* states that a person can contract for any rate of interest that is agreed upon, except of course if it violates anything else stated in the *Interest Act*, or any other piece of legislation. Section 8 of the *Interest Act* is one of those limiting sections. It states:

> No fine, penalty or rate of interest shall be stipulated for, taken, reserved or exacted on any arrears of principal or interest secured by mortgage on real property…that has the effect of increasing the charge on the arrears beyond the rate of interest payable on principal money not in arrears.

One of the purposes of s. 8 is to "protect landowners from charges 'that would make it impossible for [them] to redeem, or to protect their equity".[3] Essentially, if the borrower is already in default, the legislators felt that it was unfair for the mortgagee to be able to put the borrower further in the hole by charging a default fee or higher rate of interest on default.

The majority of the Court held that the substance of the clause will determine whether it violates the *Interest Act*, not the labels used. It matters not whether the mortgage terms are described as a "bonus", "penalty", "discount", or "benefit". "If its effect is to impose a higher rate on arrears than on money not in arrears, then s. 8 is offended". [emphasis added] [4]

The majority of the Court made it clear that an interest rate increase due solely to the passage of time, and not due to a default, does not offend the *Interest Act*. As such, the terms of the first renewal agreement were fine. However, the terms of the second renewal agreement were not. The *effect* of the second renewal agreement was "to reserve a higher charge on arrears (25 percent) than that imposed on principal money not in arrears (7.5 percent, or the prime interest rate plus 5.25 percent)."[5] Essentially, the higher interest rate only came into effect in the event there was a default and therefore imposed a penalty. It mattered not that the terms described as

a discount or that the higher interest rate would be "forgiven" if there was not default. The Court allowed interest at the higher of 7.5% and prime plus 5.25%.

In light of this decision, lenders should review their mortgage paper and may wish to reconsider the *effect* that certain mortgage terms have and whether or not certain fees, charges or interest will be collectible.

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[1] R.S.C. 1985, c. I-15, ss. 2 and 8. Fees and charges are also disallowed by the Court as penalty under Section 10 of the Judicature Act, R.S.A. 2000, c. J-1, which allows relief from forfeiture for all "penalties and forfeitures".

[2] 2016 SCC 18 (S.C.C.)

[3] Ibid. at paragraph 21

[4] Ibid. at paragraph 25

[5] Ibid. at paragraph 35