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Perennial Problem of Section 8 of the Interest Act

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Cases Considered:

Equitable Trust Co. v. Lougheed Block Inc., 2011 ABQB 193

This is one of several recent cases concerning the Lougheed Building at 604 - 1st Street SW in Calgary. The issue in this particular case was whether section 8 of the *Interest Act*, R.S.C. 1985, c. I-15, rendered mortgage terms providing for interest rate increases and administrative fees on default and in the final month of the mortgage unenforceable. Section 8 prohibits penalties for non-performance on loans secured by mortgages and is a statutory version of a long-standing equitable rule. This decision is of interest because the Master in Chambers, Judith Hanebury, adopts a limiting approach to section 8 which was rejected by the British Columbia Court of Appeal and because the mortgaged building, the Lougheed Building, is of historic interest. (The Lougheed Building has been designated a Historic Resource at both the municipal and provincial levels and was recently restored. Its heritage value lies in its representation of Calgary's tremendous commercial growth prior to World War One; it is also an excellent example of the imposing Chicago Style of commercial architecture. For photos and details of the restoration, see the Canada's Historic Places web site).

Facts

The Lougheed Block Inc. borrowed $27,000,000 from Equitable Trust Co., secured by a mortgage on the Lougheed Building. This mortgage had an interest rate of prime plus 2.875 per cent and provided for a monthly $10,000 administration fee if the mortgage went into default. The mortgage matured June 30, 2008 and the Lougheed Block could not obtain funds from another lender to pay it out. It entered into a First Renewal Agreement with Equitable Trust for seven months which specified an interest rate of prime plus 3.125 per cent for the first six months, with the interest rate increasing to 25 per cent for the seventh month. It also included the same monthly $10,000 administration fee if the mortgage went into default. When that mortgage matured, the Lougheed Block still could not obtain funds to pay it out. It entered into a Second Renewal Agreement with Equitable Trust for twelve months. The interest rate was 25 per cent, but if the Lougheed Block made monthly payments at a floating interest rate of the greater of 7.5 per cent or prime plus 5.25 per cent and there was no default, Equitable Trust could forgive the additional interest. The Second Renewal Agreement also included the same monthly $10,000 administration fee if the mortgage went into default.

The mortgage went into default the month after the Second Renewal Agreement was entered into. An Order Nisi was granted and Equitable Trust received just over $29,000,000 for the heritage office building on a judicial sale. Equitable Trust sought interest at the 25 per cent rate, plus the administration fees of $10,000 per month for each month of default.

Law

Section 8 of the *Interest Act* provides that:

> 8. (1) 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 or hypothec on immovables that has the effect of increasing the charge on the arrears beyond the rate of interest payable on principal money not in arrears.
>
> (2) Nothing in this section has the effect of prohibiting a contract for the payment of interest on arrears of interest or principal at any rate not greater than the rate payable on principal money not in arrears.

A bit of historical background to this section is necessary because of a still-relevant formal distinction that existed in England in the 1800s. As the Master noted (at para. 20), the English courts of equity relieved against penalties for non-performance on mortgages but did not interfere where a higher rate was stipulated for in the first instance and then contractually waived for prompt payment. Although a penalty charged for default and a rebate given for prompt payment are both intended to encourage borrowers to pay on time and penalize them for their failure to do so, only the latter was allowed in law. See Arthur C. Meredith, "Nicety in the Law of Mortgage" (1916) 32 L. Q. Rev. 420 for a canvass of the old authorities. Lord Chancellor Northington, in the 1763 decision in *Stanhope v. Manners*, 2 Eden 197, E.R. xxviii at 873, stated the position amusingly:

> It has been truly said that the authority of this Court has assumed in cases of mortgages the old physical maxim *forma dat esse,* and that if the interest once runs at the larger rate it shall not be abated unless you hit the bird in the eye and pay or tender within the precise time; that on the other hand if it first runs at the lower rate, it shall not be raised even on a gross default, though in fact the substantial reasonable agreement between both parties is, if you are punctual to the time agreed upon, you shall pay less than if you delay and put to me (sic) an inconvenience. I believe all authorities sensibly founded, but I never heard or could myself discover the sense of the distinction.

Section 8 of the *Interest Act*, promulgated in Canada in 1880, is believed to have been intended to do away with the distinction in form that Lord Chancellor Northington said lacked sense: see Mary Anne Waldron, 'The "Legitimate Commercial Purpose" Test Revisited: Case Comment on *Reliant Capital Ltd. v. Silverdale Development Corporation*' (2008) 41 U.B.C.L. Rev. 101 at para. 3. Section 8 asks courts to look at the substance and effect of the challenged mortgage provision, rather than at distinctions in form.

Ever since section 8 did away with the distinction between penalties charged for default and rebates given for prompt payment, lenders and their lawyers have looked for ways around section 8. The issue in this case was the typical one of whether or not those who drafted the mortgage in this case had managed to avoid section 8.

Issues

Breaking down the overall issue, Master Hanebury stated three sub-issues as follows (at para. 18):

> 1) Is the increase in the interest rate to 25% per annum found in the First Renewal Agreement and in the Second Renewal Agreement contrary to the *Interest Act* or should it be disallowed in equity?
> 2) What are the rates of interest payable under the mortgage?
> 3) Are the administration fees charged pursuant to the mortgage contrary to the *Interest Act* or should they be disallowed in equity?

Analysis

Is the increase in the interest rate to 25 per cent per annum found in the First Renewal Agreement and in the Second Renewal Agreement contrary to the *Interest Act*? Recall that the First Renewal Agreement specified an interest rate of prime plus 3.125 per cent for the first six months of its seven month term, with the interest rate increasing to 25 per cent for the seventh month, whereas the Second Renewal Agreement specified an interest rate of 25 per cent, but provided that if the Lougheed Block made monthly payments with a floating interest rate of the greater of 7.5 per cent or prime plus 5.25 per cent and there was no default, the additional interest would be forgiven. Increasing the interest rate just prior to the end of the mortgage term and forgiving accrued interest are two of the many ways that lenders and their lawyers have tried to avoid section 8. And Canadian courts have reached different conclusions on the application of section 8 to these types of provisions. As Mary Anne Waldron -- the leading scholar on the *Interest Act* -- has concluded, when considering section 8 the courts have developed artificial means of fitting modern commercial needs to an archaic statute (Waldron, "The 'Legitimate Commercial Purpose' Test Revisited" at para. 27).

A new approach to the perennial problem of section 8 came to the fore in British Columbia 15 years ago: the "legitimate commercial purpose test." In *TD Trust v. Guinness*, [1995] B.C.J. No. 1854, another case in which the interest rate increased just before the mortgage came due, Justice Tysoe found that it was apparent on the face of the provision that it was an attempt to avoid section 8, with the lender offering no alternate explanation. When considering where to draw the line, Justice Tysoe stated (at para. 20) that it "should be drawn between interest provisions which are intended to extract a higher rate of interest in the event of default and interest provisions which have a *legitimate commercial purpose*." (emphasis added).

The British Columbia Court of Appeal considered the legitimate commercial purpose test in *Langley Lo-Cost Builders Ltd. v. 474835 B.C. Ltd.*, [2000] 7 W.W.R. 46. The mortgage in that case was part of a transfer of land and no interest was payable during the currency of the mortgage because a substantial prepayment had been made. However, interest was intended to be paid after maturity and so the mortgage provided for interest commencing three days before maturity at prime plus three percent. The Court of Appeal reviewed the case law and summarized it as follows: *prima facie*, a rate of interest payable at default or increased on default offends section 8, but a court may analyse the transaction to determine whether there is a business reason for the rate increase. Section 8 did not apply on the facts before it, the court held, because the purpose of the section is to protect borrowers against penalties and oppression at the hands of a ruthless lender and there was no coercion or intimidation in the case before the court.

The British Columbia Court of Appeal considered the legitimate commercial purpose test again in *Reliant Capital Ltd. v. Silverdale Development Corp.*, 2006 BCCA 226 – this time unfavourably. In *Reliant Capital*, the interest rate on a mortgage increased from 14% to 20% in the last month of a 13 month term, with interest-only payments made prior to the due date. The loan was made to fund a real estate development in an industrial park and the mortgage was to be repaid as the lands were subdivided, serviced and sold. While the British Columbia Supreme Court had held there was a violation of section 8 because there was no legitimate commercial purpose for the rate increase in the last month, the Court of Appeal came to a different result for different reasons. The Court of Appeal noted that if the effect of the clause is to charge a greater rate of interest on money in arrears than money not in arrears, there is a violation of section 8. In this case, however, the rate increase came into effect one month before maturity and did not have the effect of charging more on arrears. The Court of Appeal concluded that the increased rate of interest therefore became effective by the mere passage of time, not by any default. (This reasoning has been rightly criticised by Waldron in her comment on *Reliant Capital*, "The 'Legitimate Commercial Purpose' Test Revisited".)

More importantly, the Court of Appeal went on (at para. 89), in *obiter*, to reject the legitimate commercial test discussed in *Guinness* and *Langley Lo-Cost Builders Ltd.*, saying that test put an "unnecessary and unhelpful gloss" on section 8. The Court of Appeal stated that section 8 required a strict or narrow interpretation, with a court determining the intention of the parties from the language used in their agreement, viewed in the context of the objective circumstances, (i.e., the commercial context) in which that agreement was made. This approach was dictated by a purposive approach to the legislation, with an eye to the harm it was intended to remedy. The Court of Appeal stated (at para. 56) that the purpose of section 8 is "to protect property owners against abusive lending practices, while recognizing that generally speaking, parties are entitled to freedom of contract." As Waldron summarizes the Court of Appeal's rejection of the legitimate commercial purpose test (at para. 14): "It appeared to substitute a purposive analysis of section 8 as the sole guiding factor in the decision. Yet it left unclear the question of how a court would distinguish between an apparent violation of section 8 that will be held nonetheless legitimate and one that will not."

As Master Hanebury notes, however, the approach of the courts in Alberta has been different, even if the number of cases considering section 8 recently is few. The only recent Alberta Court of Appeal decision is *Dillingham Construction Ltd. v. Patrician Land Corp.*, [1985] A.J. No. 652 (ABCA) — a case of limited usefulness. The mortgage in that case provided for interest at 14% after maturity and after default, but no interest was to be paid prior to those occurrences. The Court of Appeal decided that there must have been a cost for borrowing because this was a business transaction. Therefore, the rate of interest was not nil, but merely unspecified, and there was therefore insufficient evidence to indicate that the provision for interest on maturity actually had the effect of increasing the interest rate.

Master Hanebury primarily relies upon *Paragon Capital Corporation Ltd. v. 395342 Alberta Ltd.*, 2004 ABQB 25. In that case the mortgage amending agreement provided for an interest rate of 2% per month that would be reduced to 1.167% per month if the loan was not in default. Justice Sirrs stated section 8 directed a court to look more to the substance of the transaction, than its form. By agreeing to collect a lesser rate if the loan was not in default, the lender changed what appeared to be a discount into what was, in substance, a penalty that fell within section 8. Justice Sirrs quoted (at para. 18) the legitimate commercial purpose test formulated by Justice Tysoe of the British Columbia Supreme Court in *Guinness* and hinted that, even if the interest provision before him had the effect of increasing interest on arrears, it might have been saved if it had a *bona fide* business purpose. He considered whether the loan agreement was a business arrangement to permit lower payments because of the limited cash flow available to the borrowers, but decided he could not draw that conclusion because the evidence did not support it. The legitimate commercial purpose test, if it was available, did not apply on the facts.

In summarizing the case law she had reviewed, Master Hanebury set out three principles (at para. 58):

> The legislation speaks to a fine charge or penalty that has the <u>effect</u> of increasing interest on money in arrears over that not in arrears. The Court should examine the substance of the transaction, not just its form, to determine if s. 8 has been contravened. To make this determination, and taking a purposive view of the legislation, the Court, in my view, must:
> (a) ignore clever drafting devices and consider whether the effect of the interest provision is to increase the interest on money in default over that paid on money not in default;
> (b) if the provision has the effect of increasing the rate of interest on money in default, consider the substance of the transaction by examining the terms of the agreement and the circumstances of the loan objectively; and
> (c) permit the interest provision to stand if the parties are knowledgeable, there is a bona fide business reason for the increase in the interest rate and it does not appear to be coercive, unfair, abusive or a penalty.
>
> Applying s. 8 in this way retains the intent of the original legislation, while permitting lenders to deal with the present-day realities of their business. (emphasis in original)

Applying this approach to the First Renewal Agreement, Master Hanebury first found (at para. 59) that, on its face, the provision increasing the interest rate after the sixth month of the seven month term to 25% from prime plus 3.125% appeared to be an attempt to avoid section 8 because it came into effect shortly before the mortgage came due and increased the interest rate significantly. In the second step, she found (at para. 69) that there was nothing in the terms of the agreement or the surrounding circumstances that indicated any increased risk or other reason for the increase in interest rate for the last month of the term — the Lougheed Block's inability to pay out Equitable Trust affected the entire term of the loan, not just its final month. Finally, applying her third step, she found (at para. 71-72) that the Lougheed Block was vulnerable due to its inability to find alternate financing and therefore, with no apparent *bona fide* business reason to increase the interest rate substantially one month before the due date, the inevitable conclusion was that the lender included this increase in the interest rate as a penalty, violating section 8.

The Second Renewal Agreement stipulated an interest rate of 25 per cent, but provided that if the Lougheed Block made monthly payments with a floating interest rate of the greater of 7.5 per cent or prime plus 5.25 per cent and there was no default, Equitable Trust could forgive the additional interest. As Master Hanebury noted (at para. 79) this arrangement echoes the situation considered in *Paragon Capital* and is the situation that section 8 was apparently enacted to cure. Applying the same approach to the Second Renewal Agreement, she first noted that the effect of the provision was to increase the interest to be paid on money in arrears as compared to money not in arrears. Second, she found (at para. 81) that neither the documentation nor the circumstances of the loan disclosed any *bona fide* business purpose for the interest rate increase to 25% on default. Third, the Lougheed Block was even more vulnerable because it could not pay out Equitable Trust and had no options. She concluded (at para. 81): "The arrangement appears to be the very kind of coercive, unfair lending the case law has disallowed." This provision therefore also violated section 8 and this increase in the interest rate was also disallowed.

Master Hanebury spent little time on the more easily resolved second issue. Having disallowed the increased rates of interest, she held that the interest rate to be charged was the floating rate of prime plus 5.25% or 7.5%, whichever is higher, as set out in the Second Renewal Agreement.

As for the third issue -- whether the administration fees of $10,000 per month for each month the mortgage was in default were contrary to section 8 -- Master Hanebury turned to the Supreme Court of Canada decision in *Les Immeubles Fournier Inc. v. Construction St-Hilaire Limitee*, [1975] 2 S.C.R. 2. The Supreme Court held that a specific sum to be paid only upon default is a penalty that contravenes section 8. Given that the business purpose of an administrative fee of the amount stipulated for was not evident and that the fee appeared, on its face, to be punitive, Master Hanebury held (at para. 95) that it could not stand as it also violated section 8.

Comment

As I see it, there are four problems with the decision of the Master.

First, in adopting the legitimate commercial purpose test put forward by British Columbia Supreme Court Justice Tysoe in *Guinness* and disapproved of by the British Columbia Court of Appeal in *Reliant Capital*, Master Hanebury has gone further than previous Alberta decisions. Justice Sirrs in *Paragon Capital* did not expressly indicate either approval or disapproval of that test when he quoted (at para. 18) the relevant passage from *Guinness*. Neither did the three principles he formulated as the correct approach to section 8 following his review of the case law explicitly adopt the legitimate commercial purpose test. The closest he came was in his third principle where he stated (at para. 31): “Enterprise should be free to negotiate such terms of interest as the parties consider appropriate to their transaction unless the terms are clearly within the exception set out in s. 8 of the Act.” This is a far more literal approach to section 8 than is Master Hanebury’s. Not only does the Master appear to be breaking new ground, but her statement of the correct approach to section 8 is also open to the objection the British Columbia Court of Appeal took in *Reliant Capital* to Justice Tysoe’s test in *Guinness*, namely, that the test put an unnecessary and unhelpful gloss on section 8.

Second, although expressly adopting the legitimate commercial purpose test from *Guinness*, it appears that Master Hanebury also adopted the purposive approach of *Reliant Capital*. The former appears in step two of her approach and the latter in step three. Certainly the British Columbia Court of Appeal thought the two approaches were incompatible.

Third, formulating the first (and third) issue as she did — Is the increase in the interest rate to 25% per annum found in the First Renewal Agreement and in the Second Renewal Agreement contrary to the *Interest Act* or should it be disallowed in equity? — could create confusion. The Master only considers whether section 8 is violated; she does not deal with whether the interest rate should be disallowed in equity. But surely section 8 takes the place of and changes the old equitable approach to penalties – the one described by Lord Chancellor Northington -- and cannot be considered as an alternative to section 8.

Fourth, while the restrictions imposed by a literal application of section 8 may be undesirable in our modern marketplace, the 1880 law still stands and cannot be ignored or rewritten by the courts. Master Hanebury attempts to create limits on or exceptions to section 8, but such limits create their own problems. Section 8 is really quite simple. It asks only whether the arrangement does in fact have the effect of increasing the interest rate on the arrears of money beyond the rate payable on money not in arrears. Attempts to get around it have great difficulty in finding a principled basis for drawing distinctions between provisions which violate section 8 but can stand and provisions which violate section 8 and cannot stand. Even a purposive approach is not self-applying. The British Columbia courts have decided that coercive mortgage lending practices will not be allowed because section 8 is aimed at protecting borrowers from abusive lending practices, but what qualifies as a coercive and abusive mortgage lending practice? Nothing but Parliament's revision of the *Interest Act* itself will resolve this perennial problem.