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Ontario Court of Appeal rules on use of annualizing formulas in debt documents

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Established commercial practice prevails in the Ontario Court of Appeal's recent decision in *Solar Power Network Inc. v. ClearFlow Energy Finance Corp.,* 2018 ONCA 727. The issue before the Court of Appeal was the application of section 4 of the *Interest Act* to certain loans. The Ontario Superior Court ruled earlier this year that an annualizing formula did not constitute an annual equivalent rate as required under section 4. This finding was concerning for debt providers because it is customary practice to include an annualizing formula in debt documents to comply with the *Interest Act*.

A formula may work

The Ontario Court of Appeal disagreed with the Superior Court and held that formulas, including annualizing formulas and more complex alternatives, will comply with section 4. The annual equivalent rate does not need to be expressed as a numerical percentage, nor is an effective rate required if the parties could not have known, when entering into the loan agreement, whether interest would ever compound (for example, where compounding only occurs upon loan rollover or renewal).

Result of non-compliance

Debt providers were also concerned by the Superior Court's finding that if section 4 was not complied with, all interest charged by the lender would be limited to 5%. However, the Court of Appeal interpreted section 4 in light of commercial reality and held that only the portion of interest that was not disclosed as an annual rate will be limited to 5%. Note that the Court of Appeal took a contextual approach to interpreting section 4 and it is unclear whether a court would more easily find an intention to circumvent section 4 in a consumer context and whether a court, in such a case, would interpret the 5% cap to cover all interest charged on a loan.

Implications

The Court of Appeal's decision provides significant relief to lenders and other debt providers as their concerns over the validity of interest rate formulas have largely been mitigated. Where the occurrence (and quantitative impact) of compounding is certain, loan agreements should include an annual effective rate.