Interest Act - 2008 Report

CIVIL LAW SECTION

CANADA

INTEREST ACT

Report of the working Group

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Quebec City, Quebec August, 2008

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BACKGROUND

[1] In September 2007, in Charlottetown, P.E.I., Professor Thomas G.W. Telfer of the

University of Western Ontario presented a paper on the *Interest Act*, R.S.C. 1985, c.I-15, entitled “Preliminary Background Paper on the Canada Interest Act” to the Uniform Law Conference of Canada.

[2] Professor Telfer’s paper examined the history of the *Interest Act* and the subject-matters covered by its provisions. He reviewed the Act’s original purposes and questioned whether, in light of those original purposes, the *Interest Act*had continuing relevance in today’s commercial reality.

[3] After receiving Professor Telfer’s paper and oral presentation, the Commercial Section of the ULCC resolved to form a working group to further consider the issues raised by his report and to examine the provisions of the *Interest Act* in light of provincial legislation and common law developments.

[4] Most ULCC projects raise questions and concerns as to the uniformity of provincial and territorial legislation. This project does not; instead, it raises questions as to the extent to which the provisions of the federal *Interest Act* are duplicated in existing provincial and territorial legislation and the extent to which the *Interest Act* provisions, whether they are duplicated in provincial and territorial legislation or not, remain relevant.

Working Group Membership

[5] The working group on this project consisted of Professor Tom Telfer, Professor Mary Anne Waldron of the University of Victoria, David Young of Lang Michener LLP (Toronto) and Lisa Peters of Lawson Lundell LLP (Vancouver), who is a member of the B.C. delegation to the ULCC. Michelle Bissenden of Lawson Lundell LLP provided research assistance.

Methodology Adopted

[6] The working group assembled a collection of provisions in provincial and territorial statutes and regulations dealing with interest rates, disclosure of the cost of borrowing and unconscionable transactions. It then considered the relationship between those provisions and the existing provisions of the *Interest Act* in the context of the jurisprudence on those provisions and considered to what extent the *Interest Act* provisions are duplicated or made redundant by the provincial and territorial legislation.

[7] Where the *Interest Act* provision in question had no equivalent in provincial and territorial legislation, the working group considered whether the provision continued to serve a valid regulatory purpose in light of the jurisprudence considering it and modern lending and contract law and practice.

[8] The working group also reviewed provisions in other federal statutes dealing with

interest rates.

Preliminary Nature of Report and Desirability of Consultation

[9] The working group was not formed until early 2008. Because of the short time frame available for carrying out our deliberations, this report and the recommendations contained in it are preliminary only. The working group would like to continue its work into 2009 and, in particular, to have the ability to consult with lawyers practicing in the areas of real estate, consumer and banking law and with consumer and lender associations.

Constitutional Background

[10] The subject-matter of “Interest” was granted exclusively to the federal Parliament under subsection 91(19) of the *Constitution Act, 1867*. As will be apparent from this report, the provinces and territories have enacted legislation dealing directly with interest rates and also have dealt with that subject-matter more indirectly by enacting consumer legislation. From a constitutional perspective, such legislation has survived constitutional challenges where the legislation can be justified under a head of jurisdiction that courts do not classify as primarily concerned with financial matters and therefore not a major erosion of the federal authority.[1] The fact is, however, that little of the existing provincial and territorial legislation has ever been the subject of a constitutional challenge. Because the body of constitutional law in this area is small, and much of it dates from other decades or centuries, the boundaries of the federal power and the extent to which provinces and territories can encroach upon it are not clear.

SECTION BY SECTION REVIEW AND RECOMMENDATIONS

Section 2—Laissez-Faire Approach to Interest Rates

[11] Section 2 states:

Except as otherwise provided by this Act or any other Act of Parliament, any person may stipulate for, allow and exact, on any contract or agreement whatever, any rate of interest or discount that is agreed on.

[12] As Professor Telfer pointed out in his 2007 paper, Parliament enacted the original version of this provision in 1886 with a view to abrogating usury laws then in force in some of the provinces.

[13] Lenders (and others providing for contractual interest) are still subject to the other provisions of the Act, to section 347 of the *Criminal Code*,[2] and to any other federal statute prescribing interest rates. A chart attached to this paper as Schedule “A” identifies provisions in other federal statutes prescribing interest rates.

Other Federal Legislation Regulating Interest Rates

[14] There are four types of provisions dealing with interest rates in other federal legislation: those fixing an interest rate or providing a formula for fixing an interest rate; those setting out a default rate for circumstances where the interest rate cannot be ascertained; those setting out a maximum interest rate; and those setting out a range for the interest rate (the interest cannot be less than the minimum rate stated or more than the maximum rate stated).

[15] Aside from section 347 of the *Criminal Code*, the other federal provisions prescribing interest rates are very subject-matter and context specific. They include provisions:

- (a) setting the interest rate payable on government annuities;
- (b) setting the interest rate payable in relation to or as part of the calculation of federally administered pensions;
- (c) regulating the interest rate payable on Canada Student Loans;
- (d) setting the interest rate payable or the maximum interest rate payable under other federal loan or assistance programs;
- (e) setting out the interest rates applicable on sums payable to the federal government (such as amounts payable to the Receiver General under the *Excise Tax Act*[3] or penalties payable under the *Employment Insurance Act*[4]);
- (f) setting out the power of the Federal Court and Federal Court of Appeal to award pre- and post-judgment interest;
- (g) dealing with the calculation of interest on certain deposits under the *Canada Deposit Insurance Corporation Act*[5]in circumstances where the term of a deposit contract extends beyond the interest termination date and not all of the information necessary for the calculation of interest is available by that date;
- (h) setting the maximum annual rate of interest payable on promissory notes under the *Small Business Loans Regulations, 1993*[6] and the maximum annual imputed rate of interest used to calculate the scheduled payments on a capital lease under the *Canada Small Business Financing (Establishment and Operation of Capital Leasing Pilot Project) Regulations*;[7]
- (i) setting the maximum rate of interest payable under First Nations property tax laws; and
- (j) stipulating the interest rate applicable where, in the context of credit sales of goods to an importer in Canada, it is not possible to ascertain the interest rate referred to in a clause of the *Special Import Measures Act*,[8] or there is no such interest rate.

Continued Utility of Section 2

[16] While "interest" is a federal subject-matter under the *Constitution Act, 1867*, there are in fact numerous provincial and territorial statutes prescribing interest rates in the context of subject-matters within provincial or territorial competence. Schedule "B" identifies provisions in provincial and territorial statutes prescribing interest rates. Schedule "B" will be discussed below in the context of section 3 of the Act. It should be noted that provincial consumer legislation, which typically avoids specifically prescribing fixed, minimum, maximum or default interest rates but instead regulates disclosure of the cost of borrowing and provides relief in cases of unconscionable transactions, could be viewed as the modern substitute for usury legislation.

[17] Section 2 is not an impediment to commerce, nor has it given rise to difficulties in interpretation or application like some of the other provisions of the *Interest Act*. Section 2 and the principle of freedom of contract it embraces may influence the interpretation of parties' agreements by the courts.[9] While its scope may have been whittled down by the choice of both the federal Parliament and provincial and territorial Legislatures to regulate interest rates in specific contexts, and by consumer protection legislation, the working group is not prepared to say that section 2 no longer serves a purpose. It continues to articulate the federal *laissez-faire* policy first articulated in 1886 – that absent legislation to the contrary, parties are free to stipulate for any agreed-upon rate of interest. Because the policy reflected in section 2 is still current, the provision is not obsolete.

Section 3—The Default Rate of Interest

[18] Section 3 of the *Interest Act* provides as follows:

Whenever any interest is payable by the agreement of parties or by law, and no rate is fixed by the agreement or by law, the rate of interest shall be five per cent per annum.

[19] Professor Telfer's 2007 paper reveals that the rate of five percent was set in 1900, apparently to reflect the lending rates at financial institutions at that time.

[20] Section 3 is potentially applicable in two circumstances: where interest is payable in an agreement between the parties or where interest is payable by law. In both those circumstances, it only applies where "no rate is fixed."[10]

[21] The scope of the application of section 3 in the first context has been significantly reduced by the jurisprudence:

(a) It only applies "when there is no provision made in an applicable statute or in an agreement and no mechanism is provided by which a rate can be fixed".[11] Courts have

striven to identify a mechanism in contracts before them so as to oust section 3;[12] and

(b) The phrase “fixed …by law” has been construed to cover circumstances where an interest rate is fixed by statute, where a formula for setting the rate is set out in a statute, or where the statute delegates discretion to a judge, adjudicator or adjudicative agency to set the rate.[13]

[22] In short, the scope of section 3 has been limited to the “rare case, if any, where a court or statutory body cannot legitimately award interest.”[14]

Provincial and Territorial Legislation dealing with Interest Rates

[23] As with the federal provisions dealing with interest rates, there are four categories of interest rate provisions in provincial and territorial statutes and regulations: those setting a fixed rate or formula; those setting a default rate; those setting a maximum rate and those setting a minimum rate. Schedule “B” summarizes the provincial and territorial provisions under those category headings.

[24] Examples of provincial and territorial provisions dealing with interest rates include (N.B., not every example applies in every jurisdiction):

- (a) Provisions dealing with prejudgment and post-judgment interest;
- (b) Provisions dealing with interest rates payable on monies paid into court;
- (c) Provisions dealing with interest rates on arrears on required payments such as maintenance payments or wages under employment standards legislation;
- (d) Provisions setting interest rates payable on amounts owing to government (such as taxes or penalties) or on overpayments made by government;
- (e) Provisions setting interest rates payable on security deposits in a landlord-tenant relationship;
- (f) Provisions setting interest rates payable on agriculture industry loans by government or government housing loans;
- (g) Provisions setting interest rates on provincial student loans;
- (h) Provisions setting interest rates payable under other provincially-administered loan programs;
- (i) Provisions setting minimum interest rates payable by a credit union or development corporation;
- (j) Provisions setting interest rates payable on statutorily-mandated compensation;
- (k) Provisions setting interest rates payable on instalment payments on automobile insurance;
- (l) Provisions setting interest rates payable on inactive accounts in provincially-regulated financial institutions; and
- (m) Provisions setting the interest rate payable under contracts for sale of Crown

lands.

Continued Utility of Section 3

[25] In light of the range of provincial and territorial provisions dealing with interest rates and in light of the narrow scope left in which section 3 of the *Interest Act* operates both because of the provincial and territorial incursions and because of the construction given to section 3 by the courts, is this default rate required?

[26] In the view of the working group, section 3 still has relevance for three reasons:

- (a) One cannot foresee all the potential scenarios to which such a default rate may be relevant;
- (b) While there is other federal legislation dealing with interest rates, it is (aside from section 347 of the *Criminal Code*) subject-matter and context specific; and
- (c) The provinces and territories have not completely occupied the field (and constitutionally-speaking could not do so) and the interest rate provisions in provincial and territorial legislation are also subject-matter and context specific.

[27] The second question raised in relation to section 3 is whether, in a world of fluctuating interest rates, a fixed rate of 5% per annum makes sense, especially given its provenance.

[28] While some of the interest rate provisions set out in Schedules “A” and “B” contain a fixed rate (*i.e.*, 3% per annum), many contain instead a statutory formula that permits the prescribed interest rate to move with the market.

[29] Some of these formulae are quite complex. For example, subsection 13(1) of the *Canada Student Loan Regulations*[15] provides for one applicable rate of interest to be:

the aggregate of one per cent and the rate fixed by the Minister for each loan year by calculating, immediately preceding the commencement of that loan year, the simple arithmetic mean of the mid-market yields at the close of business on Wednesday in respect of the six months immediately preceding the commencement of that loan year on all Government of Canada bonds payable in Canadian currency and due to mature in one to five years, as computed and provided by the Bank of Canada, rounded to the nearest one-eighth of one per cent.

[30] Other provisions are much simpler. The *Interest and Administrative Charges Regulations*[16] provide, in subsection 5(1), for interest on amounts owing to Her Majesty to be “calculated and compounded monthly at the average bank rate plus 3%”.

[31] Some provisions set the interest payable by reference to the prime rate, typically the prime rate at a particular bank (*e.g.*, the Bank of Canada, the principal banker to the

Province, etc.). For example, under the *Enhanced Recovery of Oil Royalty Reduction Regulation*,[17] the rate of interest is "the annual rate of interest established by the Province of Alberta Treasury Branches as its prime lending rate on loans payable in Canadian dollars that is in effect on the first day of the month in which that day occurs plus 1%." A large number of Ontario regulations[18] provide for the payment of the "average prime rate", which is defined as:

the mean, rounded to the nearest whole percentage point, of the annual rates of interest announced by each of the Royal Bank of Canada, The Bank of Nova Scotia, the Canadian Imperial Bank of Commerce, the Bank of Montreal and The Toronto-Dominion Bank to be its prime or reference rate of interest in effect on that date for determining interest rates on Canadian dollar commercial loans by that bank in Canada.

[32] In the view of working group, it would be preferable for the default rate in section 3 of the *Interest Act* to be tied to market rates in some fashion.

Section 4 – Disclosure of Per Annum Rate

[33] Section 4 is a generally-applicable provision mandating disclosure of an annual interest rate in contracts, other than mortgages, containing an obligation to pay interest at a rate that is referable to a period of less than a year. Specifically, if the contract does not also contain disclosure of the yearly rate that is equivalent to the stated interest obligation, the maximum rate of interest that may be charged is 5%. The provision reads as follows:

4. Except as to mortgages on real property of hypothecs on immovables, whenever any interest is, by the terms of any written or printed contract, whenever 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.[19]

Perceived Deficiencies

[34] The main deficiency of the provision is that it provides no specification as to how the interest amount should be calculated (*i.e.,* the frequency of calculation and payment, whether in advance and whether to be compounded).

[35] A second deficiency is that the section provides no guidance as to whether the disclosure required is simply of the nominal rate of interest (*i.e.,* the actual stated rate) or

an effective rate (*i.e.,* an annual rate that reflects the actual anticipated interest to be paid on the principal from time to time over the period of a year, including periodic payments of interest and principal and compounding of interest). Consider the following example – a student pays $10,000 in tuition on January 1 using a credit card with an advertised nominal interest rate of 20% per annum. If the credit card company in fact charges interest at the nominal rate, then the student will pay $2,000 per annum in interest (assuming no payments are made during that period). However, if interest is compounded monthly, then the student will pay $2,190 since the effective rate will be 21.9% despite an advertised nominal rate of 20%. For those on a tight budget, this difference could be significant. Based on the case law, it appears that the courts interpret the disclosure requirement in section 4 to be solely that of the nominal rate.[20]

Scope of Section 4

[36] Another issue that the courts have addressed is whether the legislation only applies to consumer transactions or to all transactions. The Supreme Court of Canada has stated that the legislation is “consumer protection law,” suggesting that it does not apply to sophisticated borrowers.[21] However, this statement did not go so far as to clearly say the legislation only applies to consumer transactions and recent decisions have reached opposite conclusions. On its face, the provision is not restricted to consumer transactions.

[37] It may be noted also that the provision is not restricted to lending transactions, but applies to any contract in which interest is stipulated. Therefore, courts have applied the provision to interest on overdue utility bills.

[38] Notwithstanding the noted deficiencies, section 4 does represent a generally-applicable obligation for lenders and others to state an annual rate of interest in their contract documents. In the context of determining whether the provision should be amended or eliminated, the question may be posed whether there are other laws that perform this function equally well or better.

[39] We note that there are a variety of public sector laws that require disclosure of a rate of interest and in certain instances (such as under the *Income Tax Act*),[22] specification of that rate. In many cases there is no requirement to stipulate a precise form of interest disclosure (*e.g.,* annual rate) or on what basis it will be charged. However, it is reasonable to assume that, if not so specified, in most if not all cases the rate is intended to mean an annual rate.

Overlap with and Differences from other Federal and Provincial Legislation on Disclosure

[40] Legislation stipulating interest rate disclosure for private sector transactions is almost exclusively limited to the cost of credit disclosure requirements under provincial consumer protection laws[23] and certain federal statutes such as the *Bank Act*,[24] the *Cooperative*

Credit Associations Act[25] and the *Insurance Companies Act*.[26] The provincial consumer protection rules generally apply to “consumers” (*i.e.,* individuals who are not carrying on business);[27] the federal rules, which are very similar, apply to loans made to “natural persons” for other than business purposes.[28]

[41] The thrust of the cost of credit disclosure legislation is to provide disclosure to borrowers, including credit card users, of the full cost of borrowing. The primary means of accomplishing this objective is the determination and disclosure of an “annual percentage rate” or (“APR”) which factors in not only periodic interest calculations and principal payments, but also interest-free periods, certain fixed non-interest costs (including for example bonuses and any lump sum payments), and the cost of any other requirements that a borrower must meet (such as motor vehicle searches). In some instances, but not always, the APR is equal to the interest rate disclosed by a loan. Therefore, while the APR constitutes a sophisticated and comprehensive disclosure of an effective interest rate, it may differ significantly from the nominal annual rate of interest.

[42] However, the cost of credit disclosure legislation also stipulates that disclosure of the nominal rate of interest be made to borrowers. In most instances this requirement is described as the “annual interest rate”. In certain instances the required disclosure is stated as the “interest rate”. In all instances, however, we believe that the requirement should be read as referring to an annual rate and where this is not clearly stated, clarification by amending regulation could be accomplished.

[43] In addition to general cost of credit disclosure legislation, certain provinces have enacted “Payday Loans” laws that apply in addition to the general cost of credit disclosure rules. Some but not all of these laws require disclosure of a rate of interest, but in no case is this expressly stipulated to be an annual rate. Ontario’s payday loan rules, which are found in the *Consumer Protection Act*, do not require disclosure of a rate of interest but do require disclosure of the APR, which as noted above, may be the same as the interest rate.[29]

[44] It should be noted that the consumer protection/cost of credit/payday loans rules only apply to loan transactions. Other contracts stipulating for interest, such as overdue payment of utility bills, or contracts imposing a “service charge” stated as a percentage rate, would not be subject to these rules. Section 4 of the *Interest Act* has been held to apply to such contracts.[30]

[45] The most significant difference in application between section 4 and cost of credit/payday loans legislation, however, is that the latter only applies to consumers (or in the case of the federal rules, natural persons not borrowing for business purposes) whereas the former is not clearly so restricted. The question is posed therefore, whether section 4 has potentially beneficial application to non-consumer transactions. It may be

recalled that at the time of enacting the new cost of credit rules, certain provinces considered, but ultimately decided against, extending their application to small businesses. An argument can be made that many of such businesses are not very sophisticated in their financial dealings and would benefit from a protective disclosure regime as may be provided by section 4.

Continued Utility of Section 4

[46] Consideration should be given to whether the nature of the information provided by section 4 disclosure is useful to borrowers. It appears that all that is required is disclosure of the nominal annual rate of interest which, in differing circumstances, may be higher or lower than the effective rate. However, we note that disclosure of the nominal annual rate of interest in any transaction is a useful item of information to the borrower, whether or not other legislation requires a more sophisticated form of disclosure. The requirement for this disclosure, which may be duplicated in certain other statutes also applicable to a transaction, does not conflict with other material disclosure requirements, nor does it hamper or restrict transactions to which it applies.

[47] We also note that section 4 provides a residual rule for financing and other transactions which stipulate a cost of using money by way of an interest rate. It is residual in that it will apply to transactions not covered by the consumer protection legislation including loans to small businesses where the borrowers may be unsophisticated and to transactions involving an element of financing that do not fall within that legislation, such as overdue utility bills.

[48] While the nature of the disclosure (nominal interest rate) may not in all cases reflect the effective rate, it does require disclosure of a rate that in many instances will be a close approximation of the effective rate and therefore may be viewed as a beneficial “user-friendly” protective requirement. However, consideration also should be given to whether an amendment requiring disclosure of an effective rate of interest, instead of the nominal rate, should be made. The difficulty here would be to define what is meant by the effective rate, which will vary depending on the circumstances. Any such definition would need to be general in terms but encompass sufficient specificity to ensure applications to all materially relevant circumstances.

[49] In summary, in that section 4 does not clash with provincial and territorial legislation and covers transactions not captured by that legislation, it is not obsolete. The provision might have more utility if it required disclosure of an effective rate of interest rather than the nominal rate. This topic would form part of any consultation carried out by the working group going forward.

Section 6 of the *Interest Act*

[50] Section 6 of the *Interest Act*[31] requires a particular form of disclosure of the interest rate for certain categories of mortgage loan and provides a severe penalty for failure to comply. Section 7 restricts the lender from charging more than it is entitled under the disclosed rate.[32] The sections are as follows:

6. Whenever any principal money or interest secured by mortgage on real property or hypothec on immovables is, by the mortgage of hypothec, made payable on a sinking fund plan, on any plan under which the payments of principal money and interest are blended or on any plan that involves an allowance of interest on stipulated repayments, no interest whatever shall be chargeable, payable or recoverable on any part of the principal money advanced, unless the mortgage or hypothec contains a statement showing the amount of the principal money and the rate of interest chargeable on that money, calculated yearly or half-yearly, not in advance.

7. Whenever the rate of interest shown in the statement mentioned in section 6 is less than the rate of interest that would be chargeable by virtue of any other provisions, calculation or stipulation in the mortgage or hypothec, no greater rate of interest shall be chargeable, payable or recoverable, on the principal money advanced, than the rate shown in the statement.

Limitations of Section 6

[51] What section 6 requires is clear, although it may be of limited value. The section requires that however the lender chooses to compute its interest on a mortgage loan, it must provide the borrower with the equivalent interest rate based upon yearly or half-yearly compounding. This, one might think, could provide at least a standard mode of expression of the interest rate which could enable a borrower to conveniently comparison shop. However, two principal factors militate against the usefulness of the disclosure.

[52] First, the interest as expressed in a section 6 disclosure does not have to take into account any form of cost other than that which accrues from day to day.[33] Thus, the effect of a bonus or of various administrative[34] and service charges is completely left outside the purview of the section. This lessens the utility of the disclosure for comparison purposes. A loan with a lower stated interest rate may in fact be more expensive due to other changes. That is not something section 6 will assist the borrower to decide.

[53] Second, section 6 requires only that the disclosure be made in the mortgage itself. What the borrower has been told or discovered during the period in which he or she is deciding which loan to take or whether to borrow is not constrained by the section. The first time a mortgage borrower sees the mortgage document itself is usually in the lawyer’s office when it is presented for signature. The mortgagor is, by that time, usually

committed to the transaction and may be less than interested in technical details, having made the decision some time earlier. The section 6 disclosure, therefore, has no effect on the ability of the borrower to compare various mortgage products.

[54] Apart from the possibility that it might provide a standard form of disclosure of the narrowly-construed interest rate for a loan, section 6 requires disclosure of very few of the things modern borrowers might want to know about their loan. For one thing, the concept of an equivalent rate is not one that most consumers would understand without considerable explanation. The usefulness of disclosing an equivalent rate may therefore be questionable. On other important topics, the disclosure required says nothing about prepayment options; tells the borrower nothing about renewal costs or any other costs or charges; does not require the allocation of payments in any particular way; and does not require disclosure of the term of the loan or the amortization period (if the loan is amortized). This list of omissions is only a partial one. And, if the loan is for a variable rate of interest, section 6 provides none of the safeguards that are needed to properly inform the borrower of what he or she is paying at any given time. Indeed, to comply with section 6, a table of possible equivalent rates may be included, but the section would not, of itself, require the borrower to be informed when the rate changes.

Types of Mortgages to which Section 6 Applies

[55] These objections to section 6 alone would be significant. However, an even greater challenge to the usefulness of the section arises from the description of the three forms of mortgage loan to which it applies. No case seems ever to have decided that section 6 applied to a mortgage because it was “payable on a sinking fund plan” or because it involved “an allowance of interest on stipulated repayments.”[35] Exactly when the section’s application would be triggered by these descriptions is therefore in doubt. That it has not occurred in over one hundred years would seem to suggest that it serves no useful purpose.

[56] Many laypeople would likely consider that their mortgages were representative of a the third type of plan involving “blended payments”. Common sense would suggest that this would describe a payment in which principal and interest were mixed together as is the case in the great majority of residential mortgages where a monthly payment contains some component of both principal and interest. However, case law progressively narrowed the meaning of a “blended payment” until it has come to mean only payment plans that conceal the interest charged. Exactly what this means is still unclear. It does not include any case in which payment dates and compounding dates coincide since the mathematics required to compute the amount of principal and interest is simple.[36]

[57] Whether it applies to a case in which payment is monthly and compounding is at

longer intervals and in which dividing the payment between its principal and interest components requires the use of interest factors is still not entirely settled. However, the decision of the Supreme Court of Canada in *Ferland v. Sun Life Assurance*[37] strongly suggests that even then, unless there is an actual mathematical impossibility of separating the payments, the payment is not blended. The test of whether it was mathematically possible to separate the components of the payments was also applied in the more recent decision of *Blerot v. Attorney-General of Canada*.[38] In face of such uncertainty, the advice of the Saskatchewan Court of Appeal to save litigation costs and include an equivalent half-yearly rate is almost universally accepted in Canada.[39] In British Columbia, for example, the statutory form of mortgage includes a section for disclosing the equivalent rate compounded half-yearly.

[58] The lack of certainty in this narrow category has, as noted, led to compliance with section 6 (whether required or not) in all typical amortized mortgage loans. That certainly appears to be the only category of mortgage in which any scope for section 6 remains. Since most residential mortgages would fit this mold, one can conclude that section 6 is normally complied with in the consumer context. Whether it is needed in this context is another matter.

Other Disclosure Legislation

[59] The federal *Bank Act*[40] and a number of provincial consumer protection statutes[41] require that a borrower on a mortgage loan for personal or household purposes receive an extensive disclosure statement related to the loan, its terms and its cost, at least two days before the obligation is entered into. The disclosure statement provides much more useful and extensive information to the borrower about his or her loan than does the limited disclosure required by section 6. Most costs of borrowing have to be included in the cost of the loan. The method of disclosure of the interest rate is also highly regulated and the problem of what occurs if the interest rate is to vary over the term of the loan is extensively dealt with. The disclosure required, in short, is more useful and considerably timelier than the disclosure for section 6. For many consumer mortgagors across the country, section 6 is largely redundant.[42]

Business Borrowers and Section 6

[60] The remaining category of mortgages to which section 6 might arguably apply and which are not covered under either the *Bank Act* or consumer protection statutes is the business loan where the loan is amortized and payment and compounding dates do not coincide. Many commercial loans, of course, would not be of this type since amortized loans with monthly payments are less common in this market. Thus, the protection afforded by section 6 is “hit and miss” for loans to businesses. It may be argued, as legislators seem to accept in consumer protection legislation, that businesspeople do not

require the protection of statutorily mandated disclosure. However, people operating small businesses and borrowing, perhaps, against their residential property for business purposes, may often not be much more sophisticated than the average consumer borrower. Is there a case for retaining section 6 to protect such borrowers?

[61] While there is arguably a case that the small business owner needs protection, section 6 as it stands does little to assist him or her for reasons already noted. It applies only to a very narrow range of mortgage loans (if it applies there); does not provide adequate disclosure to properly inform the borrower about the loan; and is not timed in a way that would allow the borrower to take any advantage from what he or she is told. Section 6 is a poor substitute for more adequate protection which would be similar to what is given consumers.

A Case for Repeal?

[62] The severity of the penalty for failing to make a needed disclosure – the loss of all interest on the loan – may explain the unwillingness of the courts to use section 6 in any robust way.[43] A more moderate approach to enforcement might have allowed some development of section 6, causing it to evolve into a more effective tool. But the debate on useful credit disclosure has become much more sophisticated in the last twenty-five years. Section 6 cannot compete with modern generation disclosure statutes. Given its restrictive, almost accidental application and the shortcomings of what it provides, the preliminary view of the working group would be to recommend outright repeal.

[63] However, since the disclosure of the semi-annual rate has become the standard mode of expression of the interest rate in most amortized mortgages, we recommend consultation with lenders and real estate lawyers as to whether the repeal of sections 6 and 7 would negatively affect established practice. If there is a reluctance to repeal a section that has become so enshrined in Canadian mortgage lending practice, an alternative would be to amend section 6 so that its application to the typical amortized mortgage is clear. In the next phase of this project, the working group will also consult possible amendments to section 6 as an alternative to repeal.[44]

[64] The question might also be asked whether section 6 should rather be turned into effective disclosure legislation, mirroring that adopted in many provinces. We do not recommend this course of action. We consider that there would be little point in increasing the complexity of the varying disclosure schemes that now exist by adding another federal level to them. Rather, provinces might be asked to reconsider whether the small business borrower is not in need of protection comparable to the consumer and to make further efforts at establishing uniformity among themselves in their credit disclosure legislation and its coverage of mortgage loans.

Section 8

[65] Section 8 reads as follows:

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.[45]

Origins and Scope of Section 8

[66] In general, section 8 will prevent the lender from increasing the rate of interest on a mortgage on default. However, the section is expressed in terms of its original 1880 language and also precludes the imposition of a fine or penalty exacted on any arrears. Parliament in 1880 was responding to abusive lending practices whereby default terms were often undisclosed and therefore unknown to the borrower at the time of the loan agreement. A borrower might not understand that default and the accumulation of arrears triggered a higher rate of interest.[46] Rather than mandate any form of cost of credit disclosure, Parliament prohibited the lender from imposing higher rates of interest after default.[47]

Judicial Interpretation of Section 8

[67] Although there is extensive case law on section 8, the British Columbia Court of Appeal, in *Reliant Capital Ltd. v. Silverdale Development Corp.,* concluded that “the only thing on which the courts seem to agree is the difficulty of construing the language of section 8 in the context of the modern commercial world.”[48] There are numerous examples in the case law where increased interest rates, charges or the payment of a bonus have been held to contravene section 8.[49]

[68] There is also recognition in the case law that the parties should have some freedom to structure their transactions and not every challenge under section 8 has been successful. Some courts have emphasized that the starting point is freedom of contract under section 2 and that section 8 is an exception to that general principle.[50] This has led to an alternative line of cases in which the courts have concluded that section 8 has not been violated, perhaps in response to the “inventive drafting” of the solicitors seeking to avoid the application of the earlier case law.[51]

[69] Yet there appears to be no consistent form of reasoning in how the courts analyze section 8, leading Professor Waldron to conclude:

Other cases under the Interest Act have applied equally artificial means of accommodating modern commercial needs to this archaic statute. That is unfortunate.

The need to adopt such technical and meaningless distinctions does not advance the purposes of commercial law.[52]

Continued Utility of Section 8?

[70] It must be asked whether there is any continued role for section 8 to play as it is currently worded. Section 8 pre-dates the significant development of consumer lending and thus does not distinguish between commercial mortgages and residential mortgages.[53] Commercial mortgage transactions entail risk taking by both parties. And as Professor Waldron notes, the modern lending world is a very different one from the nineteenth century:

Stability of interest rates can no longer be counted upon in our modern world. Moreover, interest rate is no more consciously tied to risk in the lending environment. The risk of the loan that is in default may be very different indeed from the risk assumed at the beginning of the transaction. Prudent lenders, not simply rapacious lenders, might wish to provide for this eventuality. Section 8 of the Interest Act has posed a significant barrier to doing so.[54]

[71] If the commercial lender has adequately disclosed to a commercial borrower the increased rate of interest that would apply on default and there is no allegation of inequality of bargaining power at the time of the transaction why should the federal *Interest Act* stand in the way of that consensual transaction?

[72] Therefore, the working group is of the view that section 8 should be restricted in scope and should apply to mortgages that charge real property primarily used by the borrower as a principal residence. While most commercial transactions would be excluded from section 8, we propose that the section would cover a collateral mortgage given by a small business person against his or her home.

[73] The working group recognizes that the origins of section 8 clearly pre-date the development of contract law jurisprudence dealing with default provisions. Similarly section 8 also pre-dates the development of common law unconscionability doctrines as well as unconscionability legislation.[55] Although a reformulated section 8 would overlap to some extent with this provincial unconscionability law, the working group concluded that a new section 8 would supplement such provincial law. Retention of a reformulated section 8 will be a better solution than outright repeal.

[74] As with other provisions commented on in this report, consultation with practitioners and stakeholders on section 8 would be desirable.

Section 10

[75] Subsection 10(1) reads as follows:

10. (1) Whenever any principal money or interest secured by mortgage on real property or hypothec on immovables is not, under the terms of the mortgage or hypothec, payable until a time more than five years after the date of the mortgage or hypothec, then, if at any time after the expiration of the five years, any person liable to pay, or entitled to pay in order to redeem the mortgage, or to extinguish the hypothec, tenders or pays, to the person entitled to receive the money, the amount due for principal money and interest to the time of payment, as calculated under sections 6 to 9, together with three months further interest in lieu of notice, no further interest shall be chargeable, payable or recoverable at any time after the payment on the principal money or interest due under the mortgage or hypothec.

Origins of Section 10

[76] Section 10 is an illustration of the wide discrepancy between Parliament's original purpose in 1880 in relation to mortgage repayment rights and modern mortgage lending practices of today. Section 10 provides for a mortgage repayment right after 5 years and the provision was enacted in 1880 to deal with long term mortgages. In the late nineteenth century the term of the mortgage frequently matched an equally long amortization period. Without statutory protection, borrowers had to pay an enormous penalty to repay the mortgage in advance. Since there was no right under common law or equity relating to the right to prepay a borrower might be unable to pre-pay at all. If a lender did stipulate for a repayment right it could insist on any amount of liquidated damages up to all the interest that would have been earned over the balance of the term. Section 10 enabled the borrower to repay after 5 years by paying 3 months interest in advance.[56]

[77] By 1890, however, Parliament recognized that section 10 had created difficulties for corporate borrowers in obtaining long term financing and in that year, subsection (2) was added to limit the scope of the section to individual borrowers. [57]

[78] Modern lending practices have shifted to short term mortgages of 6 months to 5 years with long amortization periods.[58] Could section 10 be of any relevance to a short term mortgage? What if the borrower renewed or extended the original mortgage? When might the five year repayment right begin? A plain reading of section 10 does not provide an answer to questions arising from modern lending practices.

Judicial Interpretation and the New Meaning of Section 10

[79] The 1986 Supreme Court of Canada decision in *Potash v. Royal Trust Co.*[59] redefined the purpose of section 10 in light of these modern practices. The Supreme

Court acknowledged that Parliament adopted section 10 in light of nineteenth century practice. That did not prevent the court from "giving it an interpretation consonant with today's commercial reality if such an interpretation is equally compatible with the legislative language."[60]

[80] The Court established that where the borrower had entered into a mortgage which was longer than five years (the situation to which the section originally applied), the borrower could pay off the mortgage at the end of five years. Where the mortgage was for a term of five years or less and there is an extension of the mortgage (without altering the date of the original mortgage), the five year repayment period will begin from the date of the original mortgage.

[81] Where the borrower has not exercised section 10 rights and entered into a renewal (the terms of which deem the date of the mortgage to be the date of maturity), the borrower cannot pay off the mortgage until five years of the renewal period have elapsed. In other words, re-dating of the mortgage starts the five year period again. For example, an initial five year period which is renewed for a further five years (with the mortgage redated) will not permit the borrower to pay off the mortgage until the end of the five year *renewal period.*[61] It is the working group's understanding that *Potash* sets the standard in residential real estate mortgage practice.

Continued Utility of Section 10 and the Need for Consultation

[82] Given that the wording of section 10, as interpreted by the Supreme Court of Canada in the *Potash* decision, still has relevance today, the working group will be consulting with the legal profession as well as financial institutions on possible reform recommendations. The Working Group has no tentative or firm recommendations at this time and we will undertake a consultation before making specific recommendations on section 10.

[83] We also note that section 10 overlaps with provisions found in at least two other provincial statutes. The Ontario *Mortgages Act*[62] and the Manitoba *Mortgage Act*[63] both offer a similar repayment right to what is found in section 10 of the *Interest Act*. Our consultation would seek input on how this overlap might be best resolved.

SUMMARY OF RECOMMENDATIONS

[84] The preliminary findings and recommendations of the working group are as follows:

- Section 2 of the *Interest Act* reflects federal policy in relation to interest rates and as such does not overlap or conflict with provincial or territorial legislation.
- Section 3 of the *Interest Act* continues to serve a useful purpose but might have

more utility if it were amended so that it was tied to market rates in some fashion rather than being fixed at 5% per annum.

- Section 4 of the *Interest Act* does not clash with provincial or territorial legislation dealing with cost of credit disclosure and will apply in relation to transactions not covered by that legislation, and for these reasons still has utility. Consideration should be given to requiring disclosure of an effective rate of interest rather than an annual rate of interest under this provision.
- A strong case can be made for repeal of section 6 of the *Interest Act*, particularly if the provinces and territories were to provide protection to small business borrowers under their legislation and to make further efforts at establishing uniformity in their credit disclosure legislation and its coverage of mortgage loans.
- Section 8 of the *Interest Act* has become less relevant than it was when originally enacted in light of provincial and territorial consumer legislation. If the section was reformed so as to limit its scope to mortgages that charge real property primarily used by the borrower and collateral mortgages given by small business persons against their homes, it would serve a useful purpose not already served by the consumer legislation.
- The working group has concluded that consultation with legal practitioners and stakeholders will be required in order to formulate a recommendation in relation to section 10 of the *Interest Act*.

The working group proposes that it continue its work into 2009 and, in particular, that it consult with the appropriate sections of the Canadian Bar Association and with stakeholder groups in relation to its preliminary recommendations.

FOOTNOTES

[1] See Mary Anne Waldron, *The Law of Interest in Canada* (Scarborough, Ont.: Carswell, 1992) at 24. The leading Supreme Court of Canada case on point is still *Ontario (Attorney General) v. Barfried Enterprises Ltd.*, [1963] S.C.R. 570.

[2] R.S.C. 1985, c. C-46. The impact of this provision on commercial transactions was dealt with in a paper by Jennifer Babe entitled “Section 347 of the *Criminal Code of Canada*: Business Law Problems Remain” presented at the 2007 ULCC Conference. That topic will not be covered in this paper.

[3] R.S.C. 1985, c. E-15.

[4] S.C. 1996, c. 23.

[5] R.S.C. 1985, c. C-3.

[6] S.O.R./93-169.

[7] S.O.R./2001-527.

[8] In the *Special Measures Import Regulations*, S.O.R./84-927.

[9] See, for example, *Bank of Nova Scotia v. Dunphy Leasing Enterprises Ltd.* (1991), 83 Alta. L.R. (2d) 289 at para. 105 (C.A.); aff'd (1994), 18 Alta. L.R. (3d) 2 (S.C.C.).

[10] Note that s. 122(2) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, may be linked to or based upon section 3 of the *Interest Act*. It provides as follows:

If interest on any debt or sum certain is provable under this Act but the rate of interest has not been agreed on, the creditor may prove interest at a rate not exceeding five per cent per annum to the date of the bankruptcy from the time the debt or sum was payable, if evidenced by a written document, or, if not so evidenced, from the time notice has been given the debtor of the interest claimed.

[11] *British Pacific Properties Ltd. v. British Columbia (Minister of Highways & Public Works),* [1980] 2 S.C.R. 283 at 290.

[12] See, for example, *IAC Ltd. v. Guerrieri* (1982), 139 D.L.R. (3d) 352 (Ont. C.A.); *Toronto-Dominion Bank v. F.G. Connolly Ltd.* (1982), 56 N.S.R. (2d) 289 (S.C. – T. Div.); *McLeod Young Weir Ltd. v. Nunziata*, [1991] O.J. No. 701 (C.J. – Gen. Div.); *Huber v. Commcorp Financial Services Inc.*, [1996] 7 W.W.R. 506 (Sask. Q.B.).

[13] *British Pacific Properties Ltd., supra* note 11 at 289-90.

[14] *Pizzey Estate v. Crestwood Lake Ltd*. (2004), 69 O.R. (3d) 306 at para. 37 (C.A.).

[15] S.O.R./93-292.

[16] S.O.R./96-188.

[17] Alta. Reg. 348/1993, s. 16.

[18] See, *e.g.,* R.R.O. 1990, Reg. 944, s. 2.

[19] R.S.C. 1985, c. I-15, s.4.

[20] *Canadian Tire Acceptance Ltd. Card Holders v. Canadian Tire Acceptance* (1994), 118 D.L.R. (4th) 238 (Ont. Ct. (Gen. Div.)) aff'd (1995), 26 O.R. (3d) 95 (C.A.); *Prince Albert Co-operative Assn. v. Rybcka* (2006), 289 Sask. R. 92 (C.A.).

[21] *V.K. Mason Construction v. Bank of Nova Scotia*, [1985] 1 S.C.R. 271.

[22] R.S.C. 1985, c. 1 (5th Supp.), s. 162.1.

[23] See, *e.g., Consumer Protection Act*, *2002*, S.O. 2002, c. 30, Sch. A, ss. 77-81; *Business Practices and Consumer Protection Act*, S.B.C. 2004, c. 2, ss. 57-70.

[24] S.C. 1991, c. 46, ss. 450-453, 568-571.

[25] S.C. 1991, c. 48, ss. 385.16-385.2.

[26] S.C. 1991, c. 47, ss. 480-484.

[27] See *Bank Act*, *supra* note 24 at s. 1.

[28] See *Consumer Protection Act*, *supra* note 23 at s. 1; see also *Business Practices and Consumer Protection Act*, *supra* note 23 at s. 1.

[29] O. Reg. 17/05, s. 62.1.

[30] *Elcano Acceptance Ltd. v. Richmond, Richmond, Stambler and Mills* (1991), 79 D.L.R. (4th) 154 (Ont. C.A.).

[31] R.S.C. 1985, c. I-15.

[32] And any amount overpaid may be recovered back or deducted from any other interest. See section 9, *Interest Act*.

[33] *London Loan and Savings Co. of Canada v. Meagher*, [1930] S.C.R. 378.

[34] *Metropolitan Trust v. Twin Grand Development Ltd.*, [1995] 1 W.W.R. 533 (Sask. Q.B.); aff'd [1995] 10 W.W.R. 576 (Sask C.A.).

[35] The phrase has been considered, but never applied. See *Commonwealth Savings Plan Ltd. v. Triangle "C" Cattle Co. Ltd. and Pozzobon* (1966), 55 W.W.R. 52 (B.C.C.A.).

[36] *Re Kilgoran Hotels Ltd. and Samek*, [1968] S.C.R. 3.

[37] [1975] 1 S.C.R. 266.

[38] (2001), 203 Sask. R. 73 (C.A.).

[39] *Saskatchewan Co-Operative Financial Services Ltd. v. Tarel Hotel* (1994), 118 D.L.R. (4th) 629 (Sask. C.A.); leave to appeal to S.C.C. refused, [1995] 2 S.C.R. ix.

[40] S.C. 1991, c. 46.

[41] *Business Practices and Consumer Protection Act*, S.B.C. 2004, c. 2; *Fair Trading Act*, R.S.A. 2000, c. F-2; *Cost of Credit Disclosure Act, 2002*, S.S. 2002, c. C-41.01; *Consumer Protection Act*, C.C.S.M. c. C200; *Cost of Credit Disclosure Act*, S.N.B. 2002, c. C-28.3; *Consumer Protection Act*, R.S.P.E.I.1988, c. C-19.

[42] Ontario has chosen not to include mortgages in its cost of borrowing disclosure legislation. That policy choice, of course, affects a significant number of consumers, although those borrowing from federal banks would have the protection of the *Bank Act*.

[43] Only one case appears to have applied s. 6 to deprive the lender of interest.

See *Bank of Nova Scotia v. Daniel*(1986), 38 R.P.R. 316 (Alta. Q.B.).

[44] Proposed amendments to section 6 have been passed, but never brought into force. The 2001 amendment (c. 4, s. 176) appeared to expand the classes of mortgage covered by the section to include those set out in regulation and to allow regulations to require the kind of disclosure to be made. This does not seem an advisable choice since it left the current archaic language and the timing of the disclosure unchanged.

[45] Subsection 8(2) provides: “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.”

[46] Senate Debates (28 April 1880) at 404; House of Commons Debates (31 March 1880) at 963; Mary Anne Waldron, "The Federal Interest Act: it sure is broken, but is it worth fixin’" (1997), 29 Can. Bus. L.J. 161 at 164.

[47] Section 9 provides that “if any sum is paid on account of any interest, fine or penalty not chargeable, payable or recoverable under section …8, the sum may be recovered back or deducted from any other interest, fine or penalty chargeable, payable or recoverable on the principal.”

[48] *Reliant Capital Ltd. v. Silverdale Development Corp.,* 2006 BCCA 226; 270 D.L.R. (4^{th}) 717 (B.C.C.A.) at paras. 68-69; leave to appeal to S.C.C. refused, [2006] 2 S.C.R. viii.

[49] See T. Telfer, “Preliminary Background Paper on the Canada Interest Act” (Uniform Law Conference of Canada, 2007) at para 35.

[50] See *e.g.*, *Reliant Capital Ltd. v. Silverdale Development Corp., supra* note 48 at para. 56.

[51] *N.B.Y. Enterprises Inc. v. Duffin,* [2006] O.J. No. 982 (S.C.J.).

[52] Mary Anne Waldron, Q.C., “The ‘Legitimate Purposes’ Test: Are Roses Changing Their Names?” U.B.C. L. Rev. (forthcoming).

[53]*Reliant Capital Ltd. v. Silverdale Development Corp., supra* note 48 at para. 55.

[54] Waldron*, supra*, note 52.

[55] Waldron, *supra*, note 46. See *e.g.*, *Unconscionable Transactions Act*, R.S.A. 2000, c. U-2; *Unconscionable Transactions Relief Act*, R.S.S. 1978, c. U-1; *Unconscionable Transactions Relief Act*, C.C.S.M. c. U20; *Unconscionable Transactions Relief Act*, R.S.O. 1990, c. U.2; *Unconscionable Transactions Relief Act*, R.S.N.L. 1990, c. U-1; *Unconscionable Transactions Relief Act*, R.S.N.B. 1973, c. U-1; *Unconscionable*

Transactions Relief Act, R.S.N.S. 1989, c. 481; *Unconscionable Transactions Relief Act*, R.S.P.E.I. 1988, c. U-2.

[56] Waldron, *supra*, note 1; Telfer, *supra*, note 49 at para 42; House of Commons Debates (31 March 1880) at 964.

[57] Subsection (2) reads as follows:

“Nothing in this section applies to any mortgage on real property or hypothec on immovables given by a joint stock company or other corporation, nor to any debenture issued by any such company or corporation, for the payment of which security has been given by way of mortgage on real property or hypothec on immovables.”

[58] Mary Ann Waldron, “Section 10 of the Interest Act: All the King’s Men” (1988), 13 C.B.L.J. 468 at p. 473-474; Waldron, *supra,* note 1 at 91-92; *Potash v. Royal Trust Co.,* [1986] 2 S.C.R. 351 at para.13.

[59] [1986] 2 S.C.R. 351.

[60] *Ibid.* at para. 32.

[61] Waldron, *supra*, note 1 at 92-93. See *e.g., 233467 B.C. Ltd. v. Montreal Trust of Canada* (1994), 115 D.L.R. (4th) 124 (B.C.C.A.); *Litowitz v. Standard Life Assurance Co. (Trustee of)* (1996), 30 O.R. (3d) 579 (C.A.) ; leave to appeal to S.C.C. refused, [1997] 2 S.C.R. ix.

[62] R.S.O. 1990, c. M.40, s. 18(1).

[63] C.C.S.M. c. M200, s. 20(6).

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