Is Interest in Solar Power Over-Heated?

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An Ontario court's reliance on section 4 of the *Interest Act* (Canada) to dramatically reduce the interest rate on a series of loans from the over 25% contracted for to just 5% has raised alarm bells for lenders and their counsel. One of the reasons for the concern is the doubt expressed by the court as to the efficacy of a formula converting a rate that is not expressed as an annual rate to an annual rate. Is all that concern justified, particularly when it comes to its application to LIBOR based rates that are expressed on a 360 day basis? Maybe not. While the court definitely found that the formula was ineffective in the circumstances of the case, it is not clear that the court decided that such formulas are generally ineffective or ineffective where they do not convert to an "effective" versus a nominal rate. We do agree, however, that the case is an excellent reminder to use caution when expressing interest rates (or fees that may be construed as interest) on the basis of a period that is substantially less than a year.

Facts

Solar Power Network Inc. v. ClearFlow Energy Finance Corp., 2018 ONSC 7286 considered a series of numerous loans (and numerous is a vast understatement) from ClearFlow Energy Finance Corp. to Solar Power Network Inc. and its affiliates. The documents contemplated that the loans would be short-term (initially up to 90 days and, if unpaid, they would roll into new loans with terms of up to 180 days). The loan charges were (usually):

- a stated **base interest rate** of 12% per annum and 24% per annum in the event of a default, compounded and calculated monthly;
- an **administration fee** of 1.81% or 3.55% of the loan, charged when the loan was advanced or renewed, and rolled over into a new loan, if unpaid, and
- a **discount fee** of 0.003% of the loan, calculated on a daily basis for every day the loan was outstanding, which rolled over into the new loans.

Solar Power did not challenge the base interest rate. Rather, it took the position that each of the administration fee and the discount fee constituted interest rather than fees, and that the expression of those fees did not comply with Section 4 since they were not expressed as annual rates. On that basis, Solar Power argued, a maximum of 5% interest was payable on the loans, as stipulated by Section 4.

Section 4 requires that a contract that provides for the payment of "interest … made payable at a rate or percentage per day, week, month, or at any rate or percentage for any period less than a year" contain "an express statement of the yearly rate or percentage of interest to which the other rate or percentage is equivalent". If it does not, interest charges are restricted to 5% per annum.[i]

The ClearFlow loan documents contained the following formula that ClearFlow claimed enabled Solar Power to calculate the equivalent annual rate for each of the administration fee and the discount fee (in the event they were found to constitute interest and to be subject to Section 4):

Unless otherwise stated, in this Agreement if reference is made to a rate of interest, discount rate, fee or other amount "per annum" or a similar expression is used, such interest, fee or other amount shall be calculated on the basis of a year of 365 or 366 days, as the case may be. If the amount of any interest, fee or other amount is determined or expressed on the basis of a period of less than one year of 365 or 366 days, as the case may be, the equivalent yearly rate is equal to the rate so determined or expressed, divided by the number of days in the said period, and multiplied by the actual number of days in that calendar year.

The Decision

The Court found that the administration fee was not interest. We'll leave a discussion of this aspect of the decision for another day.

The Court did find that the discount fee was interest.

The Court also held that the formula that ClearFlow had relied on in order to comply with Section 4 with respect to the discount fee was not sufficient to save it from the consequences of Section 4. Commenting generally on the formula, Justice McEwen said that he did not accept ClearFlow's submission that the formula saves it "in this case" (para. 52). But he also went on to express the view that Section 4 requires an express statement of the annual rate in order to do away with the type of dispute and uncertainty that formulas can raise.

He didn't really decide the case on the basis that formulas are ineffective though. He went on to find that the annual rate produced using the formula in the ClearFlow loan documents (0.003% x 365 = 1.095%) was not, in fact equivalent in the circumstances. Given the loan documents expressly provided that the discount fee would be compounded when the applicable loan rolled over, the Court found that the equivalent annual rate required by Section 4 would be the *effective* annual rate, which takes into consideration the effects of compounding (as opposed to the nominal annual rate resulting from the formula). The formula did not work for that purpose. The Court held that, as a result, Section 4 required that the aggregate interest on the loans be limited to a rate of 5% per annum.

What appear to have been significant driving factors in the Court's conclusion that the equivalent annual rate required was the *effective* annual rate were that the discount fee was expressed using a daily rate and that the loan documents expressly provided that the discount fee would be compounded.

Implications

Utilization and Other Fee Disclosure. This decision is a reminder that interest (and fees that may be characterized as interest) should be expressed using an annual rate. For instance, utilization fees (applicable when, for instance, loans greater than a specified percentage of the aggregate loan commitments are outstanding) are sometimes expressed as a fee that is calculated daily based on a percentage of the loans outstanding on such day. Given the potential for such fees to be characterized as interest, it would be advisable to reformulate this as an annual rate, calculated daily and payable quarterly (for instance). If, instead of expressing the discount fee as 0.003% each day, the ClearFlow loan documents had provided that the discount fee was 1.095% per annum, calculated daily and compounded on maturity of the applicable loan, Section 4 likely would not have applied. At the very least, Solar Power would have had a more difficult case to make under Section 4. Solar Power did not challenge the base interest rate of 12% per annum or 24% per annum in the event of default, which was compounded and calculated monthly, and which was presumably a nominal rate, and the Court did not comment on it.

LIBOR Rate. The Court's finding that the formula in the ClearFlow documents did not satisfy the requirements of Section 4 is potentially of significant concern to lenders' counsel, who routinely employ a formula along the lines of the formula in the ClearFlow loan documents. Such a formula may be included in agreements that provide for interest rates based on LIBOR, for instance, since such rates of interest are calculated based on a period of 360 days. Although, in principle, the Court's reasoning in the *Solar Power* decision could extend to any rate of interest payable for any period of less than 365 days, we believe there are compelling reasons why the decision should not be read as impacting the validity of the formula when used in the context of LIBOR.

- As we note above, while the judge expressed doubt about the use of formulas generally to comply with Section 4, he didn't actually decide the case on that basis. He decided that the application of the formula did not result in adequate disclosure in this case. There is no reason to believe that he considered LIBOR based rates as being affected by his comments on the formula. We should not be too ready to throw our much loved formula under the bus based on two short judicial paragraphs.
- Section 4 was enacted over 100 years ago, long before LIBOR came into being. LIBOR is calculated according to market convention – a borrower that had bargained for a LIBOR-based interest rate could reasonably be expected to understand and expect that the rate was based on a 360-day year. Given that LIBOR is a screen rate and, therefore, potentially transparent to the borrower, if a lender were to recalculate and restate LIBOR based on a 365/366-day year, the borrower might reasonably be expected to be confused and to object. This could also make comparing LIBOR-based rates difficult for a borrower.
- Interpreting section 4 in the context of modern commercial lending practices, we'd vigorously argue that a 360 day rate is an expression of an annual rate, particularly in the context of LIBOR. Section 4 refers to interest based on a week, day or month or other period less than a year, but 360 days is close enough to a year to allow an interpretation that includes it as the expression of a yearly rate given that expression of an interest rate on such a basis is a widely understood, commercially sound global practice. The difference in such a rate if it were expressed as an effective rate based on a 365 day period would be minimal and would be affected more by the compounding feature than the number of days. Any benefit conceivably derived by the borrower from such disclosure would likely be outweighed by the detriment represented by its difficulty in comparing rates and the loss of transparency of a screen-based rate.
- It would be virtually impossible for the lender to state an equivalent effective annual rate that takes into account the effects of compounding, particularly given the unknown variable of the borrower's choice of interest period for any particular loan. A formula is the most reasonable and meaningful way for a lender to express an equivalent annual rate for LIBOR to the extent it is required to do so under Section 4. Taking *Solar Power*'s holding on formulas to its logical conclusion, LIBOR would not be available to Canadian borrowers as a result of a lender's inability to comply with section 4. That can't be the case: interest based on LIBOR must be distinguished from the particular circumstances in *Solar Power*, where the interest rate was expressed as a daily rate, and the annual interest rate resulting from the formula was not representative of the interest rate expected by the parties to apply (given that compounded interest was expressly provided for in the documents).

Therefore, while it is not free from doubt given how the judge addressed the efficacy of formulas to address section 4, we believe the ClearFlow decision should not be taken as requiring 360 day based rates to be expressed as effective rates or as finding that the formula is not meaningful disclosure of an annual rate.

What's Next

We understand that ClearFlow has appealed the decision. Until that appeal is resolved, there is likely to be lively discussion about the impact of this trial-level decision on typical loan documentation. Hopefully,

regardless of how the Court of Appeal decides the merits of the case, the court clearly restricts any findings regarding the formula to the particular circumstances of these fees. In the meantime, this decision highlights the questionable nature of the value of section 4. If one accepts that ClearFlow could have avoided the application of section 4 by expressing the discount fee as a nominal annual rate (which would not be a particularly meaningful statement of the applicable annual interest rate in the given circumstances), then section 4 does not appear to provide substantive borrower protection. Meaningful rate and fee disclosure has been extensively addressed with respect to consumers by federal legislation in the case of bank lenders and provincial-level consumer protection legislation, and the disclosure required looks nothing like what section 4 requires. Section 4 has outlived its usefulness: it's time to repeal it.

[i] The exact wording is: Except as to mortgages on real property or hypothecs on immovables, whenever any interest is, by the terms of any written or printed contract, whether 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.