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Ontario Court of Appeal *Interest Act* Decision Has Lessons for Both Lenders and Borrowers

by Kym Stasiuk
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Kym Stasiuk is a Partner in Blaney McMurtry's corporate/commercial practice group. Primarily, he is involved with lenders (both private and institutional) and borrowers in secured real estate financing transactions. He also acts for clients on the purchase and sale of businesses, general corporate matters and the provision of ongoing strategic advice to business owners and managers.

Kym may be reached directly at 416.593.3995 or kstasiuk@blaney.com.

The Ontario Court of Appeal has delivered important messages to lenders who take mortgages on real property as security and to borrowers who provide such security.

Those messages are contained in the Court's recent decision in *P.A.R.C.E.L. Inc. v. Acquaviva* (2015 ONCA 331).

Chief among them is a caution, arising from section 8 of the Interest Act, that interest-escalation provisions, late payment charges and default fees included in any debt instrument secured by a mortgage on real property are simply unenforceable in certain circumstances.

In the business world of money lending, other than rates that exceed the criminal rate of 60 per cent per annum, lenders and borrowers are free to negotiate and agree on any rate of interest applicable to a loan.

If the loan goes into arrears, often a lender will have in place in the loan contract a requirement for the borrower to pay a substantially higher interest rate, sometimes known as an interest escalation provision. This clause is recognized as a legitimate and effective way to ensure the prompt repayment of the loan.

When it comes to mortgage loans, however, a different rule comes into play. As a movie director might say, cue section 8. This section prohibits lenders from levying fines, penalties or rates of interest on any arrears of principal or interest that are secured by a mortgage on real property and that have the effect of increasing the charge on the arrears beyond the rate of interest payable on principal money not in arrears.

While recognizing the general notion that parties are entitled to freedom of contract, section 8 is intended to protect property owners against abusive lending practices. For example, the courts have recognized that if an owner of real estate were already in default of payment under the interest rate charged on monies not in arrears, a still higher rate, or greater charge on the arrears would render foreclosure all but inevitable, thereby making it impossible for owners to redeem or protect their equity.

The *P.A.R.C.E.L. Inc. v. Acquaviva* decision takes an interesting look at the circumstances that trigger section 8.

In this case, Acquaviva loaned P.A.R.C.E.L approximately $500,000. The repayment of the loan was secured by a promise to pay set out in a promissory note. The note was secured, in turn, by a mortgage on real property in the same amount.

The interest rate set out in both the mortgage and the note was 0.75 per cent per annum. Unlike the mortgage, however, the note contained an interest escalation provision whereby the interest rate was increased to 10 per cent after default.

The mortgage also provided that Acquaviva would be entitled to a late charge of $10 per day in the event of their late receipt of monthly payments due under the mortgage and payment of a $300 "Missed Payment Fee" if payments under the mortgage were missed.

On a motion for summary judgment, the motion judge awarded Acquaviva interest at the rate of 10 per cent, rather than 0.75 per cent, per annum along with significant late payment charges and default fees.

Included in the grounds of appeal, of course, P.A.R.C.E.L raised the issues that the provisions in the note and mortgage that set out both the 10 per cent interest rate and the late payment charges and default fees violate section 8 of the Interest Act. The Court of Appeal agreed with P.A.R.C.E.L on both grounds.

In finding that section 8 applies to the single loan secured by both the note and the mortgage, the Court said it was not necessary that the mortgage contain a provision that payment of the note constitutes payment of the mortgage or vice versa. The Court also did not see the need for commonality between the parties to the note and the parties to the mortgage (that they be one and the same) since the debt owed under both the note and the mortgage was the same.

The Court said that section 8 applies regardless of which debt instrument contains the prohibited charges and that where the debt is secured by a note that is itself secured by a mortgage, each for the same principal amount, and where payment of one is payment of the other, but where each contains different terms regarding post-default interest, the terms of the note determine the rate.

With respect to the late payment charges and fees, the Court said that in the absence of evidence that the charges in question reflect real costs legitimately incurred by Acquaviva for the recovery of the debt, in the form of administrative costs or otherwise, the only reason for the charges was to impose an additional penalty or fine, apart from the interest otherwise payable under the mortgage, thereby increasing the burden on P.A.R.C.E.L beyond the rate of interest agreed upon in the mortgage. The late payment charges and default fees were therefore found to violate section 8 of the Interest Act and were disallowed by the Court.

The takeaways from the case, from this writer's perspective, are threefold.

First, to avoid costly litigation, it is obviously very important that the repayment provisions contained in debt instruments that secure repayment of the same mortgage loan are consistent.

Second, if there are conflicting rates of interest on default with respect to the same loan under both a mortgage and a promissory note secured by such mortgage, the terms of the note determine the applicable rate.

Finally, as indicated earlier, both lenders and borrowers should take heed of section 8 of the Interest Act and be aware that interest-escalation provisions, late payment charges and default fees included in any debt instrument secured by a mortgage on real property that have the above described effect are simply unenforceable. ■