



Getting Interest Rates Right

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In April 2004, the Supreme Court ordered Enbridge Gas Distribution to pay back late payment penalties charged to gas customers that exceeded the limit on interest rates in the *Criminal Code*. This decision provides a reminder that companies that are not careful in setting interest rates can get into trouble.

Rules on interest rates

There are two sets of federal rules on interest rates. The first is found in the *Interest Act*. It says that:

- Parties are free to set any interest rate or discount.
- If an agreement provides for interest, but does not say in what amount, the rate is 5% per annum.
- If interest is expressed as a rate over a period of less than a year (eg, daily, weekly, or monthly rates), the equivalent *annual* rate must also be stated, otherwise the rate is 5%. This rule does not apply to mortgages.

There are also special rules on mortgages in the *Interest Act*.

The second set of rules is in the *Criminal Code*. Section 347 makes it a crime to enter into an agreement to charge more than 60% interest annually; or to actually receive payment of interest at a rate over 60%, even if there is no agreement to charge interest at such a rate. These are two separate offences: it is possible to *receive* interest at a rate of over 60% even if the agreement does not require it.

Although both of these rules were enacted to protect consumers, they apply to businesses as well.

Following the rules

The meaning of "interest"

The term "interest" is more broadly defined in s. 347 than in the *Interest Act*.

Under s. 347, "interest" includes all charges for the advancing of credit, no matter what they are called. For example, the interest on a loan would include the interest charged as well as any set-up fees, late payment or penalty fees, fees paid to defer interest, bonuses, and any other additional compensation. In the Enbridge case, the Supreme Court held that one-time late payment penalties of 5% were "interest" within the meaning of s. 347 even they were imposed to encourage people to pay on time and did not increase if the bill wasn't paid.

The term "interest" is not defined in the *Interest Act*. It is unclear whether set-up fees, bonuses, or one-time penalty fees would constitute "interest" and thus be subject to the *Interest Act*.

In most commercial relationships, interest is charged on overdue invoices. Such interest charges are subject to s. 347 and are probably subject to the *Interest Act*.

Many companies offer a discount for early payment. Such discounts are not "interest" under s. 347 or the *Interest Act*. However, if you offer a discount for early payment, be sure that it is clearly expressed as such and that the bill itself is for the full amount. You want to avoid the discount appearing to be a penalty for late payment.

Staying under 60%

In most cases, it is relatively easy to ensure that the interest is under 60%: make sure that the interest rate works to less than 60% annually. Be sure to take into account the effect of compounding on the rate of interest. Interest charged at 5% per month but

not compounded is 60% per annum, but 5% interest charged and compounded monthly works out to over 79% per annum.

Fees and additional charges sometimes get companies – even sophisticated ones – into trouble. Basically the rule is that you add up all the fees, interest, and anything else that the contract says must be paid as consideration for advancing credit, and work out the effective annual interest. If that rate exceeds 60%, it is unlawful. Usually credit is not advanced for exactly one year, and there are payments of blended interest and principal, which can make it complicated to work out the true interest rate. In those cases you should obtain professional assistance.

Lenders also need to be careful not to let the interest exceed the 60% threshold after the fact. This can happen where there are demand and acceleration clauses. For instance, a promissory note for \$1,000 due after one year (with no monthly payments) with an interest rate of 25% and a fee of \$100 works out to 35% (\$250 in interest plus \$100), which is lawful. However, if the promissory note allows the lender to demand payment of the note upon some event, and the lender demands payment after only two months, the combined fee and accrued interest are well over the 60% threshold (\$100 + \$41.67 accrued interest = \$141.67, which works out to 85% interest per annum¹). It has

not yet been decided whether an acceleration clause that operates automatically, as opposed to one that allows the lender to demand repayment, violates s. 347 if it results in interest exceeding 60%. It should be noted, however, that a voluntary early repayment by the debtor does not make the interest rate illegal, even if it results in the interest paid exceeding an annual rate of 60%. Using the example above, if the debtor voluntarily repays the note after two months, the lender is not put in the position of being in violation of s. 347.

Complying with the Interest Act

Complying with the *Interest Act* is relatively easy. If interest is charged monthly, then the annual rate must be disclosed. It is acceptable to disclose the nominal annual rate, even if the interest is compounded monthly. For the sake of clarity, contracts or invoices should also indicate whether the interest is compounded monthly or not, and when it starts to run.



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¹ $(141.67 \div 1000) \div 2 \times 12 = 85\% \text{ per annum}$