Interest Act at centre of battle

Appeal Court nixes escalating interest penalty

BY MARG. BRUINEMAN
For Law Times

The Ontario Court of Appeal cautions that late payment charges, default fees, and interest-escalation provisions in a debt instrument may not be enforceable in some situations.

In *P.A.R.C.E.L. Inc. v. Acquaviva,* the appellate court found that s. 8 of the federal Interest Act could prohibit some penalties in the event of a default if the arrears are secured by a mortgage on real property.

"I was really gratified to see a case on point," says Walter Traub, a certified specialist in real estate law whose main area of focus is mortgage law at Goldman Sloan Nash and Haber LLP. "My reservation, however, is that the decision itself may have created more confusion and didn't go far enough to give clear direction."

Walter Traub says Interest Act ruling 'may have created more confusion and didn't go far enough to give clear direction.'

Section 8 of the Interest Act states that a lender can't charge an increased interest rate upon default of a mortgage when real estate is involved. The issue in *P.A.R.C.E.L.* is that the only interest rate mentioned in the mortgage was the agreed-upon rate of .75 per cent; it was rather the promissory note that spelled out a regime seeing an escalation of the interest rate in the event of default of the mortgage payments.

P.A.R.C.E.L.'s sole officer and director, Bijan Pardis, executed a promissory note and a mortgage for $458,488 from Sam Acquaviva's Premier Homes Realty Ltd. at an interest rate of 0.75 per cent. The note included an interest escalation provision increasing the interest rate to 10 per cent in the event of default, but the mortgage didn't include a similar stipulation. The mortgage listed a late payment charge of $10 per day for mortgage payments received after the regularly scheduled payment date, as well as an administrative fee of $300 for each unreturned or NSF payment, or for each missed or late installment, which were not included in the promissory note.

Pardis made monthly payments for the first year and then stopped. Premier Homes sued him and his companies and won in summary judgment.

"The critical question is whether s. 8 applies to the single loan secured by both the note and the mortgage, where the terms of the note provide for escalated interest on default but where the mortgage, which admittedly secures the note, contains no such provision," wrote Eleanore A. Cronk in the unanimous Court of Appeal decision, to which the court answered: Yes.

Cronk further wrote that if the position of Premier Homes was accepted, it "would result in commercial uncertainty as well as fundamental unfairness to the appellants."

The offending provisions on default in *P.A.R.C.E.L.* may well have evolved from what Traub calls "legal creativity," which he says has taken over. In order to overcome hardships, lenders and their lawyers try to create contractual provisions to preclude borrowers from purposely defaulting on loans when the interest rate changes after an agreement has been signed. Borrowers might be tempted to go into default if the rate drops.

An accepted principal of law holds that courts should not interfere with contractual agreements unless they're in violation of the law.

The lenders won a summary judgment at the trial level in which the borrower wasn't represented and didn't initially show up. They argued that the penalties were laid out in the promissory note, not the mortgage, so s. 8 doesn't apply. The Court of Appeal found that since the promissory note was secured by a mortgage for the same amount, they represented the same debt and the provisions of the note, including the penalties, apply and are, therefore, invalid.

The court also found the fees to be paid out on default, which were stipulated in the mortgage, also violate s. 8.

"The obvious question is: What costs did the lender incur and are they justifiable?" asks Traub. "The court basically said unless it is a justifiable cost incurred, the lender is not entitled to it."

But, he says, the court doesn't provide a detailed analysis on this issue nor the issue of default of interest that he had hoped for because the court tied the debt and mortgage instruments together instead of examining the promissory note in isolation and determining if either violated the intent of s. 8 in modern financing.

"I agree with the decision overall. . . . Instead of it being a guiding light, however, it raises some further questions and issues that may lead to even greater confusion," he says. "In my view, the provisions in the note are valid as they do not impact real estate."

Section 8 provides a level of protection reflecting a pillar of common law, property law, and real property law that a lender cannot convert his loan into property. It acknowledges that real estate is a special asset afforded special protection under the law and attempts to level the playing field and enforce fair practices between lenders, which generally have greater bargaining power, and borrowers.

According to Traub, in this case — aside from some of the penal administrative costs set out in the mortgage, which he acknowledges were unenforceable — the escalation of interest provisions contained in the promissory note did not violate s. 8, and lack of absence of such provisions in the mortgage itself did not require the protection intended by s. 8.

In *P.A.R.C.E.L.*, the court said that s. 8 applies regardless of which debt instrument contains the prohibited charges so long as they evidence the same repayment terms and where payment of one is payment of the other, observes Kym Stasiuk, whose practice at Blaney McMurtry LLP focuses on real estate financing.

"Notwithstanding the fact that some of the provisions in the loan documents were held by the court to be unenforceable, the litigation, at this high level, may have been avoided had the loan documents been more carefully drafted with clear, consistent provisions," he says.

"One of the takeaways from this case is that I think it's just a good reminder of the provisions that are out there to protect borrowers from abusive lending practices," he says. "For lenders who include these types of provisions in their loan documents, this case should serve as a caution that such provisions will not hold up in court."

If the after-default rate is higher than before, then this is a clear violation of s. 8 and is, therefore, unenforceable, adds Stasiuk.

"*P.A.R.C.E.L.* clearly annunciates what s. 8 is all about," adds Alicia S. Natividad, who practises business and property law under ASN Law Professional Corporation in Ottawa. "The intent of s. 8 is to safeguard the borrower from abuse-of-loan practices . . . . I think the court paid attention to that."

The message for lenders, she says, is careful drafting to structure a loan secured by a mortgage where an increased rate of interest is not triggered by a default or a maturity date to respect the protection afforded borrowers in s. 8 from aggressive lending practices that could prevent them from repaying their loans.

In *P.A.R.C.E.L.*, there was just one loan but two debt instruments with different instructions.

"To me, it just shows how careful drafting is so essential," says Natividad. "When drafting the loan document, the question in my mind is: 'What is the primary debt and what is the primary instrument that reflects that debt?'"

If it's just a single loan, both instruments must be reflected in the same way. **LT**

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