May 10, 2016

Penalty/Relief – Two Sides of the Same Mortgage Interest Coin When it Comes to Offending S. 8 of the *Interest Act*?

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The Supreme Court of Canada issued its reasons today in *Krayzel Corp. v. Equitable Trust Co.*, 2016 SCC 18, adding some clarification to a mortgage lender's right to protect itself from the increased commercial risk associated with a defaulting mortgagor through the use of interest rates, given s. 8 of the *Interest Act* which reads as follows:

> **No fine, etc., allowed on payments in arrears**
>
> **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.

At issue before the Supreme Court of Canada was the various terms of renewal of a mortgage granted in favour of Equitable Trust. The initial interest rate was prime plus 2.875% per annum. The mortgage matured on June 30, 2008, at which time Equitable Trust agreed to extend the mortgage by seven months, with the interest rate increasing to prime plus 3.125% for the first six months and then 25% for the seventh month. When that matured, and the borrower Lougheed was still unable to pay out the mortgage, a second renewal term was granted, this time retroactive to one month prior to expiry of the first renewal agreement, and stipulating interest at 25%. Monthly interest payments were stated to be at the "pay rate" of either 7.5% or at the prime interest rate plus 5.25% (whichever was greater). Complicating matters, however, was that the difference between the amount payable at the stated interest rate of 25% and the amount payable by Lougheed at the lower "pay rate" would accrue to the loan; and if there was no default by Lougheed, the accrued interest would only then be forgiven.

The majority of the Court found that these terms were contrary to s. 8 of the *Interest Act*, noting that

> …a rate increase triggered by the passage of time alone does not infringe s. 8. That said, a rate increase triggered by default does infringe s. 8, irrespective of whether the impugned term is cast as imposing a higher rate penalizing default, or as allowing a lower rate by way of a reward for the absence of default. I would therefore allow the appeal.

The result of the case was that the 25% interest rate set by the second renewal agreement was held to be void, with Equitable Trust only entitled to interest under the second renewal agreement at the higher of 7.5% and the prime interest rate plus 5.25%.

Of significance is, firstly, the first sentence of the above statement by the Court, and subsequent statement that an interest rate increase "triggered by the mere passage of time (and not by default) such as that imposed under the First Renewal Agreement, clearly does not offend s. 8."

Many lenders' current practice to ensure that they are not offending the *Interest Act* is to provide for an initial interest rate to a certain date, with the interest rate increasing at a specific and identifiable date some time prior to maturity, specifically not linked with default. The comment by the SCC suggests that such a practice is likely still permissible.

Secondly, the SCC distinguished *Krayzel* from the British Columbia Court of Appeal's decision *North West Life Assur Co. of Can v. Kings Mount Hldg Ltd.* (1987), 15 BCLR (2d) 365 (CA), where a term providing for relief on interest when the loan was repaid when due, was upheld. The difference being that in *Northwest Life Assur Co. of Canada*, the reduction was given as a term of one renewal – the original mortgage was 19%, the renewal provided for interest at the same rate of 19%, but if the loan was repaid on time, the interest for the renewal would be reduced to 13%. In *Krayzel*, each renewal resulted in an increased interest rate, with a significant overall increase from the originally agreed upon rate of prime plus 2.875% to 25% (with retroactive effect).

What this means is that there is still an available avenue to protect a mortgage lender's ability to use interest rates to compensate it for the very real commercial risk associated with lending to high risk borrowers, whether by way of an interest rate increase prior to maturity (and not tied to default) or by way of interest rate relief if the mortgage is repaid on time. However, mortgages must be carefully drafted to ensure that their interest rate provisions fall within what the British Columbia Court of Appeal in *Northwest Life Assur Co. of Canada*, and subsequent case authority, has indicated is acceptable, and outside of what the Supreme Court of Canada in *Krayzel* has indicated is not.

For more information, please contact Kimberley Robertson or Brenda Lightbody.

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