

CORPORATE FINANCE BULLETIN

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SUPREME COURT OF CANADA RULES ON CRIMINAL INTEREST RATES

In our January 2003 Corporate Finance Bulletin (“January 2003 Bulletin”), based on the Ontario Court of Appeal (“OCA”) decision in *Transport North America Express Inc. v. New Solutions Financial Corp.* (“*Transport 1*”), we reported that Ontario Courts would no longer read down interest provisions of credit agreements to comply with interest rate limitations in the *Criminal Code of Canada* (the “Code”). On February 12, 2004, the Supreme Court of Canada (“SCC”) overturned the *Transport 1* decision.

“NOTIONAL SEVERANCE” V. THE “BLUE PENCIL” RULE

Under Section 347 of the Code, the maximum legal interest rate, defined to include a broad range of fees and expenses charged under a loan, is 60%. The main issue in *Transport 1* was the appropriate judicial treatment of credit agreements in which the agreed upon rate of interest exceeds the criminal limit, but which are otherwise unobjectionable. In *Transport 1*, the OCA favoured the “Blue Pencil” technique over that of “notional severance” applied by the lower court. The “Blue Pencil” technique calls for the complete severance, or running of a blue pencil through, any clause of a credit agreement causing the effective interest rate to exceed the maximum allowable rate of 60%, provided that such clause can be severed without affecting the meaning of the remainder of the contract. The concept of “notional severance” differs in that it requires simply that offending provisions be “read down” by the court only to the extent required to put the credit agreement “on-side” the 60% interest rate limit.

SCC DECISION - THE RETURN OF “NOTIONAL SEVERANCE”

The issue before the SCC was whether “notional severance” is a remedy available to courts in curing credit agreements that run afoul of Section 347 of the Code. The majority of the court first reiterated the established rule that four factors are to be considered when deciding between partial enforcement as opposed to the complete voiding of an offending agreement: 1) whether the purpose of the criminal interest rate offence would be subverted by severance; 2) whether the parties entered into the agreement for an illegal purpose or with an evil intention; 3) whether there was anything troubling about the relative bargaining position or conduct of the parties in reaching the agreement; and 4) whether there is any potential for the debtor to enjoy a windfall.

The SCC then ruled that, where partial enforcement is an appropriate remedy, “notional severance” is a technique available to courts and that it is generally preferred over the “Blue Pencil” technique.

While the SCC did not rule out the use of the “Blue Pencil” technique, it suggested that the technique can often lead to arbitrary and inconsistent results because it involves mechanically removing offending provisions in their entirety. By contrast, the “notional severance” technique is flexible and allows courts to reach a more equitable solution by appropriately factoring in the intention of the parties and focussing on the substance of the agreement, rather than the way in which it was drafted.

CONSEQUENCES OF THE “NOTIONAL SEVERANCE” RULE

Lenders will welcome the SCC decision since it minimizes the potential for courts to drastically reduce interest rates that have been agreed upon in good faith by commercially experienced parties. In cases where the parties are commercially sophisticated, professional advice was received by both parties, the violation of section 347 of the Code by the parties was unintentional, and it is equitable to give effect to the highest legal interest obligation

available, the Court maintains the discretion to read down the interest provision to provide for a 60% return. On behalf of the majority of the SCC, Arbour J. wrote: "Given that this was a commercial transaction engaged in by experienced and independently advised commercial parties, it is difficult to see why the choice of a 30.8 percent rather than 60 percent rate better fosters compliance with s. 347(1)(a) of the Code." It should be noted, however, that the discretion of the courts remains broad and that, under different circumstances, courts may find that the equitable solution is to set the interest rate well below the legal limit.

USE OF MODIFICATION CLAUSES STILL PRUDENT PRACTICE

That the SCC did not completely reject the "Blue Pencil" technique is notable. The SCC decision reduces the range of circumstances under which the technique may be used and warns against certain pitfalls associated with mechanically striking out offending clauses, but courts may still use the technique as long as the illegality can be cured while only minimally altering the intention of the contracting parties. As such, the addition of modification clauses to credit agreements in an attempt to influence the way in which courts exercise their discretion, as discussed in our January 2003 Bulletin, remains prudent practice. Such clauses present an opportunity to specify the order in which the various elements of interest within the meaning of the Code are to be reduced if the maximum allowable rate is exceeded. Modification clauses may also provide courts with evidence that the contracting parties turned their minds to the various components of interest and reduce the likelihood that a rate of less than 60% will be imposed.

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The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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