Increasing Mortgage Interest During the Term – Confirming the Loophole Around s. 8 of the *Interest Act*

By: Avi Bourassa and Sara Romeih, Ross Nasseri LLP

Prepared for the Law Society of Ontario's CPD program: The Six-Minute Debtor-Creditor and Insolvency Lawyer 2022 (held virtually on October 13, 2022)

I. Overview

This paper discusses the judicial interpretation of s. 8 of the *Interest Act*, beginning with the Supreme Court of Canada's seminal 2016 decision in *Krayzel Corp. v. Equitable Trust Co*., and in subsequent case law.[1] This paper concludes with some key takeaways for practitioners drafting interest provisions in mortgages on real property, to avoid contravening s. 8 of the *Interest Act*.

Section 8, which applies only to loans secured by mortgage on real property, effectively prohibits a mortgagee from increasing the interest rate on arrears beyond the rate payable on principal not in arrears, in the context of a default. In *Krayzel*, the SCC majority emphasized substance over form: what matters is the effect of the interest rate provision, not necessarily how it is worded. Whether a provision is framed as an interest rate hike or penalty/fine upon default, or as a discount/incentive/reward in the absence of default, is not determinative. If the effect is to increase the interest rate for arrears over the rate for principal not in arrears, then the provision offends s. 8.

However, both the SCC majority and dissent in *Krayzel* confirmed that an interest rate increase triggered by the mere passage of time – as opposed to a default – does not infringe s. 8 of the *Interest Act*. As a result, mortgagees have been increasing interest rates in the last month of the term before maturity so that the rate increase is triggered by the passage of time under the mortgage contract, and not by default, even though the increased rate will technically continue to apply upon default. In *Alleghe Mortgage Fund Ltd. v. 1988758 Ontario Inc.*, the Divisional Court confirmed that such practice does not breach s. 8.[2]

[1] *Interest Act*, R.S.C., 1985, c. I-15, s. 8; *Krayzel Corp. v. Equitable Trust Co*., 2016 SCC 18 [*Krayzel*].
[2] *Alleghe Mortgage Fund Ltd. v. 1988758 Ontario Inc.*, 2021 ONSC 4887 (Div. Ct.) [*Alleghe*].

In the sections that follow, this paper: (a) summarizes the SCC's ruling in *Krayzel*; (b) examines the Divisional Court's subsequent decision in *Alleghe*; (c) discusses several additional cases that have considered s. 8 of the *Interest Act* since *Krayzel*; and (d) provides some key takeaways for lawyers advising mortgagees on compliance with s. 8 of the *Interest Act*.

II. The Supreme Court of Canada's decision in *Krayzel Corp. v. Equitable Trust Co.*

The SCC's decision in *Krayzel Corp. v. Equitable Trust Co.*, 2016 SCC 18, remains the leading case on s. 8 of the *Interest Act*. In that case, the SCC was tasked with deciding whether an interest rate provision framed as a discount in the event of non-default, designed to incentivize prompt re-payment by the borrower, contravened s. 8. Prior to *Krayzel*, there was uncertainty in the law on this point.

Section 8(1) of the *Interest Act* provides as follows:

> 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.[3]

Justice Brown, writing for the SCC majority, stressed that the substance, not the form, of the interest provision at issue is more important: "What counts is how the impugned term operates, and the consequences it produces, irrespective of the label used. If its effect is to impose a higher rate on arrears than on money not in arrears, then s. 8 is offended".[4] When applying s. 8, courts must look beyond the wording associated with a charge and examine the effect.

By way of background, the facts of *Krayzel* were as follows:[5]

---

[3] *Interest Act*, R.S.C., 1985, c. I-15, s. 8(1). Section 8(2) provides: "Nothing in this section has the effect of prohibiting a contract for the payment of interest on arrears of interest or principal at any rate not greater than the rate payable on principal money not in arrears."
[4] *Krayzel* at para. 25.
[5] *Krayzel* at paras. 4-7.

- Equitable Trust (the "Mortgagee") loaned $27 million to Lougheed Block Inc. (the "Mortgagor"), secured by a mortgage over a commercial building held by the Mortgagor. The interest rate was prime plus 2.875% per annum.

- The Mortgagor failed to pay out the loan on maturity. The parties negotiated a renewal agreement, extending the term by seven months (the "First Renewal Agreement"). The interest rate for the first six months of the renewal term was prime plus 3.125% per annum, and 25% per annum in the final, seventh month of the renewal term.

- The Mortgagor again failed to pay out the loan at the end of the first renewal term. The parties entered into a second renewal agreement (the "Second Renewal Agreement"), which was made effective retroactively to one month prior to the expiry of the First Renewal Agreement. Under the Second Renewal Agreement, the "interest rate" was 25% per annum. However, for the Mortgagor's monthly payments on the outstanding principal, only a "pay rate" (not the "interest rate") was charged, equal to the greater of (i) 7.5% per annum, and (ii) prime plus 5.25% per annum. The shortfall between the "pay rate" and "interest rate" accrued to the principal balance and would be forgiven in the absence of any default by the Mortgagor for the remainder of the second renewal term.

- After the Mortgagor defaulted on its first payment under the Second Renewal Agreement, the Mortgagee demanded payment in full, including interest at 25% per annum (i.e. at the "interest rate", not the "pay rate", under the Second Renewal Agreement). The Mortgagor then challenged the elevated "interest rate" under the Second Renewal Agreement as a violation of s. 8 of the *Interest Act*.

At a high-level, the SCC majority interpreted s. 8 of the *Interest Act* as follows:

- The legislative purpose of s. 8 is to "protect landowners from charges 'that would make it impossible for [them] to redeem, or to protect their equity'". In other words, "[i]f an owner [i.e. mortgagor] 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". Regardless of how a provision for higher interest is framed (i.e. as a penalty on default or a discount for punctual payment), if the effect is to impose a higher rate on arrears than principal not in arrears, this makes it more difficult for defaulting borrowers to protect their equity, contrary to the purpose of s. 8.[6]

- By its wording, s. 8 captures a "fine" and a "rate of interest", not just a "penalty", and expressly requires consideration of an interest rate provision's "effect". These components of the s. 8's wording demonstrate that the legislature intended to capture interest rate provisions characterized as bonuses, discounts or benefits, not just those characterized as penalties, if the ultimate effect runs afoul of s. 8.[7]

- Therefore, based on both the purpose and wording of s. 8, there should be no distinction between: (1) terms imposing, by way of penalty, a higher rate in the event of default, and (2) terms reserving, by way of discount, a lower rate in the event of no default, if the ultimate effect in either instance is to charge a higher rate of interest on money in arrears than that charged on principal not in arrears, in the event of default by the mortgagor.[8]

- Section 8 is purely "results-oriented". Other considerations, such as whether there is any "legitimate commercial purpose" for the interest rate provision at issue, or the relative sophistication/bargaining power between the parties, should not factor into the analysis on s. 8. The analysis should focus on the effect of the interest rate provision at issue.[9]

Based on the above reasoning, the SCC majority concluded that the interest rate provisions in the Second Renewal Agreement contravened s. 8 of the *Interest Act*. While framed by their wording as a discount incentivizing prompt payment, the interest rate provisions in the Second Renewal Agreement had the effect of increasing the interest rate payable by the Mortgagor for

[6] *Krayzel* at paras. 20-22, quoting from the BCCA's decision in *Reliant Capital Ltd. v. Silverdale Development Corp.*, 2006 BCCA 226.
[7] *Krayzel* at paras. 24-25.
[8] *Krayzel* at paras. 1, 3, 31.
[9] *Krayzel* at para. 32.

amounts in arrears upon default, from 7.5% (or prime plus 5.25%, whichever was greater) to 25% per annum. In effect, the "interest rate" charged on arrears in the event of default was higher than the "pay rate" charged on principal not in arrears. Consequently, the 25% "interest rate" was void; the Mortgagee could only charge the lower "pay rate" under the Second Renewal Agreement.[10]

The SCC dissent did not find the interest rate provisions of the Second Renewal Agreement to contravene s. 8 of the *Interest Act*. The dissent interpreted the relevant interest rate provisions in the Second Renewal Agreement differently than the majority, with respect to the interest rate payable on principal not in arrears. The dissent concluded that the rate payable on principal not in arrears was 25% (i.e. the "interest rate", not the "pay rate", under the Second Renewal Agreement), the same that would be payable on arrears in the event of default under the Second Renewal Agreement.[11] While the SCC majority relied on the fact that the interest rates throughout the initial term and the applicable period of the First Renewal Agreement were significantly lower than the 25% "interest rate" under the Second Renewal Agreement,[12] the dissent limited its analysis on this point to the terms of the Second Renewal Agreement only.[13]

The SCC also briefly considered the terms of the First Renewal Agreement and found them to be compliant with s. 8 of the *Interest Act*. The interest rate increase in the final (seventh) month of the first renewal term, from prime plus 3.125% to 25% per annum, was deemed lawful, as the increase was triggered by the mere passage of time, not by default (unlike in the Second Renewal Agreement). Both the SCC majority and dissent agreed that an interest rate increase triggered by the mere passage of time does not contravene s. 8 of the *Interest Act*.[14] However, the SCC did

[10] *Krayzel* at paras. 35 and 38.
[11] *Krayzel* at paras. 42-45. The SCC dissent also relied on the absence of any express reference to "discounts" in s. 8 of the *Interest Act*, which it contrasted with the express reference to "discounts" in s. 2 of the Act, as evidence of the legislature's intent to exclude discounts from the application of s. 8 – see paras. 48-51.
[12] *Krayzel* at para. 37.
[13] *Krayzel* at paras. 42-45.
[14] *Krayzel* at paras. 3, 33, 59.

not engage in any meaningful analysis on whether such an interest rate increase is consistent with the legislative intent of s. 8 of the *Interest Act*.

This distinction – between an interest rate increase triggered by the passage of time, as opposed to a default – set the stage for future cases, as discussed below. Arguably, it creates a loophole allowing mortgagees to increase interest rates just before maturity – i.e. before a potential default (in the event the loan is not repaid on maturity) – such that the higher rate will continue to apply in the event of default, while avoiding the application of s. 8 of the *Interest Act*.

III. The Divisional Court's decision in *Alleghe Mortgage Fund Ltd. v. 1988758 Ontario Inc.*

In *Alleghe Mortgage Fund Ltd. v. 1988758 Ontario Inc.*, 2021 ONSC 4887, the Divisional Court considered whether an interest rate increase was triggered by the mere passage of time, or whether it was triggered by default so as to contravene s. 8 of the *Interest Act*.

The plaintiff lender/mortgagee had been granted a mortgage over the defendant borrower/mortgagor's commercial property. The term was seven months, with interest-only payments for each month until maturity. The relevant interest rate provisions stipulated that interest would be charged at 8.25% per annum for the first six months of the term, and 18% thereafter, beginning in the seventh/final month, unless the mortgage was renewed or discharged before the final month of the term.[15] The mortgagor defaulted on its mortgage payments during the initial term (without renewal). It then challenged the higher interest rate charged for the last/seventh month of the term as violating s. 8 of the *Interest Act*.[16]

The relevant interest rate provisions were as follows:

[15] The mortgagor had the option of renewing the mortgage for an additional seven months, with the seventh month of the initial term becoming instead the first month of the renewal term. Interest during the renewal term would be 8.99% per annum for the first six months, and 18% thereafter (plus a renewal fee).
[16] *Alleghe* at paras. 4-13.

> 8.25% per annum for the first six (6) months of the mortgage term and 18.00% per annum thereafter, unless renewed or discharged, or after the second renewal term has expired. […]
>
> The principal amount of the mortgage will bear interest at 8.25% per annum for the initial six months and 18.0% per annum thereafter and will be repayable upon loan maturity.

While the motion judge found that the above interest rate provisions violated s. 8, the Divisional Court disagreed and upheld the provisions at issue. The Divisional Court considered the interest rate increase in *Alleghe* to be similar to the rate increase approved by the SCC in *Krayzel* in the First Renewal Agreement (discussed above). In each instance, the interest rate was increased for the final month of the term, prior to maturity. Like the SCC in *Krayzel*, the Divisional Court in *Alleghe* found such an increase to be triggered by the mere passage of time (i.e. a scheduled increase beginning in the final month of the term), not tied to any default.[17]

In considering the wording of the relevant interest provisions in *Alleghe*, the Divisional Court noted the absence of any reference to default or arrears.[18] The Court also found that the parties' contractual intention was that the mortgagor would need to renew or discharge the mortgage before the final month to avoid the higher interest rate.[19]

In considering the effect of the relevant provisions, the Divisional Court found that the interest rates "before and after default were the same".[20] The higher rate of interest came into effect by the normal operation of the contract in the last month of the term prior to maturity (and not as a result of default). Therefore, if the mortgagor then failed to discharge the mortgage on maturity, there was no higher rate of interest charged on arrears than on principal not in arrears (i.e. the higher rate charged in the last month before maturity/default continued to apply after).[21]

---

[17] *Alleghe* at paras. 22-23, 29, 35.
[18] *Alleghe* at paras. 26-29.
[19] *Alleghe* at para. 34.
[20] *Alleghe* at para. 31.
[21] *Alleghe* at paras. 35-36, 38.

The Divisional Court's decision seems to imply that the "rate of interest payable on principal money not in arrears" – a central component of the results-oriented analysis required under s. 8 – simply means the interest rate payable under the contract immediately before the default (e.g. in the final month before maturity, as in *Alleghe*), as opposed to a broader analysis of the various interest rates charged over the entire mortgage term. The result is that mortgagees can simply provide for a scheduled increase to the interest rate in the final month of the term, and have that higher rate continue to apply after maturity (including in the event of default), without offending s. 8 of the *Interest Act*.

IV. Other relevant cases considering s. 8 of the *Interest Act* since *Krayzel*

The following three cases serve as additional (non-exhaustive) examples of how courts in Ontario have undertaken the relevant statutory analysis under s. 8 of the *Interest Act* since the SCC's decision in *Krayzel*.

(i) *Lee v. He*, 2018 ONSC 5932

In *Lee v. He*, one of the questions before the Ontario Superior Court was whether an increased interest rate imposed by the mortgagee after maturity of the mortgage was valid pursuant to s. 8 of the *Interest Act*.

Under the terms of the mortgage, the interest rate was 12.99% per annum until maturity, when the interest rate was increased according to the following provision:

> A. 12 INTEREST ON PAST DUE: The Borrowers hereby agree that upon maturity of this mortgage and in the event the outstanding principal and accrued interest is not repaid on the balance due date, interest at that rate of 20% per annum will be charged from the maturity date until repayment in full, unless otherwise agreed upon.[22]

The Court rejected the mortgagee's argument that the interest rate increase was simply due to the passage of time (i.e. the loan maturing).[23] The Court found that this interest rate increase

[22] *Lee v. He*, 2018 ONSC 5932 [*Lee*] at para. 10.
[23] *Lee* at paras. 19-20.

violated s. 8, as it was triggered upon default and was designed as a penalty. It would impose an increased interest rate on arrears (20%) if the mortgage was not repaid by maturity, which was higher than the interest charged on principal not in arrears (12.99%). In its reasoning, the Court noted that the provision specifically referred to interest on "past due" amounts (i.e. the notion of default was incorporated into the wording of the term).[24]

(i) ***Walia v. 2155982 Ontario Inc.*****, 2020 ONCA 493**

In *Walia*, the Ontario Court of Appeal upheld a motion judge's decision that an interest rate provision increasing the rate of interest on amounts unpaid at maturity or upon default violated s. 8 of the *Interest Act*.[25]

The rate of interest charged during the term of the mortgage was 12% per annum. The following provision then imposed a higher rate of interest if the mortgage was not fully paid by maturity, or in the event of default:

> The mortgage will become due and payable at the end of the term, failing which or in default of any payment interest rate of interest will be 21% per annum.[26]

The Court of Appeal rejected the mortgagee's argument that the increase in the interest rate was triggered by the mere passage of time (i.e. the loan reaching maturity). Instead, the Court found, based on the express language of the interest rate provision, that the rate increase was triggered by default: either a default on a monthly payment during the term, or the loan not being paid in full by maturity.[27]

[24] *Lee* at paras. 20-21.
[25] *Walia v. 2155982 Ontario Inc.*, 2020 ONCA 493 [*Walia*].
[26] *Walia* at para. 12.
[27] *Walia* at paras. 13-16, 21-22.

(ii) *Ahmaddi v. Mak et al.*, 2022 ONSC 752

In *Ahmaddi*, the Ontario Superior Court considered whether several charges that appeared on a mortgage discharge statement were valid and enforceable, including whether they violated s. 8 of the *Interest Act*.[28]

Under the relevant loan agreement, the interest rate was 12% per annum during the mortgage term. Among other charges that were challenged in the discharge statement, the plaintiff borrower/mortgagor challenged the following charges:

a) an interest rate of 18% being applied after the date of maturity; and

b) a default maturity charge of $42,000.[29]

The mortgagee relied on the following maturity clause:

> … if the mortgagor has not paid the principal balance owing together with any interest, or entered into a renewal agreement with the Mortgagee, the mortgage shall bear interest at the rate of eighteen percent (18%) plus any applicable fees including the "lender fee and broker fee" will be charged and add on to the principal until such time the mortgage is paid in full or renewed.[30]

The Court swiftly disposed of the interest rate increase from 12% to 18% in the event of a failure to pay the principal upon maturity or to renew. The Court found that this was precisely the type of increase that s. 8 prohibits: "a rate of interest imposed at default that has the effect of increasing the charge on arrears beyond the rate of interest payable on principal money not in arrears".[31]

With respect to the $42,000 "default maturity charge", the Court found that this was charged only upon the failure to pay the principal in full, or renew, by maturity (given the express wording of the clause relied on by the mortgagee, quoted above). Aside from the fact that the $42,000

---

[28] *Ahmaddi v. Mak et al.*, 2022 ONSC 752 [*Ahmaddi*].
[29] *Ahmaddi* at paras. 3-5.
[30] *Ahmaddi* at para. 6.
[31] *Ahmaddi* at para. 9.

charge was not even contemplated by the plain wording of the mortgage contract, the Court found this charge to be a "penalty that has the effect of increasing the charge on arrears beyond the interest rate payable on principal money not in arrears", contrary to s. 8.[32]

The Court rejected the mortgagee's arguments that the $42,000 fee was triggered by the mere passage of time (rather than default), or that it was not an interest charge but instead a commission payable to him as a lending fee. In its analysis, the Court relied on the mortgagee's affidavit evidence that the $42,000 fee was a "penalty to compensate himself for foregoing earning the same financing fee by lending the funds out again". The Court also appears to have relied on the absence of any evidence that the charge in question reflected real costs legitimately incurred by the mortgagee for the recovery of debt (in the form of actual administrative charges or otherwise).[33]

V. Key takeaways for practitioners considering compliance with s. 8 of the *Interest Act*

Note that the following takeaways apply only to loans secured by mortgages on real property (or hypothecs on immovables), given that s. 8 of the *Interest Act* only applies to such loans.

1. **Counsel advising lenders on their mortgages should scrutinize the <u>effect</u> of the mortgage's interest rate provisions in the event of default.** As set out in *Krayzel*, the focus of the court's analysis when an interest rate provision is challenged will be on the provision's effect, not necessarily its wording. Courts are supposed to look past the labels used in the contract (e.g. "penalty" or "discount") and consider whether the ultimate effect of a provision is contrary to s. 8 of the *Interest Act*. The key question will be: is the interest rate applicable to arrears in the event of default higher than the interest rate payable on principal not in arrears?

2. **Notwithstanding the focus on effect, the wording still matters.** Courts still place some weight on how a provision is worded, including whether there is reference to default or

[32] *Ahmaddi* paras. 6-8.
[33] *Ahmaddi* paras. 7-8.

arrears in the provisions at issue (see the decisions in *Alleghe* and *Lee* discussed above). Similarly, while the purpose of the interest rate provision is not supposed to govern the analysis (per the SCC in *Krayzel*), courts can still consider the parties' contractual intentions (as in *Alleghe*).

3. **Discounts/incentives that operate in the event of non-default are to be treated the same as penalties on default, under s. 8 of the *Interest Act*.** It doesn't matter whether the provision is framed as a penalty on default, or a reward for non-default; if the effect is to charge higher interest on arrears than on principal not in arrears, s. 8 is infringed. However, this does not mean that all incentives/discounts are impermissible; what matters is the effect. For example, a discount/incentive is less likely to infringe s. 8 if it is not coupled with an increase in the interest rate triggered by default to which the discount/incentive is being applied (as in the Second Renewal Agreement in *Krayzel*).

4. **What courts consider to be the interest payable on principal not in arrears will likely dictate the rest of the court's analysis.** One of the reasons for the SCC majority and dissent arriving at different conclusions in *Krayzel* was because they made different findings on the interest rate payable on principal not in arrears. Based on the case law since *Krayzel* (discussed above), it seems courts will find that the interest rate payable during the contract period immediately before default to be the rate payable on principal not in arrears in their analysis under s. 8 of the *Interest Act*.

5. **While the interest rate cannot be increased upon maturity (as in *Lee*, *Walia*, or *Ahmaddi*, discussed above), it can be increased during the contract term just before maturity (e.g. a month before, as in *Krayzel* and *Alleghe*, discussed above).** Courts consider the latter type of rate increase to be triggered by the mere passage of time, which does not violate s. 8 of the *Interest Act*. Whether courts would accept a scheduled rate increase less than a month before maturity (e.g. a day before maturity) remains to be determined.

6. **Any lump sum fees payable upon discharge or in the event of default should be clearly based in the language of the mortgage/loan agreement, and should reflect the mortgagee's legitimate expenses.** To avoid such fees being considered a penalty and running afoul of s. 8, evidence is necessary to demonstrate that the fees in question reflect real costs legitimately incurred by the mortgagee in relation to the recovery of the debt (e.g. administrative or legal fees).