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*The magistrates are the ministers for the laws, the judges their interpreters, the rest of us are servants of the law, that we all may be free.*

~ Marcus Tullius Cicero  
(106 – 43 BC)

**Supreme Court rules discounts caught by s. 8 of *Interest Act***

Barbara L. Grossman and  
Emily Quail (Student-at-Law)  
*Dentons Canada LLP*

**The Supreme Court of Canada has ruled that discounts for punctual mortgage payments are caught by s. 8 of the *Interest Act*.**

Section 8 of the *Interest Act* (Canada) (the “Act”) prohibits mortgage lenders from charging a higher rate of interest after default than is charged before default or maturity. In its May 2016 decision in *Krayzel Corp v. Equitable*

*Trust Co.* (“*Krayzel*”), the Supreme Court of Canada clarified the application of s. 8 to post-default interest rate increases structured as a discounted rate applicable to punctual payment rather than a higher rate or penalty charged after default.

In a 6-3 decision, the majority of the Court held that mortgage provisions that provide a discount for making punctual payments have the effect of increasing the interest rate after default and, therefore, offend s. 8 of the Act. As a result, the higher rate of interest is void and unenforceable, and the discounted rate continues to apply after default.

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## DIRECTORS' AND OFFICERS' LIABILITY

**Employees cannot claim against directors for failing to stop fraud**

Matthew Fleming & Holly Cunliffe,  
*Dentons Canada LLP*

**The Ontario Superior Court of Justice has held that directors and officers do not owe fiduciary or other duties to employees who have defrauded the corporation.**

Parties to litigation involving corporate entities occasionally seek to bring claims against an organization’s directors and officers in addition to a claim against the organization itself. However, the ability of parties to do so has been carefully circumscribed by the courts.

In *Ontario Psychological Assn. v. Mardonnet*, the Ontario Superior Court of Justice considered whether an employee — who was alleged to have committed fraud against the

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# Commercial Property and Leases

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This ruling is important not only for the immediate parties to the mortgage, but also for subsequent encumbrancers and trustees in bankruptcy and/or creditors of insolvent mortgagors who benefit if the lower discounted rate applies both before and after default.

## S. 8 of the Act

Enacted in 1880, s. 8 of the Act was intended to protect mortgage borrowers from losing their land as a result of ever-increasing rates of interest. Today, s. 8 remains largely unchanged. It states that,

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 ... that has the effect of increasing the charge on the arrears beyond the rate of interest payable on principle money not in arrears. [emphasis added]

The application of s. 8 to modern mortgage lending has led to varied results in Canadian jurisprudence. The courts have taken different approaches to applying s. 8 to discounts for prompt payment and to the application of a “legitimate commercial purpose” test.

## Krayzel issues

In *Krayzel*, the Supreme Court of Canada considered three issues.

First, whether interest rates that increase with the passage of time offend s. 8;

Second, whether s. 8

is offended by terms of a mortgage agreement imposing an ‘interest rate’ that takes effect only where the mortgagor falls into default by failing to make prescribed payments at a lower ‘pay rate’ of interest or by failing

to pay out the loan upon maturity.

Consideration of this issue required the Court to examine the distinction between “penalties” and “discounts” under s. 8.

Third, whether a “legitimate commercial purpose” analysis is appropriate in applying s. 8.

## Krayzel facts

*Krayzel* involved a mortgage on commercial property. Twice, the mortgagor was unable to pay on maturity and, twice, the mortgagee agreed to extend the mortgage at higher rates of interest. The second extension agreement carried an annual interest rate of 25 percent and provided for discounted monthly interest payments at a significantly lower “pay rate.”

The terms stipulated that if the mortgagor made punctual monthly payments at the “pay rate,” the mortgagee would forgive the difference between the two rates. The Court unanimously held that, “an interest rate increase triggered by the mere passage of time (and not by default)... clearly does not offend” s. 8. However, the bench split on the interpretation of the mortgage terms at issue as well as on the application of s. 8 to the discounted monthly pay rate for punctual payment.

## Discounts and penalties

The majority of six judges stated that drawing a distinction between a higher rate cast as a penalty for default, and a discounted interest rate for punctual payment, could not be supported; the two are different sides of the same coin.

A provision, no matter how labelled, the effect of which is to impose a higher rate of interest after default, makes it more difficult for borrowers (who are already in default) to redeem or protect their equity, which is precisely what s. 8 is aimed at protecting against.

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### Intention

Furthermore, the majority held that had Parliament intended to limit the prohibition in s. 8 to only penalties, it would not have included a “fine” or a “rate of interest” in addition to a penalty, as a type of charge that is prohibited. The omission of the word “discount” in s. 8 (as compared to s. 2) was held not to be determinative or persuasive on the issue of whether discounts are within the ambit of the s. 8 prohibition.

### Substance over form

When interpreting s. 8 “[s]ubstance, not form is to prevail.” The majority emphasized that s. 8 prohibits any mortgage term that has “the effect” of increasing the rate of interest on default. As stated in the majority decision,

[w]hat 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.

### Minority opinion

The minority of three judges differed from the majority in its interpretation of the mortgage terms as well as the application of s. 8. The minority reasoned that the interest rate on the principal was 25 percent throughout

the entire term of the mortgage and this rate was not triggered by default or maturity.

The minority also concluded that s. 8 does not prohibit “forgiving discounts” that provide a mortgagor with a “less onerous path to fulfill ... payment obligations and protect its equity.”

### Commercial purpose

The Court also considered whether contextual factors should influence the application of s. 8. The majority held that the legitimate commercial purpose analysis was “incompatible with s. 8.” In addition to often creating commercial uncertainty and arbitrary application, the majority held that s. 8 is explicitly concerned only with *the effect* of the mortgage provision and not with its purpose.

The minority disagreed on this point. It reasoned that in the commercial context of the second renewal agreement, invalidating the higher rate would not give effect to Parliament’s protective purpose; rather, it would reward the borrower with an “unmerited windfall” and this should be considered in applying s. 8.

### Significance

In this decision, the majority of the Supreme Court has made it clear that substance prevails over form, and discounts for prompt payment fall within

the ambit of the s. 8 prohibition. Any mortgage term, however structured or labelled, that has *the effect* of increasing the rate of interest after default or maturity, will offend s. 8.

The result of that offence is that the lower rate of interest applicable before default will continue to apply after default or maturity.

REFERENCES: *Interest Act* (Canada), R.S.C. 1985, c. I-15, paras. 1, 33, 22, 25, 40, 32, 47; *Krayzel Corp. v. Equitable Trust Co.*, 2016 SCC 18, 2016 CarswellAlta 788, 2016 CarswellAlta 789 (S.C.C.); *Reliant Capital Ltd. v. Silverdale Development Corp.*, 2006 BCCA 226, 2006 CarswellBC 1090 (B.C. C.A.) at para. 53, leave to appeal refused 2006 CarswellBC 2864, 2006 CarswellBC 2865 (S.C.C.); Mary Anne Waldron, “The ‘Legitimate Commercial Purpose’ Test Revisited: Case Comment on *Reliant Capital Ltd. v. Silverdale Development Corporation*” (2008) 41 U.B.C.L. Rev. 101; *Weirdale Investments Ltd. v. Canadian Imperial Bank of Commerce*, 1981 CarswellOnt 1128, 32 O.R. (2d) 183 (Ont. H.C.); *North West Life Assurance Co. of Canada v. Kings Mount Holdings Ltd.*, 1987 CarswellBC 207, 15 B.C.L.R. (2d) 376 (B.C. C.A.).

## Directors’ and Officers’ Liability *continued from page 65*

organization that terminated her employment on this basis — could seek contribution and indemnity from the directors and officers of that organization for any damages for which the employee was found liable to the organization.

In a welcome decision for directors and officers, the court concluded that directors and officers did not

owe fiduciary or other duties to the employee in such a situation.

### Facts

In November 2013, a not-for-profit organization, the Ontario Psychological Association (“OPA”), terminated the employment of one of its employees who had had responsibility for the day-to-day administration of the

OPA’s finances. The OPA alleged that the employee had abused her role and misappropriated in excess of \$1.6 million over a ten-year period.

In 2014, the employee was charged criminally with fraud and the OPA commenced a civil action against her to recover the funds it alleged were misappropriated. The employee filed a defence and

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