Court of Appeal: Arrangements to receive criminal rates of interest can take the form of purchase agreements

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In certain circumstances, loan, debt or credit arrangements can take the form of purchase agreements. A party seeking to charge criminally high rates of interest to less sophisticated parties could use the form of a purchase agreement to skirt laws prohibiting criminally high rates of interest. On Nov. 25, 2022, the Ontario Court of Appeal released its decision in *Hybrid Financial Ltd. v. Flow Capital Corp.* 2022 ONCA 820, which considered the interpretation of section 347 of the *Criminal Code* relating to agreements and arrangements to receive criminal rates of interest, which, when calculated in accordance with generally accepted actuarial practices and principles, exceed 60 per cent on the credit advanced under an agreement or arrangement.

Background

- In 2017, Hybrid needed alternative financing to pay off a bank loan and entered an “Amended and Restated Royalty Purchase Agreement” with Flow.
- In exchange for $750,000, Hybrid was to make minimum monthly “royalty” payments of $15,625 until Jan. 1, 2019, and thereafter payments amounting to either the greater of $15,625 or an amount tied to Hybrid’s revenues.
- There was a buyout option stipulating that once Hybrid made payments totaling at least $750,000, Hybrid could pay the greater of $1,500,000 or 5 per cent of Hybrid’s net equity value. Unless the buyout was exercised, Hybrid was to make the royalty payments in perpetuity.
- In November of 2020, the accountant jointly retained by the parties estimated Hybrid’s net equity value to be approximately $75,500,000. This would have required Hybrid to pay a buyout of $3,775,000, an amount – after only three years – five times greater than the amount of capital provided to Hybrid by Flow or continue to make royalty payments in perpetuity.
- Hybrid brought an application seeking an order that the financial formula in the Agreement exceeded the criminal 60 per cent interest rate under s. 347.

The lower court decision

The application judge determined that the agreement – read as a whole – did not support a characterization as predominantly a loan agreement or credit facility agreement. The application judge emphasized that the agreement characterized the $750,000 payment as consideration for the purchase of royalties rather than a loan, debt or credit and that Hybrid's payment obligations were characterized as "royalty payments" rather than interest. In addition, there was no allocation between principal and interest. The application judge noted the lack of a requirement on Hybrid to repay the $750,000 sum and that the royalty payments were to be made in perpetuity. The application judge also found that since the royalty payments were not sufficiently fixed or readily calculable, they were not "interest". Finally, the application judge found that Hybrid voluntarily triggered the alleged criminal rate of approximately 70 per cent when it exercised its right to end the monthly royalty payments.

Hybrid's appeal

The Court of Appeal determined that the key issue was the application of the *Criminal Code* to the agreement, specifically, considering the substance of the transaction and not the form. The Court of Appeal cited the Supreme Court of Canada's decision in *Garland v. Consumers' Gas Co.*, [1998] 3 S.C.R. 112, to say that the interpretation of "interest" mandated by s. 347 "may not follow intuitively from the concepts of 'credit' and 'interest' as those terms are employed at common law and in everyday life". The Court of Appeal determined that the substance of the transaction was that Flow advanced money to Hybrid and that Hybrid was required to pay money in return. The money Hybrid had to pay in return was an expense incurred for the advance of credit and was therefore subject to s. 347.

Additionally, the Court of Appeal found that the application judge failed to consider section 6.13 of the agreement, which stipulated that Flow could not receive payment at a rate prohibited under law (the only law applicable being s. 347). Section 6.13 of the agreement provided for an adjusted rate one percentage point less than the lowest effective annual rate prohibited. Section 6.13 of the agreement indicated an anticipation that payments under the agreement might engage s. 347, and that an adjusted rate would result in that event.

Takeaways

The Court of Appeal indicated that this case will be particularly relevant in situations involving less sophisticated parties. It is imperative that parties who provide money to parties not charge criminal rates of interest. In addition, if parties provide money to parties in exchange for future royalties, it is imperative that they ensure that the nature of any such agreements are not in actuality loan, debt or credit agreements carrying criminal rates of interest.

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