SECTION 347 OF THE CRIMINAL CODE: "A DEEPLY PROBLEMATIC LAW"[1]

By
Mary Anne Waldron
Professor of Law, University of Victoria

I. Introduction

[1] It is commonly accepted wisdom that the repeal of the Small Loans Act and the enactment of the Criminal Code amendment, although accomplished by the same statute,[2] had nothing in common. The Small Loans Act[3] had attempted to control lending rates to borrowers of relatively small amounts, on the assumption that these loans would be consumer loans and some protection of the borrower from unreasonable rates was desirable.[4] But the law was easily avoided: lenders generally refused to make loans under the dollar value set by the statute. And once credit cards became widely used, the usefulness of the statute was obviously gone.

[2] Canada, unlike other countries, has never had much appetite for regulating the cost of borrowing. From the earliest of debates in the House of Commons, the widespread commitment to treating money as a marketable commodity for which the market must set a value is clear.[5] Indeed, for many years, faithful members of the New Democratic Party took a principled stand against that trend and presented an annual private member's bill to regulate interest charges. It never succeeded.[6] It remained, until 1981, a surprising feature of our generally mixed economy that interest rates were largely unregulated, contrasted to the arguably more free market economy of the United States where a patchwork of usury laws still abounds.

[3] So repeal of the Small Loans Act[7] made both practical sense and fit with the Canadian economic wisdom. But the same statute[8] by which the Small Loans Act was repealed also enacted a usury limit of general application and enshrined it in the Criminal Code.[9] The stated justification was not consumer protection in the same sense as the Small Loans Act had been consumer legislation, but to give the police a clear test to aid in prosecution of loan sharks. Loan sharking, as prohibited under the previous law, required proof of some kind of threatening or violent behaviour. This was difficult to obtain, such persons who were victims in the cases generally being unwilling to appear in court. An objective test of a fixed interest rate was therefore desirable.[10]

[4] There does not appear to be any evidence that the statute was regarded as addressing other than genuinely criminal behaviour. Yet there is an ambiguity in our views about

lending at interest that probably underlies the source of the difficulties that have emerged with s. 347 . Is it "genuinely criminal" simply to charge an extremely high rate of interest? Of course, such is often the hallmark of organized crime, but unless we consider the rate alone sufficient to trigger the moral stigma of criminalized conduct, the use of the rate alone as a test for criminality is an effort to attack a cause by treating the symptom. Unfortunately, as is the case in many diseases, one symptom in isolation is not usually a very reliable indicator of cause: a high fever may be flu or it may be strep infection.

[5] It seems unlikely, given Canadian history, that Canadians do view simply charging a high rate as criminal in and of itself without at least some very serious qualifications. This may be part of the reason why prosecutions under the section require the consent of the Attorney General.[11] And, of course, the question remains as to what that level would be. No one is morally offended by the mailroom lender advancing $20 for a week for a $2.00 charge. Yet, as has been pointed out, the rate is in the 1000's of percentage points based upon the normal actuarial principles used to compute effective annual rates.[12] Therefore it would seem that there would need to be some flexibility in the rate that is regarded as criminal; s. 347 gives no flexibility at all.

[6] As well, no one is morally offended by a loan in which the lender has a chance to "take a piece of the action", no matter how high the percentage might work out on the return. New commercial ventures are inherently risky and it takes a good deal of work in some cases to come up with a financing opportunity that will be attractive in the market. The alternative is simply to let the venture go un-financed, thereby limiting economic development and market expansion.

[7] Is there a rational solution to s. 347 commercial problems? Calls have been issued for the section's repeal. But before repeal is recommended it might be wise to consider the issues from all perspectives.

II. Charging Interest as a Criminal Activity

[8] Commercial lawyers probably have little sympathy for a view that any interest is criminal in the commercial context. Yet the fact remains that outside the legitimate commercial transaction, the poor may be victimized through a variety of factors such as inaccessibility of credit markets, lack of stable income and needs based on consumption of their families which income cannot meet. It is not the function of this paper to describe in detail those interests. However, it is not the function of any moral person to deny the need for protection in some circumstances. It is easy to suggest, as noted, that the problems of s. 347 demand the section's repeal. But it may be more difficult to find a

compromise with the policy behind the aims of the statute to target criminal lending activity and the needs of the commercial community.

[9] In an earlier paper,[13] I noted that few reported criminal violations of s. 347 had occurred. However, at that time, statistics on cases prosecuted under the section were not separately compiled. Further, as I noted, dearth of reported cases is no indicator of what is happening in the Provincial courts where loan sharks would normally be prosecuted. Current Department of Justice statistics reveal that of the provinces and territories participating in their collection of statistics, 13 charges under s. 347 were reported in the past year and 7 cases proceeded to trial.[14]

[10] This is not a large number. However, each of these cases is potentially a serious situation of victimization that might not have been addressed without the section. It may neither be necessary or desirable to give up the concerns of police protection for the weak to prevent what has become a stumbling block to commercial practice. As well, the original amendment was enacted particularly at the request of the police. Not all jurisdictions report their statistics under this program and information is therefore still limited. Thus it could be the case that the section has accomplished some of its purposes but that the information is still not readily available. If possible, a good solution to this problem might promote useful police action while ending the restrictions on commercial freedom.

III. The Problems of s. 347

[11] The section encompasses two ways of committing a criminal offence with respect to interest. First, one may enter into a contract which sets the interest at a rate above 60% per annum, effective annual rate.[15] Second, even if one has not contracted for a criminal rate of interest, one may still commit the offence if, at the end of the day, one receives interest at what turns out to be a criminal rate.[16] Both these are problematic in the commercial arena because, I will suggest, of the very provisions that are essential to make them useful in criminal prosecution.

A. Contracts for Usurious Interest

[12] It may be thought that 60% per annum is an excessive rate, particularly in this day of generally low inflation and correspondingly low conventional lending rates. However, the mailroom lender example mentioned above illustrates that there may be other methods used to cover the costs of lending and produce a profit apart from charging a stipulated rate of interest. The courts have defined rate of interest as that "accruing from day to day".[17] This is a common sense definition which reflects the fact that most lenders are

compensated for the use of their money proportionately to the time the borrower has use of it. But the "mailroom lender" was compensated in another way – by a flat rate charge. Such flat rate fees have proved a problem for efforts to control charges for borrowing.

[13] When efforts have been made directly to control interest rates, the first evasive strategy has usually been to charge some flat fee. It may be a "service charge", an "administration fee", a "brokerage fee", a "bonus" or any one of innumerable ingeniously named charges. The flat fee can be used to allow the lender to claim that it is not in fact charging "interest" and therefore is not controlled by the legislation. This strategy defeated the entire purpose of consumer protection under the long-defunct Moneylenders Act.[18] It substantially weakened the disclosure provisions of the Interest Act[19] in mortgage lending.[20] The history of the flat fee as an evasion device is long, if not perhaps honourable. Such fees were the method by which Renaissance banking houses avoided strict church prohibitions about charging any interest at all on loans.[21]

[14] Further, although one court suggested that a flat bonus charge was easier to understand than interest,[22] the reality is that fees charged "up front" have a greater impact on the return to the lender than is generally understood. If you borrow $100 for one year at 10% per annum interest, at the end of the year you repay $110. If you borrow $100 for one year at 10% interest, but also pay the lender a $10 "service charge" out of the loan proceeds, you still repay $110 at the end of the year. But the return to the lender on this second loan was in fact $20. And the credit you actually received was only $90. Therefore, expressed as a percentage of the credit received, the cost of this loan was 22.2%. The "extra" 2.2%, of course, is earned through the fact that the service charge was not only paid to the lender, but it formed part of the principal of the loan and itself bore interest throughout the year.

[15] It is no wonder, with this history in mind, that any serious effort either to require disclosure of interest rates or to limit lending charges must include in some way a control on flat fee charges. The Criminal Code section includes an extremely broad definition of interest to avoid just these difficulties. Interest is defined to mean "the aggregate of all charges and expenses, whether in the form of a fee, fine, penalty, commission or other similar charge or expense or in any other form.."[23]

[16] The definition goes on to stipulate that it does not matter to whom the charges are paid or payable. Once again, this is an effort to curtail an evasion of the section. Lenders may incorporate separate "Credit Assessment" agencies or brokerage arms to which the fees may be payable. Unless actual fraud is involved, the doctrine of separate corporate personality can shield a lender from accusations that it is being compensated by the fees paid to the separate entity.

[17] Certain very minor charges are excepted from the inclusion in interest, including amounts on mortgages required to be paid in property taxes and official fees which are themselves narrowly defined as fees "required by law to be paid to any governmental authority in connection with perfecting any security."[24] The nature of these exceptions also illustrates the efforts to curtail ingenious evasions. The primary independent recipient of fees which are recognized expressly as excluded from interest is the government.

[18] If the section is to accomplish its purpose as public protection, these definitions and limitations are essential. But in the commercial world, they can be traps for the unwary. Sometimes money is needed for short periods of time. A lender will have a certain irreducible cost to making any loan. The application must be processed; the credit assessment must be done; the legal paperwork must be prepared; interviews must be held; documents must be reviewed. This all takes time. And a profit must be made if the lender is to continue its business. Yet fees for all these matters will be considered "interest" under the Criminal Code.

[19] This brings to light the other feature of the section which combines with the broad definition of interest to cause commercial difficulty. The fees, when considered interest, are converted to an annualized rate. This is required by the definition of "criminal rate". "Criminal rate" is defined as "an effective annual rate".[25] In other words, once all the interest charges (under the expanded definition) are computed and the corresponding principal advanced determined (money or benefits actually advanced, less fees, fines, etc.), a formula is applied to decide what the rate would be if the loan was outstanding for a year and the return on the loan for the period during which the borrower actually has use of the money was repeated for equivalent periods through the year.

[20] The actual formula for doing this is $\mathbf{A} \times (\mathbf{1} + \mathbf{I})^t = \mathbf{B}$, where A is the payment advanced by the lender; B the payment made by the borrower; I is the effective annual rate of interest; and t is the time expressed in years between the date of the advance of the loan and the date of repayment. And the result is that the "mailroom lender" charging 10% for a week is charging an effective annual rate of 14,000% per annum.[26]

[21] For these reasons the short term commercial lender, even if only charging what would be reasonable costs for its services, is at serious risk of committing a criminal offence. Of course, legitimate lenders are normally not prosecuted under s. 347 . Indeed the section contains a built-in protection for such lenders in that before a prosecution is brought pursuant to this section, the Attorney-General of the province must consent. However, the result has been that the lender can find its charges either reduced or

eliminated if, when the lender attempts to collect the loan, the borrower resists payment on the ground that the rate is criminal and the transaction illegal.

[22] Such defences have been the most common use of s. 347 in the superior courts, at least. In many cases, the claim of illegality does not result in the lender being unable to recover any part of the loan. Instead some form of severance has been applied to eliminate one or more of the charges or to reduce the total amount below the criminal rate. A further discussion of severance and why it does not provide a satisfactory solution to the problems of commercial lenders and s. 347 will be provided later in this paper.[27]

[23] Courts themselves have also attempted to provide some relief for this problem by confining their interpretation of what fees are in fact included in interest. The definition is, as noted, drafted in the widest possible terms. Fairly early in the section's judicial interpretation, the inclusion of lawyers' fees in interest was recognized.[28] However, courts have adopted as well the limitation that the fee must be payable for the lenders' benefit. Thus if the borrower pays the lender's legal fees (as is commonly required), that amount is added to interest. But the borrower's own independent legal fees are not.[29] This is probably justifiable on the words of the definition which require that the fees be paid "for the advancing of credit." Some cases have gone so far as to hold that fees to an independent third party mortgage broker are not included.[30]

[24] As well as being triggered by short term lending situations, s. 347 (a) may also cause problems when the parties fully anticipate a substantial profit or increase in the value of an asset being financed by the transaction and the lender seeks to capture a fixed amount of that profit. These were the facts of the first case to be decided in which s. 347 was raised as a defence to a civil action. In *Mira Design* v. *Seascape*,[31] the parties wanted to finance the purchase of real estate.

[25] The market in Vancouver was hot (overheated, as events unfortunately proved). The purchaser needed interim financing for up to a month. The vendor was convinced, given the rate of increases in property values, that it could sell the property in another month for a substantial additional profit. To agree to the financing, the vendor required that a capture of this "lost" profit be included in the principal of the mortgage loan if the loan was not repaid in a month. The amount actually advanced was $84,000; the amount to be repaid if the loan was outstanding for more than a month was $100,000; the loan, if not repaid was to become a demand loan. During the month, the market collapsed and payment of the full amount plus the compensation for "lost" profit was demanded 15 days after the due date. It was the effort to capture that amount of anticipated gain that created the criminal problem.

[26] Profit sharing as part of a lending arrangement is hardly unusual. Where the profit is pre-estimated and the loan repayment based upon that pre-estimate, the possibilities of charging a criminal rate of interest are very real. In *Tong* v. *Advanced Wing Technologies Corp.*,[32] a joint venture agreement provided an arrangement in which the parties were to finance the purchase of an aircraft for refurbishing and resale.[33] The plaintiff advanced approximately $200,000 to the defendant, half of which was to be in form of a loan and half of which would be a private placement for shares of the company. The plaintiff was to receive $280,000 from the defendant if the net sale proceeds of the Aircraft exceeded $280,000 and the entire net sale proceeds, whatever they might be, if the net proceeds were less than $280,000.

[27] The line between investments through debt and investment through equity participation can become a fine one. In this case, that line was crossed when the proposed purchase and resale of the airplane was abandoned by the defendant due to legal complications. The plaintiff did not discover until much later that these problems had arisen. However, by a second oral agreement, the defendant agreed to repay the plaintiff $280,000 plus interest at 6% per annum. The parties agreed that this agreement was illegal. Presumably, although the court does not make this explicit, because the payment was to be made independent of the joint venture agreement which provided this return only contingent upon the sale of the aircraft for the stipulated price.

[28] In the result, the defendant was found liable to pay the plaintiff $280,000 based upon the defendant's issue to the plaintiff of three post-dated cheques for that amount which the court held were payments under the joint venture agreement. In effect the court held that the payments were in the nature of damages for failure to proceed with the joint venture agreement. They were not held to have been issued in consequence of the second illegal agreement. The court held that the defendant had made it impossible for the plaintiff to prove her loss on the joint venture agreement and had accepted that $280,000 was the appropriate measure of that loss. Such damages were awarded by the court.

[29] The difficulty at which this case hints is the risk in using "mixed" investment models. As long as an investment is "purely" equity, where a share of both profits and loss is at stake, one can argue that no "credit" is being advanced. But "investors" do not clearly separate in their own minds the line between equity and debt. Further, this joint venture agreement indicates that the two modes of supplying capital may be shifted and adjusted to respond to changing problems. In such cases, the possibility that s. 347 will be violated and that the violation will not be appreciated, are high.

[30] The complexities that can arise in a mixed debt equity situation are illustrated in the decision of the British Columbia Court of Appeal in *J.D.M. Capital Ltd.* v. *Smith*.[34] In

that case, ACo wished to acquire a substantial shareholding in BCo. BCo in turn controlled CCo. ACo negotiated a loan from DCo to assist in the purchase of the shares. As part of the consideration for the loan, ACo agreed to use its best efforts to cause a company related to DCo (ECo) to acquire treasury shares of CCo at a discount from book value to produce a tax free "lift" of $1.666 million. The loan was made, but ACo failed to honour its promise. The trial judge held that the $1.666 million was interest on the loan and that this made the contract illegal under s. 347 (1) (a) of the Criminal Code. The Court of Appeal disagreed.

[31] The court found that the value of an investment opportunity could be considered interest[35] under the Criminal Code but that if the cost could not be quantified, the agreement was not proved to violate s. 347 (1) (a), although it might still run afoul of s. 347 (1) (b). In this case, the borrower had not promised to pay $1.666 million if the best efforts were not successful. The question in finding what the interest on the transaction was had to be determined by looking at the cost to the borrower. Since CCo had minority shareholders and since the transaction would have to be approved by CCo's board, the value of the transaction to the company (and thus to ACo) would have had to balance out the cost of the discount. Otherwise, the best efforts of ACo would come to nothing and nothing would be payable to DCo. The court concluded that interest was not payable at a criminal rate under the contract.

[32] The difficulty in valuing such components of "interest" is apparent. The approach of the Supreme Court to s. 347 (1) (a) is of assistance in such a case, allowing a court to find that because the value of the interest is uncertain, the criminal rate is not surpassed. However, had the parties included language in their contract ensuring DCo of the $1.666 million it expected to receive, the decision would have been different.[36] As it was, the matter was referred back to the trial judge for a determination of the damages arising from the loss caused by ACo's failure to honour its best efforts promise.

[33] When the profit is pre-estimated, a criminal rate may be foreseeable from the inception of the loan. But in the case in which profit is not pre-estimated, as in *J.D.M. Capital*, s. 347 (1) (a) will not create a problem. However, if the profit is realized, and so creates a windfall at some point in the transaction, producing an effective criminal rate, s. 347 (1) (b) may be engaged. To a discussion of that second offence I will now turn.

B. Receiving Usurious Interest

[34] Another way to avoid controls of interest rates in contracts is to ensure that the contract does not provide for a criminal rate, but to insert provisions that will in effect give the lender a return much higher than the disclosed rate. When the British usury laws

were in effect, mortgagees often contracted outside the mortgage loan document for another kind of payment. These were referred to as "collateral advantages" and, if identified as an effort to subvert the usury laws, were regularly declared void by the courts. It was not until 1914 in England that the legitimacy of contracts for collateral advantages in mortgage transactions was established. This was long after the last of the usury laws had been repealed.[37]

[35] Again, it would be a sloppy drafter, given the history of interest rate controls, who did not think of and provide for some device to block this useful avenue of avoidance. In the Criminal Code, this device consists of the "wait and see" provisions of s. 347 (1) (b) which provides that it is an offence to receive "a payment or partial payment of interest at a criminal rate." The problems this creates for commercial lending may be summarized as follows:

1. Where the situation changes unexpectedly and what was anticipated as a legal rate is, due to the definition of interest and the process of conversion to an effective annual rate, now a criminal rate; or
2. Where the return to the lender is uncertain, being dependent upon such matters as profitability of the borrower, and the ultimate payment received, when converted to an effective annual rate may exceed 60% per annum.

[36] The potentially wide scope of s. 347 (1) (b) was recognized in *Nelson* v. *C.T.C. Mortgage Corp.*[38] In that case, a loan was legal on the face of the contract. The interest and fees paid over the term of the loan for which the borrower was entitled to the use of the money, when converted to an effective annual rate, did not exceed 60%. However, the agreement also contained provision for the borrower to shorten the term of the loan by prepaying. This the borrower did. When the return to the lender over the shortened period was converted into the effective annual rate, the criminal limit was exceeded. The borrower claimed that the loan was illegal because under it the lender would receive payment of interest at above the criminal rate.

[37] The British Columbia Court of Appeal found it unacceptable that a lender could be converted into a criminal by the voluntary act of the borrower when the transaction, on its face, had been perfectly legal. The majority certainly suggested that a criminal offence would not be committed when the contract was legal according to its terms. Hutcheon J.A. dissented, realizing that this interpretation of the majority in fact rendered s. 347 (1) (b) meaningless.

[38] Taking the strict approach, Hutcheon J.A. would have found that the lender was receiving a payment in excess of 60% per annum and had thereby violated the law, even though the lender had no choice in the matter. The paradoxical aspect of this position was

that to be safe a lender ought to with hold from a borrower any prepayment rights that could shorten the loan sufficiently to engage the criminal limit. Most borrowers would not regard such limitations as a favour! Indeed, unrestricted rights to prepay are generally considered highly advantageous to a borrower. The Supreme Court of Canada dismissed the appeal without giving additional reasons.[39]

[39] Even with this restrictive approach to s. 347 (1) (b), worries were expressed about the position of the demand loan. By its contractual terms, a demand loan could be called almost immediately after the advance is made. The insistence of the Court of Appeal on treating the legality of a lending arrangement based solely upon the terms of the contract seemed to raise a real possibility that every demand loan was criminal in its inception under s. 347 (1) (a).

[40] But the more benign aspects of the *Nelson* decision,[40] which allowed lenders to believe that they were protected provided the transaction was legal on its contractual terms, were rejected in 1998 by the Supreme Court of Canada in the two decisions *Garland* v. *Consumers' Gas Co.*[41] and *Degelder Construction Co.* v. *Dancorp Developments Ltd.,*[42] released together. Both established clearer principles for the interpretation of s. 347 (1) (b). Neither was any comfort to the lending community. Indeed, they gave s. 347 (1) (b) very much more scope than the British Columbia Court of Appeal had been prepared to allow it.

[41] *Garland*,[43] which is the better known of the two decisions (no doubt because of publicity characterizing it as high profile consumer activism) involved a claim by a consumer that his gas utility company was charging a criminal rate of interest in imposing its late payment charges. With the blessing of the regulatory agency, Consumers Gas charged a flat 5% of the bill as an overdue charge if payment was not made on time. Actuarial evidence showed that if a customer paid her or his bill one day late, but before the expiry of 38 days from the due date, the overdue charge, when converted to an effective annual rate, was illegal.

[42] A number of arguments were raised in defence of the company. First, it was argued that the charge was not payable under an arrangement for credit which should require a voluntary credit agreement on both sides. The gas company did not want customers to pay late and did not encourage them to do so. In fact, a major purpose of the charge was to discourage this behaviour. However, the court rejected this argument and held that credit arrangements were contemplated by the gas company even if not encouraged and that the late charges did produce significant revenue for it. Furthermore, the payment was provided for under the regulatory scheme which in effect created contracts between the company and its customers for services. This constituted a credit arrangement.[44]

[43] Perhaps more of concern to the lending community was the court's interpretation of *Nelson*.[45] First, the suggestions in the majority judgment that a credit arrangement which was not illegal on its contractual terms could not violate s. 347 (1) (b) were firmly rejected. The Supreme Court of Canada gave the section its obvious meaning. If it was intended to circumvent the avoidance of the section by contracting in ways that were not obviously a violation of s. 347 (1) (a), then s. 347 (1) (b) had to have a quality of "wait and see". Even if a loan was not criminal in its inception, it could become so if the actual payment received constituted an interest rate in excess of the criminal limit. Thus the fact that the overdue charge did not necessarily, on the face of the contract, produce a rate greater than 60% per annum did not help Consumers' Gas.

[44] The second problematic aspect to the decision was the restriction of the "voluntary" exception. The Supreme Court of Canada agreed with the British Columbia Court of Appeal that a violation of s. 347 (1) (b) that occurred because of a borrower's voluntary act which the lender was powerless to prevent was offensive. It agreed that it would not create an illegal transaction where the contract was not illegal on its face but where a payment exceeding 60% per annum interest was received as a result of, for example, early repayment by the sole choice of the borrower. However, it held that *Garland*[46] was not a case in which the criminal rate was triggered by a voluntary act.

[45] Once credit was advanced (the customer paid late), then it would require the customer to wait more than 39 days to avoid paying an illegal rate. A large majority of customers paid within ten days. Moreover, most did not believe that they were free to wait as long as they wanted before paying. Other possible penalties might be imposed such as a stoppage in service. Therefore, the court held that paying within the 38 days and thus triggering the illegality of the interest rate was not a voluntary choice by the customer.[47]

[46] The "companion" judgment, *Degelder Construction Co.*,[48] illustrated the Supreme Court's understanding of the relationship between s. 347 (1) (a) and s. 347 (1) (b). In that case, a second mortgage loan provided for an advance of up to $2.5 million, to be drawn down by Dancorp to meet construction requirements. The terms included bonuses for each draw including additional bonuses if the principal advanced exceeded $1.55 million. As well, placement, processing and legal fees were payable. The term of the loan was contemplated to be 11 months.

[47] Until the draws were made, it would not be possible to tell exactly how much "interest" (as that term is defined in the Criminal Code) would be payable. Probably it was for this reason that Dancorp did not subsequently challenge the loan on the basis that

it was a contract for an illegal rate. Instead, Dancorp argued that the loan was illegal because the fees, bonuses and interest payments that were actually paid by Dancorp produced an illegal rate when computed as a return for the 11 month contractual period of the loan. However, the loan was not repaid in fact on the contractual due date, but on a date more than two years later. When the fees, bonuses and interest were converted to an effective annual rate over the actual time the credit was outstanding, the effective annual rate was below 20%.

[48] The court held that s. 347 (1) (b) was not engaged under these facts. It set out a "coherent framework for the interpretation of s. 347 ."[49] In this framework, the court considered the relevant questions as follows:

> For the purposes of subs. (1) (a), the relevant question is: "what rate of interest does the agreement require?" For subs. (1) (b), the question is: "at what rate of interest has a payment actually been received?" As the respondent contends, a payment of interest may be illegal under subs. (1) (b) even if the loan agreement under which it is made did not itself violate subs. (1) (a) at the time it was entered into.[50]

[49] The court further held that s. 347 (1) (a) was to be narrowly construed and was "complete upon the formation of an agreement or arrangement for credit and provable by its terms."[51] Thus,

> If there is merely a possibility that the rate of interest could become illegal under the agreement, subs (1) (a) is not violated. That case can arise where the period of repayment is subject to change, or where a substantial interest charge is payable on demand or upon the occurrence of a named event…the effective annual rate of interest remains speculative until the actual amount of interest and the actual period of repayment are known. It is the function of subs. (1) (b) to catch violations of s. 347 in those circumstances. The provision must be construed broadly enough to account for interest payments that are actually received by the lender at a criminal rate.[52]

[50] The consequences of this clarity, which one can hardly dispute given the words of the section and the anti-avoidance purposes described earlier in this paper,[53] sent a further chill through the commercial community. First, although the position of demand loans seemed safer under s. 347 (1) (a), it became quite obvious that, in the appropriate circumstances, the loan might violate s. 347 (1) (b). Where a bonus or other up-front fees, including fees of the lender's lawyer, are payable for a demand loan, it will be uncertain what the final interest rate will be. Thus, in the words of the Supreme Court, there is

"merely a possibility that the rate of interest could become illegal."[54] However, if some unforeseen event should occur to make the lender demand payment in a short period, the payment received may well transgress the criminal boundary.

[51] But of even more concern were such arrangements as convertible or exchangeable debt. A demand loan will not normally be called in such short time as to make the payments of interest illegal. Only in the unusual case, an emergency situation in which the transaction has gone seriously wrong is this likely to happen. In such extremity, the risk of losing a part of the fees originally charged may be the least of the lender's worries. Exchangeable or convertible debt is a relatively common venture capital arrangement. Concerns about the legality of such transactions are particularly worrisome and may result in lawyers being required to qualify important opinions on the risks of such investment.[55]

[52] In his excellent article, "Protecting Goliath From David",[56] Christopher C. Nicholls thoroughly discusses the issues in this area. As he points out, convertible or exchangeable debt contains an embedded option which has a value which can be computed at the date the debt instrument is issued. The value of the option at this time, of course, is a matter of some speculation, but can be assessed, as Professor Nicholls puts it, "using mathematical models, independent judgment and experience, or some combination of the two."[57] In reality, this means that although a present value can be assigned legitimately to the option, the ultimate value is uncertain. The value of the option is the value of a chance. And it is, in part, just that uncertainty which will make it an attractive possibility to some investors in some circumstances. It is also just that uncertainty which makes it a risk under the Criminal Code.

[53] When the conversion or exchange takes place, the value produced may be very different from the value of the option. In fact, that is precisely what the lender hopes will occur. If shares have increased dramatically, (a happy event for both investor and company) then the payment that could result to the lender might certainly exceed 60% per annum. Under the *Degelder* principles,[58] this will trigger s. 347 (1) (b) of the Criminal Code. And, again as Professor Nicholls notes so clearly, the voluntary defence will be no assistance.[59] It will be the call of the lender that triggers the exchange, not the borrower. Yet, of course, in such transactions, typically the "goliath", the stronger and more sophisticated party will be the corporate issuer or borrower; while the David, the smaller, less sophisticated party, will probably be the lender or investor to whom the security has been issued.

[54] The problem can be generalized to any collateral return to the lender which will generate income that may become very large based upon the success of the enterprise.

This risk was recognized in *J.D.M. Capital,*[60] discussed above. A case illustrative of the point is *Boyd* v. *International Utility Structures Inc.*,[61] a recent decision of the British Columbia Supreme Court. A loan was made to a corporate borrower to finance acquisition of technology for the manufacture of metal utility poles by an advanced welding process. The loan (for 120 days) carried interest at 30% per annum but also provided for a royalty agreement in which the lender received a royalty payment for every pole made using the technology. The loan was repaid, but the royalty agreement remained.

[55] The court correctly analyzed the situation as perfectly legal under s. 347 (1) (a). However, it found the royalty payments to be interest and did not find that this was an arrangement "akin" to a profit sharing equity relationship. The court stated that "the royalty payments are, in substance if not in form, charges paid or payable for the advancing of the loan."[62] The court further held that the payments were not "voluntary" in the sense of *Nelson*, as clarified in *Garland*. The only way in which the borrower could avoid paying the royalty was by "abandoning its raison d'etre …This is not 'voluntariness' in the sense contemplated in *Nelson*."[63]

[56] The court concluded that royalty payments could not be recovered once their payment would exceed a 60% per annum rate of "interest". Until that point was reached, however, the lender could maintain an action to recover the payments. The court's sympathy was not engaged. Henderson J acutely summarized the situation before him stating,

> This application … presents another instance of a sophisticated, corporate borrower which, having negotiated a loan in circumstances free of coercion or power imbalance, seeks to escape the consequences of its bargain by calling in aid the criminal interest rate provisions of the Criminal Code.[64]

[57] Once again, the structure of the transaction as a debt relationship rather than an equity one was crucial. The lender argued that he in fact had wanted to make an investment in shares of the company and it was only when the company proved reluctant to grant this that the royalty scheme was derived as a compromise. One of the most interesting features of the problems arising under s. 347 illustrated in this case and in the *Tong*[65] decision discussed above may be interference with the design of mutually attractive investment vehicles. While this may have its most general impact upon the convertible financing arrangements described in Professor Nicholls' article,[66] it would appear that it also seriously hampers the ability in smaller, tailor-made deals to negotiate and renegotiate acceptable and flexible arrangements.

IV The Effect on Commercial Practice

[58] Lawyers report concerns with the effect of s. 347 on their commercial practice. Academics have called for its repeal.[67] As we have seen, the two most obvious commercial problems are with short term lending and with venture capital financing in which some profit participation is desirable to a lender. The three aspects of s. 347 that cause these difficulties are, in combination of effect, the broad definition of "interest", the conversion of all costs and charges to an annualized rate of interest, and the provisions for "wait and see" in s. 347 (1) (b). All three of these features are important measures to protect the integrity of any criminal provisions that use as a test of criminality only the rate of interest charged.

[59] The Uniform Law Conference sought input from lawyers about how their commercial practice was affected by the section. Forty-three commercial lawyers responded, providing at least an anecdotal report of what aspects of the section have engaged their attention. Not surprisingly, 91% of the respondents indicated that they had either occasionally or frequently considered whether a loan transaction would violate the section (28% reported frequently having to do this). As well, significant impact was reported on the giving of opinions relating to lending transactions. 65% of respondents had occasionally or frequently qualified an opinion on a loan transaction as a result of concerns about criminal lending rates (30% had done so frequently).

[60] While the numbers responding are small and no suggestion is being made that this information has other than anecdotal force, there would appear to be significant legal expertise and thought devoted to matters that would have no relevance to a commercial transaction without the existence of s. 347. Transaction costs are no doubt at least marginally increased by the need to review and consider the potential risks of criminal contravention. Few lawyers apparently use actuaries in determining what the potential of a loan is to reach a criminal rate, but many reported performing the calculations themselves or using the opinions of experienced commercial bankers. Time and money are no doubt expended on these issues.

[61] As well, risks to lenders may be increased. 74% of respondents had occasionally or frequently (30% frequently) advised a client to alter a deal or to delay or modify the process of realization on security because of concerns about a criminal rate. One might speculate that when a situation requiring realization proceedings on a loan agreement has occurred, delay is likely to worsen the difficulties and lessen the prospects for recovery. Of course, there would be no way to accurately measure this effect.

[62] The opinions of the judiciary have already been alluded to. The title of this paper is, of course, a quotation from the decision of Major J in the Supreme Court of Canada in *Garland* v. *Consumers' Gas Co*.[68] In that case, the court acknowledged that considerable civil litigation had been spawned by the section and was likely to be increased by their decision. However, Major J. concluded that "If the section is to be given a more directed focus, it lies with Parliament, not the courts, to take the required remedial action."[69]

V. Remedial Action

a) Efforts in the courts

[63] The idea that s. 347 could impact perfectly legitimate commercial arrangements in which no inequality of bargaining power nor use of unsavory collection procedures would be a feature came as a shock to the commercial world. When the argument was first raised in *Mira Design*,[70] Huddart J. (as she then was) had to adjourn the proceedings to give counsel for the lender an opportunity to consider this very novel suggestion. She was confronted as well for the first time with the problem of what should be done about the situation once a breach of s. 347 was established.

[64] The solution the courts adopted was the application of severance. The root of the problem is that in a fundamentally illegal contract (for example, a contract to commit a murder),[71] the court will not aid litigants to any degree. Thus early cases argued that because the loan was illegal, not even the principal should be repaid. Lack in most cases of intent to break the criminal law coupled with the result that depriving the lender of even the return of its principal would greatly and unfairly enrich the borrower persuaded courts that these drastic results were inappropriate. The purposes of the Criminal Code did not seem to be served even by limited application in the civil courts; declaring the loan illegal from its inception and depriving the lender of any aid in recovery would seem to bring the law into even greater disrepute.

[65] These three factors – the policy of the statute; the intent of the parties; and the potential for unjust enrichment of the borrower – have, together with a consideration of equality in bargaining power, become the fundamental test for severance of the illegal provisions. Huddart J. in effect applied all these factors although the most commonly quoted formulation of them was the decision of the Ontario Court of Appeal in *Thompson (William E.) Associates Inc.* v. *Carpenter*.[72] But despite almost universal agreement on the principles to be applied in deciding to sever, the methodology employed to effect the severance has varied.

[66] Huddart J. applied what has come to be known as the "blue pencil" test. This involves simply striking out portions of the words of the contract. So, in the *Mira Design* decision,[73] the court struck out those words which provided for the "bump" in the principal sum. This approach has also been used to eliminate bonuses or brokerage fees.[74] It presumably has the effect of comforting the court that it is leaving as much of the parties' own arrangement in place as it possibly can.[75]

[67] However, on occasion the court has severed the entire compensation for the loan, refusing to pick and choose among provisions that might render the payment illegal. In *Terracan Capital Corp* v. *Pine Projects Ltd.*,[76] the judge declined to make these distinctions and refused to allow the lender to recover anything but the principal. Writing for the Court of Appeal, Prowse J.A. stated that the matter was one for the appropriate discretion of the trial judge. She declined to interfere. The same result was approved in the *Thompson* decision.[77]

[68] A third possible method of severance has, until recently, been neglected. In many cases, it may simply be possible to order payment of all interest, as agreed to under the loan document, but to require the lender to forego any amounts exceeding 60% per annum. In one decision, *Trillium Computer Resources Inc*. v. *Taiwan Connection Inc*.,[78] this type of severance was indirectly permitted in a claim by a plaintiff to have returned to it amounts of interest that had been paid which were grossly in excess of the criminal rate. A similar approach was taken in *Boyd* v. *International Utility Structures*[79] discussed earlier in which the lender was allowed to sue for royalty payments up to the 60% limit. Neither of these cases, strictly speaking, involved severance of portions of the agreement to allow a lender to enforce a modified version. However, this application was given a thorough consideration in the Ontario Superior Court in *Transport North American Express* v. *New Solutions Financial Corp*.[80]

[69] The facts in the *New Solutions* case[81] were also an interesting illustration of the problems that arise out of mixing debt and equity goals. The lender had been interested in taking an equity stake in the company, but ultimately, this was converted to "royalty payments"[82] payable for a loan. As well as the so-called royalty, the lender was to receive interest at 4% per month, calculated daily and payable monthly (60.10% per annum effective rate); a monitoring fee of $750 per month; legal and administration fees; and a $5,000 commitment fee. "All in", the effective annual rate would be 90.9%; if not repaid until later, the rate might fall to as low as, but never below, 82% per annum.

[70] This was also a case in which the policy reasons for severance were present. The court pointed out that "There is no suggestion that the applicant was misled or, indeed, that its principals did not fully understand the terms of the agreement and the extent and

cost of the obligations it accepted."[83] Using the blue pencil test, the court found that it could strike out the obligation to pay 4% per month interest. The result of this would be to reduce the payments substantially below the criminal rate and deprive the lender of the largest item of return it had anticipated. No other "strike outs" however would achieve the result of reducing the total interest rate payable sufficiently to come below the criminal bar.

[71] Cullity J conducted a reasoned and indeed impressive review of the case law on severance. He concluded that,

> I believe there is force in the view that the blue-pencil test is intellectually indefensible and continued adherence to it is anomalous…The blue-pencil test is, I believe, a relic of a bygone era when the attitude of courts of common law – unassisted by principles of equity – towards the interpretation and enforcement of contracts was more rigid than is the case at the present time.[84]

[72] He proceeded to apply instead "notional" severance in which provisions were read down "so that the criminal rate of interest would not be exceeded [and] not merely by striking out words."[85] The lender was therefore allowed to enforce all the charges agreed to, but the monthly interest was reduced so that the total amount paid would not exceed the criminal rate.

[73] The approach of "notional" severance is to be welcomed. Although the blue-pencil test has been justified, as Cullity J. suggests, by the argument that simply excising particular words from an agreement leave the transaction to the greatest extent possible in the form the parties negotiated,[86] the facts of this case illustrate perfectly that this is not always true. One needs only to ask: Would the parties themselves say that the deal with the 4% per month interest charge struck was closer to what they intended than the deal with the 4% per month interest charge reduced as Cullity J. provided? It seems apparent that the "deal" as the parties negotiated it was to get an interest rate in terms of total return that approached 90% per annum because of their views of what would happen to the value of the company. It was negotiated to compensate, in effect, for the company refusing to sell a 30% equity share to the lender.

[74] Another flexible tool for courts to use in the appropriate case to approximate the intentions of the parties is therefore desirable. As long as severance is the only method by which the court can accommodate the commercial reality to the criminal constraints, it is crucial that the process of severance not become rigid. Thus far it does not appear that any convertible debt problem has been considered by the courts. However, the question of how a court might apply severance to that situation reveals the need for this flexibility.

Simply to excise the share option would, I suggest, be grossly unfair to the investor who probably was attracted to the investment largely because of the option. It might be greatly preferable simply to reduce the number of shares for which the option could be exercised to limit the return to 60%. The *New Solutions*[87] decision leaves open this possibility.

[75] But the forgoing discussion also illustrates why the courts' efforts to find a remedial solution to the problems of s. 347 are inherently unsatisfactory. If severance is to be applied, its methodology must be flexible; if the methodology is to be flexible, the results will always be uncertain. And, one might paraphrase, commercial law abhors an uncertainty! The risk remains that certain kinds of transactions may fall within the ambit of the section and, once that has occurred, some damage will be done to the deal as originally written. The fact that this damage may be attenuated if one finds a sympathetic judge willing to exercise creative discretion is likely to provide little joy to a client.

b) Legislative reform

i) Repeal

[76] The primary argument for repeal is that the section constitutes a serious interference with market rates in commercial transactions.[88] But the difficulty with this argument is that, just as the Criminal Code amendment and the Small Loans Act repeal, although contained in a single statute,[89] had unrelated goals, promoting free market conditions (as the commercial law may aim to do) is not the purpose of the criminal law. Moreover, some forms of market control may be a necessary or desirable trade off against the benefit of protection of the vulnerable from loan sharking. It is not possible to conclude, however strong the commercial argument for repeal may be, that it necessarily must outweigh the protective purposes of the law.[90] On what basis are the two very different aims to be balanced against each other?

[77] It may be possible to argue that even as criminal law, the section does not do the job it should. As noted earlier in this paper, Canadians have not historically been in favour of general control of interest rates. What makes a transaction criminal is probably its connection to more commonly recognized criminal activity, including the very real threat of violent reprisals rather than simply high rates. This seems to be supported by the fact that payday loan companies (which generally charge rates in excess of the criminal limit) are socially tolerated and rarely prosecuted.

[78] It might be desirable therefore to return the loan sharking laws to their former situation and require some threat or violence before prosecution was possible. But this argument has a weakness as well. The practical result of requiring this additional hurdle

may be to make the law useless as an effective control of loan sharking behaviour. While theoretically we may agree that it takes more than a high interest rate to make a transaction suitable for criminal sanction, establishing and proving those additional factors may be impracticable.

[79] Arguments may also be made that provinces have legislation limiting unfair trade practices,[91] requiring disclosure of lending costs[92] and striking down unconscionable transactions in the consumer arena.[93] These statutes do not rely on a "bright line" test of a named rate, but rather on the flexible notions of fairness, equality of bargaining power and provision of information to enable comparison shopping. While this kind of flexible test would be problematic in a criminal prosecution, no one objects to giving the courts power to make such determinations in the civil context. Therefore if s. 347 was repealed, these laws could be used to protect consumers adequately.

[80] I suggest that this is simply untrue. The utility of the kind of legislation that is used in the civil context to protect the consumer is largely unproven in the social context in which loan sharking occurs. Access to protection under these statutes requires access to the courts. That requires a financial and educational status which many borrowers in the criminal market simply do not have. Reputable corporations that worry about public opinion and media coverage may well be encouraged to adopt practices consistent with this legislation to avoid unpleasant publicity. The loan shark will not care. Nor will his victims find their rights adequately protected by the ability to engage legal counsel and prosecute a court action to resist payment on the basis of consumer statutes. The harsh reality is that the criminal law and the actions of the police that can be engaged by that law often comprise the only realistic access to justice that the poor have.

ii) "Tinkering"

[81] There are a number of amendments that might be incorporated into s. 347 that would reduce the risk of commercial loans violating the limits. None of these, however, can completely remove the three areas of the statute that most seriously cause the risk of a violation occurring. As discussed above, the broad definition of interest, the requirement of converting to a standard annualized rate and the "wait and see" provisions of s. 347 (1) (b) are all very important anti-avoidance provisions. Without them, the section would have no utility in controlling loan sharking either.

[82] But there are a number of changes which could help without transgressing that boundary. First, the definition of interest could be narrowed to exclude fees or charges of members of professional associations such as lawyers and accountants. That definition could also be clarified by expressly excluding fees to third party independent agents

which are not affiliated with the lender. This would not seem to put at risk the anti-avoidance measures. Typical loan sharking transactions do not involve lawyers, accountants or independent brokers. As discussed earlier, the courts have gone some way toward accomplishing this goal.[94] However, legal fees of the lender are still included and doubt remains about some other charges.[95] This kind of exclusion would greatly reduce the risk offending the criminal law by an unforeseen event requiring a premature termination of a demand loan. In such cases, it will often be the fees that, over the short period of credit, produce the criminal rate.

[83] A further modification of the definition of interest could be made to limit the section's application to mixed debt/equity transactions, an area which we have seen is particularly at risk of offending the law. For example, interest could expressly exclude the value of any return to the lender that is related to the success of the activities of the borrower. For greater clarity, the definition of interest would exclude any equity participation, whether expressed as a feature of convertibility or exchange, a share of the profits whether contingent or based upon a genuine pre-estimate, or a royalty dependent upon use of property.

[84] Another possibility is simply to raise the criminal rate to (for example) 500% per annum effective annual rate. While 60% appears very high today in light of conventional lending rates, it has not always been so outrageous even in the conventional field. Further, examination of the case law discussed above suggests that perfectly reasonable transactions may exceed 60% per annum. And the charges of even "respectable" usurers such as payday loan companies, are usually wildly in excess of the 60% limit. It may be that those who proposed this original limit did not fully appreciate the effect of the formula used to convert to the effective annual rate, as noted above. It is by no means impossible to set the rate sufficiently high that the normal practices of organized crime would fall clearly within it, but even the most unusual corporate transaction would be excluded.[96]

iii) Limitations

[85] It may be desirable, instead of making a series of complex amendments, to enact a general limit to the applicability of the section. If we could say with confidence that s. 347 is in effect directed at consumer lending, an exemption for commercial loans might have the desired effect. Commercial and consumer loans are commonly distinguished under provincial lending statutes and the distinction would not be difficult to adopt in a way that makes sense. However, this assumes that criminal lending activities are never employed in commercial contexts or, if they occur, should not be prosecuted. We should

not lose sight of the fact that criminal law has purposes beyond civil aspects of consumer protection.

[86] In civil provincial statues that protect consumers from unfair transactions, it is perfectly acceptable to take the view that those who play in the commercial field must be required to look after themselves and to exclude commercial transactions from their ambit. If a commercial player is a small company (which may be in fact very little more sophisticated than its sole shareholder), it must be able to afford business and legal advice or its survival is unprotected. This is a purely economic issue. But there is no difference, I suggest, from the perspective of the criminal law between the usurer who will threaten the safety of Ms Jones, the individual borrower or the safety of Ms Smith, the corporate president. In other words, the commercial character of the transaction does not necessarily affect the criminal character of the act.[97]

[87] A better directed limitation might target expressly the use of s. 347 in civil actions. The sole difficulty experienced in the cases has been the use of s. 347 as a defence to a civil claim for repayment of a loan or, again in civil proceedings, a claim to repayment of amount paid in excess of the criminal limit. Both s. 347 and provincial limitation statutes might be amended to provide that where a loan is for a commercial purpose, unless a criminal prosecution has been approved by the Attorney General, no civil claim or defence founded upon the payment or requirement for payment of any interest in excess of the limit in the Criminal Code can be maintained. This would leave in place the possibility of criminal sanctions where the Attorney General so decides.

[88] If a decision is made to limit the use of the section in civil proceedings, some thought should be given as well to the effect on the consumer market. A consideration of consumer related problems is beyond the scope of this paper. However, the targeted limitation I suggest might be adaptable to some issues of concern in the consumer lending area as well as in the commercial. It would be advantageous if any reform of s. 347 was potentially compatible with methods that may be used to address other difficulties presented by s. 347.

[89] Currently, a particular problem is posed by the so-called “payday” lenders. Typically, these lenders charge a fee for a very short term loan (until the next paycheque). They would all violate the criminal rate because of the length of the loan term. As well, if the loan is not repaid on the payday, they typically add NSF service charges and fees that compound the problem dramatically. But as already noted, payday lenders are not usually considered the type of lender that loan sharking provisions are meant to prosecute. In fact, they may provide a needed service for some parts of the

credit market. The solution to their activities is probably not criminal prosecution, but regulation under provincial statutes with licensing requirements and reporting rules.

[90] They, as well, run the risk of incurring civil consequences for breach of s. 347. In most cases, however, the borrower has no idea that the rate is criminal, would not realize the civil consequences if she did, and does not think to dispute legal proceedings that may be taken against her in provincial court. An exception is found in the decision *Dean's Cash Connection Ltd.* v. *Nelson-Wiger*,[98] an Alberta Provincial Court decision, reported by Quicklaw. Judge Ingram pointed out that in most similar cases, the question of the legality of the interest charges in this case would never have come before the court. However, the defendant in the case filed a dispute note, not alleging criminal interest, but arguing that she had not been able to afford the repayment on the stipulated date because she had been laid off. She had since offered to pay the loan in installments, but the offer had been refused. She therefore disputed not the original cost of the loan (which at a $25 fee for a $100 loan over eleven days was clearly usurious), but the NSF and other collection charges. The court severed all interest charges and allowed the lender to recover $100.

[91] I do not anticipate that many of us are very sympathetic to the plight of a lender who wanted to recover $375.00 for a loan of $100 that had been outstanding (at the time this amount accrued) for less than two weeks. However, if payday lenders are recognized as legitimate players in the lending market and if the solution to control of their activities is legislation, some amendment of the Criminal Code will be necessary to protect them from potential prosecution and to protect them from the civil consequences of the law. In almost all cases, the payday lender will commit an offence under s. 347 (1) (a) even if the loan is repaid on time because of the short term.

[92] The Criminal Code could be amended to exempt from prosecution any loan made by a lending company regulated under applicable provincial legislation. This would not create the same problem as a blanket exemption for commercial transactions would do. The exemption would apply to the source of the loan, not the type of transaction. Not only would this be easier to define, but it would also narrowly confine protected transactions to companies that would operate within regulations of provincial law and which could be controlled as to the extent of their charges and their terms by those statutes.[99]

[93] A limitation on the use of s. 347 in civil proceedings would still leave the players in the commercial transaction in the uncertain position of being potentially subject to criminal prosecution. While from a practical perspective, experience with the section does not suggest this is a serious risk and, indeed, it is a risk which is both recognized and

minimized by the requirement of the Attorney General's consent to prosecution, one might feel reluctant to have even that potential threat. This might be particularly true for lawyers who understandably may feel nervous assisting a client to carry out a deal which may be civilly enforceable but which might, even remotely, result in the lawyer being an accessory to a criminal offence.[100]

[94] For this reason, as well as limiting civil consequences of the section, additional amendment might be advisable. The single most useful amendment would probably be raising the criminal rate to a more realistic figure.

VI Conclusion

[95] The experience of the profession and the comments of academics and judges suggest that s. 347 needs to be re-thought. Repeal is obviously the simplest and most often suggested reform. However, current impact of the section is not solely on commercial transactions. It is used to prosecute loan sharks and, although the test of a fixed rate of interest may not be the ideal description of the crime of loan sharking, it has practical benefits that are difficult to assess. It is not, I suggest, possible to recommend repeal by focusing solely on the commercial problems with the statute.

[96] Apart from repeal, the alternatives are to limit the definition of interest in ways that will not seriously erode the purposes of the section in controlling criminal behaviour; to raise the commercial rate; to exempt certain transactions or lenders; or to limit the civil consequences of exceeding the statutory rate. As with most complex issues, while one might wish the situation could be simplified, a complex solution is probably the most likely to produce the desirable results while minimizing the unintended consequences.

[97] In conclusion, I propose the following amendments to the section:

a) The definition of "interest" should exclude the value of consideration for a loan that takes the form of participation in the borrower's profits, whether by an equity share, by royalty for use of property, or by a genuine pre-estimate of profits. It should also exclude the value of fees paid to independent professionals.
b) The criminal rate of interest should be raised significantly. The figure should be selected in consultation with law enforcement authorities.
c) The civil consequences of violating the criminal rate should be restricted unless the transaction is subject of a criminal prosecution.
d) Certain industries which are subject to separate regulation should be exempted from the operation of the statute entirely. This could include payday lenders, should provincial legislation regulating their activities be enacted, as well as utilities subject to the scrutiny of regulatory agencies.

[98] These amendments should virtually eliminate the typical case in which the sophisticated corporate borrower, in the words of the Ontario Court of Appeal, "attempt[s]on technical grounds to avoid performance of an important business obligation."[101] It will further reduce the risk for lenders and their lawyers that the transaction will be criminal in its effect or unpredictable in its civil results. Moreover, the suggested changes will not complicate the application of the section to the criminal law. None of these suggestions should impact on the ability of the section to provide a clear, simple to use test for loan sharking.

[99] The fascinating history of efforts to define, understand and control usury is in many ways reflected in the troublesome history of s. 347 . If Canadian law has found this section "deeply problematic",[102] it is not alone. In many countries, the perceived need to control the extremes of lending practice through the criminal law conflict with the need to address particular credit markets and provide flexibility in lending arrangements.[103] A broad analysis of the usury problem explains why the situation is so complex. The mathematics of interest calculation cannot easily be made amenable to the social and economic purposes of the law; the social and economic purposes are, to a degree, in conflict; civil remedies broaden unduly the effect of the criminal sanction; and the demands of our legal system that criminal statutes be interpreted narrowly and criminal guilt proved beyond reasonable doubt make flexibility impossible and undesirable. For these reasons, an ideal fix to the problem is not available. But much can be done if the specific problems illustrated by a review of the case law and the experience of the profession as described in this report are specifically addressed through legislative reform.

---

1 *Garland v. Consumers' Gas Co.*, [1998] 3 S.C.R. 112, at p. 143.

2 An Act to Amend the Small Loans Act and to Provide for its Repeal and to Amend the Criminal Code, S.C. 1980-81-82-83, c. 43.

3 Small Loans Act, R.S.C. 1970, c. S-11.

4 Stephen Antle, "A Practical Guide to s. 347 of the Criminal Code – Criminal Rates of Interest" (1994) 23 Can. Bus. L.J. 323, at p. 324.

5 House of Commons Debates, 1st Sess., 1st Parl. 31 Vict. 1867-68 at p. 642; 2nd Sess., 1st Parl. 32 Vict. 1869 at p. 33-34; 3rd Sess., 1st Parl. 33 Vict. 1870 at p. 155.

6 Mary Anne Waldron, *The Law of Interest in Canada* (Thompson Professional Publishing, 1992) at p. 9-10.

7 *Supra*, note 3.

8 *Supra*, note 2.

9 R.S.C. 1985, c. C-46.

10 See Jacob S. Ziegel, "The Usury Provisions in the Criminal Code: The Chickens Come Home to Roost" (1986) 11 Can. Bus. L.J. 233 for a discussion of the policy.

11 s. 347 (7).

12 See Christopher C. Nicholls, "Protecting Goliath from David: Criminal Rate of Interest and Finance Transactions after *Garland* and *Degelder*" (2000) 15, B.F.L.R. 249, at pp. 271-278.

13 Mary Anne Waldron, "White Collar Usury: Another Look at the Conventional Wisdom" (1994) 73 Can. Bar Rev. 1.

[14] The Adult Criminal Court Survey 1999-2000, Statistics Canada. Four provinces/territories do not participate.
[15] s. 347 (1) (a).
[16] s. 347 (1) (b).
[17] *Attorney-General for Ont.* v. *Barfried Enterprises Ltd.* (1963), 42 D.L.R. (2d) 137 (S.C.C.) at 145.
[18] S.C. 1906, c. 32 repealed by S.C. 1956, c. 46, s. 8.
[19] R.S.C. 1985, c. I-15.
[20] *London Loan and Savings Co.* v. *Meagher* [1930] S.C.R. 378.
[21] James B. Sauer, "Religious Texts, Moral Prescriptions and Economy: The Case of Interest" (1999) 25 Managerial Finance 4. The difficulties in a growing economy that stem from religious prohibitions on lending at interest are discussed.
[22] *London Loan and Savings Co.* v. *Meagher*, *supra*, note 20.
[23] s. 347 (2).
[24] *Ibid.*
[25] *Ibid.*
[26] *Supra*, note 12 at p. 273-275. Professor Nicholls notes that I inaccurately state the effective annual rate in a similar example in my book *supra*, note 6. He is correct, although my purpose was not to compute the actual effective annual rate, but to illustrate that even by nominal methods (which was not the correct method to use) the rate was obviously in excess of the criminal limit. However, in retrospect, I should have made that point more clearly.
[27] *Infra*, V Remedial Action a) Efforts in the Courts.
[28] *Thompson (William C.) Associates Inc.* v. *Carpenter* (1989), 61 D.L.R. (4th) 1 (Ont. C.A.).
[29] *Cresswell* v. *Raven Bay Holdings Ltd.* (1984), 53 B.C.L.R. 183 (S.C.).
[30] *Ingram* v. *Dorian* (1992), 22 R.P.R. (2d) 198 (Ont. Gen. Div.). Mr. Antle suggests this decision is wrong (*supra*, note 4 at p. 329). I agree. See also *Cresswell*, *supra*, note 29.
[31] *Mira Design Co. Ltd.* v. *Seascape Holdings* (No. 1) (1981), 34 B.C.L.R. 55 (S.C.).
[32] (2001) B.C.S.C. Docket #S001809, Vancouver.
[33] As long as the investment is an equity investment with a risk of profit and loss, the transaction has not been considered at risk under s. 347. See *Pacific National Developments Ltd.* v. *Standard Trust Co.* (1991), 53 B.C.L.R. (2d) 158 (S.C.). However, as I will discuss in this paper, equity and debt are not always clearly separated and, as Professor Nicholls notes (*supra*, note 12 at p. 251), our interpretation of this limit may have been "allowing hope to triumph over reason".
[34] [1999] 6 W.W.R. 687 (B.C.C.A.).
[35] *Ibid*, at p. 692.
[36] *Ibid*, at p. 693.
[37] *G. and C. Kreglinger* v. *New Patagonia Meat and Cold Storage Ltd.*, [1914] A.C. 25 (H.L.).
[38] (1984), 16 D.L.R. (4th) 139 (B.C.C.A.) aff'd [1986] 1 S.C.R. 749.
[39] *Ibid.*
[40] *Ibid.*
[41] *Supra*, note 1.
[42] [1998] 3 S.C.R. 90.
[43] *Supra*, note 1.
[44] *Ibid*, at p. 137-142.
[45] *Supra*, note 38.
[46] *Supra*, note 1, at p. 144-151.
[47] Professor Nicholls (*supra*, note 12) sets out the calculations for this figure.
[48] *Supra*, note 42.
[49] *Ibid*, at p. 106.
[50] *Ibid.*
[51] *Ibid.*
[52] *Ibid*, at p. 107.
[53] The court discussed this policy *ibid*, at p. 105.
[54] *Supra*, note 52.
[55] Such qualifications are apparently fairly common in lending transactions. See *infra*, IV The Effect on Commercial Practice.

[56] *Supra*, note 10.
[57] *Ibid*, at p. 265.
[58] *Supra*, note 42.
[59] *Supra*, note 12, at p. 267-268.
[60] *Supra*, note 34.
[61] [2001] 5 W.W.R. 492 (B.C.S.C.).
[62] *Ibid*, at p. 498.
[63] *Ibid*, at p. 499.
[64] *Ibid*, at p. 494.
[65] *Supra*, note 32.
[66] *Supra*, note 12.
[67] Most notably, of course, Professor Jacob Ziegel. See "Editorial – The Overdue Repeal of Section 347 of the Criminal Code" (1999) 31 Can. Bus. L.J. 173. Indeed, Professor Ziegel urged the Uniform Law Conference to take up the project.
[68] *Supra*, note 1.
[69] *Ibid*, at p. 144.
[70] *Supra*, note 31.
[71] *McFarlane* v. *Daniell* (1938), 38 S.R. (N.S.W.) 337 at p. 345 quoted with approval in *Carney* v. *Herbert*, [1985] 1 All E.R. 438 at p. 443.
[72] *Supra*, note 28.
[73] *Supra*, note 31.
[74] See *Pacific National Developments Ltd.*, *supra*, note 33; *Milani* v. *Banks* (1997), 32 O.R. (3d) 557 (C.A.).
[75] Antle, *supra*, note 4, at p. 337-338.
[76] [1993] 3 W.W.R. 724 (B.C.C.A.).
[77] *Supra*, note 31.
[78] (1994), 11 B.L.R. (2d) 1 (Ont. Div. Ct.).
[79] *Supra*, note 61.
[80] (2001), 200 D.L.R. (4th) 560 (Ont. Sup. Ct.).
[81] *Ibid.*
[82] The court held this was not the common usage of the word "royalty", *ibid*, at p. 568.
[83] *Ibid*, at p. 572.
[84] *Ibid*, at p. 571 and p. 573.
[85] *Ibid*, at p. 574.
[86] *Ibid*, at p. 573.
[87] *Ibid.*
[88] David Coyne and M.J. Trebilcock, "Market Considerations in the Formulation of Consumer Protection Policy" (1973) 23 U.T.L.J. 396.
[89] *Supra*, note 2.
[90] I am assuming here, of course, a basis for criminal law that goes beyond economic considerations. Some theorists would certainly not agree!
[91] For example, The Trade Practice Act, R.S.B.C. 1996, c. 457.
[92] For example, the Cost of Consumer Credit Disclosure Act, S.B.C. 2000, c. 13.
[93] For example, the Consumer Protection Act, R.S.B.C. 1996, c. 69.
[94] *Supra*, note 28.
[95] See the discussion of independent brokers' fees, *supra*, note 30.
[96] This is, of course, the result of conversion to the effective annual rate. As Professor Nicholls puts it: "A Day Late… and a 5.4 billion per cent rate", *supra*, note 12 at p. 271.
[97] While a definition of consumer transaction is well established, attempting to further restrict the section by providing a sophisticated borrower exemption would, I suggest, produce serious drafting complications.
[98] [2001] A.J. No. 246.
[99] After *Garland*, *supra*, note 1, was decided by the Supreme Court, the problem of what happens when the practice approved by a regulatory body is illegal still had to be sorted out. See Christopher C.

Nicholls, "Winning isn't Everything: The Latest Installment in *Garland* v. *Consumers' Gas Co.*" (2000) 16 B.F.L.R. 131.

100 I have not directly addressed the potential for lawyers' liability in this paper. However, certainly it is at least negligence to fail to advise as to the risks inherent in s. 347. See *Block* v. *Arniko* [1999] B.C.J. No. 2925 (B.C.S.C.).

101 *William E. Thompson Associates Inc.* v. *Carpenter, supra*, note 28.

102 *Supra*, note 1.

103 For example, the microcredit industry in under-developed countries.