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Case Note and Comment

Criminal Interest Revisited: Apparent Immunity for Equity Kickers

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1. OVERVIEW

Most commercial lenders don't have the risk of fine or imprisonment on their minds when they extend credit to their borrowers and might be surprised to learn that it can be a criminal offence to receive or contract for too high a rate of return. And yet, there is, even in commercial loan transactions, a risk of contravening section 347 of the *Criminal Code.* [1]

Crafted as a deterrent to loan-sharking, section 347 makes it an offence to receive interest, or enter into an agreement to receive interest, at a criminal rate, which is defined to mean an effective annual rate of interest exceeding 60% per year. While it would be unusual for a commercial loan agreement to expressly provide for a nominal interest rate higher than 60% per annum, the potential trap for the unwary lies in the broad definition of "interest".

Interest is defined to encompass the aggregate of all charges and expenses, of any nature or kind regardless of the form, paid or payable for the advancing of credit under an agreement or arrangement. This expansive formulation potentially sweeps into the "interest" calculus a wide range of charges, including upfront loan fees, royalties, commitment and facility fees, capitalized interest, legal expenses and even possibly equity incentives such as the issuance of shares.

However, as seen in the recent decision of *Bimman v. Neiman,* [2] Ontario courts appear to have drawn the line at equity incentives such as the issuance of shares, warrants or convertible debentures which are a typical feature of subordinated and mezzanine debt offerings, LBOs, equity recapitalizations and similar financings at the riskier end of the credit spectrum.

2. BACKGROUND

The definition of "interest" in the *Criminal Code* is, on its face, very broad. While courts have also interpreted the definition of "interest" broadly, there is ***622** very little case law addressing whether the issuance of shares to a lender ought to be characterized as interest.

Section 347 of the *Criminal Code* states that:

347. (1) Despite any other Act of Parliament, every one who enters into an agreement or arrangement to receive interest at a criminal rate, or receives a payment or partial payment of interest at a criminal rate, is

(a) guilty of an indictable offence and liable to imprisonment for a term not exceeding five years; or

(b) guilty of an offence punishable on summary conviction and liable to a fine not exceeding $25,000 or to imprisonment for a term not exceeding six months or to both.

(2) In this section,

"interest" means 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, paid or payable for the advancing of credit under an agreement or arrangement, by or on behalf of the person to whom the credit is or is to be advanced, irrespective of the person to whom any such charges and expenses are or are to be paid or payable, but does not include any repayment of credit advanced or any insurance charge, official fee, overdraft charge, required deposit balance or, in the case of a mortgage transaction, any amount required to be paid on account of property taxes [emphasis added].

The Supreme Court of Canada, in *Garland v. Consumers' Gas Co.,* held that section 347 imposes "a generally applicable ceiling on all types of credit arrangements" including a very broad range of commercial and consumer transactions involving the advancement of credit, including secured and unsecured loans, mortgages and financing agreements. [3] The Court in *Garland* considered the meaning of "interest" as broad, but also stated that it must be "paid or payable for the advancing of credit under an agreement or arrangement." [4]

The *Garland* decision acknowledges that the definition of interest in the *Criminal Code* is much more exhaustive and expansive than what interest is considered at common law or through general accounting principles. It is this conclusion from *Garland* that most likely influenced the British Columbia trial court in *Boyd v. International Utility Structures Inc.* [5] The B.C. court took an ***623** expansive approach to the definition of "interest" and found that the issuance of shares at a discount to a lender by a company related to the borrower was a collateral advantage connected to the loan and therefore was "interest" within the meaning of section 347 of the *Criminal Code*. On appeal, the B.C. Court of Appeal affirmed the trial decision on other grounds, but did briefly touch upon the definition of "interest". The Court made it clear that the determination of "interest" should always be determined in the circumstances of each case, stating that:

> ... the question of whether a particular payment is "interest" as defined in s. 347(2) will be determined in the circumstances of each case. It is impossible to set out a general rule based on the facts of this particular transaction or any other, given the ingenuity of the financial world and the variety of financial transactions developed to meet the needs of its participants. [6]

The only other reported case that has considered whether shares constitute "interest" is *J.D.M. Capital Ltd. v. Smith.* [7] In *Smith,* the B.C. Court of Appeal did not specifically decide whether the acquisition of shares can or always constitutes "interest" under the *Criminal Code,* but did observe in *obiter* that it may sometimes be appropriate in the circumstances for an investment opportunity to be included in the definition of "interest" under section 347(2) of the *Criminal Code.* [8]

3. THE BIMMAN DECISION

Evident from the discussion above, Courts had not conclusively decided on whether the issuance of shares at less than fair market value falls under the scope of "interest" in the *Criminal Code*. Courts have consistently held that the definition of "interest" should be broad and expansive, but also acknowledge that each case should be determined on its own specific circumstances.

This leads us to the recent Ontario case of *Bimman*.

(a) The Facts

In *Bimman,* the plaintiff and his numbered company commenced an oppression remedy action against the various defendants, alleging that the defendants marginalized and squeezed out the plaintiffs from the defendant ***624** Corayana Enterprises Limited (CEL). The oppression was allegedly a result of two cash calls undertaken by the defendants and the granting of a mortgage against the assets of CEL by the defendants. The plaintiffs claimed for general damages, as well as for repayment of certain amounts required under a shareholders agreement and punitive damages.

The defendants denied that the plaintiffs were oppressed in respect of the cash calls and claimed that the decisions made in advance of the cash calls were protected by the business judgment rule.

In the end, the trial judge ruled in favour of the plaintiffs and ordered the recovery of over $1 million. As part of the decision, the Court considered whether one of the plaintiff's interest in CEL should be diluted, because the issuance of shares in response to the two cash calls possibly engaged the criminal interest rate provisions of the *Criminal Code*.

(b) Court's Decision Regarding the Criminal Interest Rate

Gans J. held that a promise to issue shares at less than fair market value in connection with shareholder loans made under a shareholders agreement was not "interest" within the meaning of the *Criminal Code*. Therefore, the "criminal interest rate" provisions of section 347 did not apply to that promise.

The Court suggested that the issuance of shares will not necessarily be characterized as "interest". He found that the shares to be issued in that case were not a "charge or expense" to the borrower and did not constitute a charge that was "paid or payable" by the borrower. In particular, the Court held that:

• a shareholder loan coupled with the issuance of shares did not seem to be the type of transaction Parliament intended to prohibit under section 347;

• while there may be a cost associated with issuing shares at less than fair market value, that cost was borne by the shareholders of the company, not by the company itself (by reason of the company receiving less for the shares than it should otherwise have received, thereby diluting the value of the shareholders' shares). Therefore, the company per se did not incur a "charge or expense" in connection with the issuance of the shares; and

• the issuance of the shares was not a charge that was "paid or payable" by the company, and therefore was not "interest" within the meaning of section 347 on that ground as well. That was the case because the shares were not redeemable, the company was under no obligation to re-purchase them at a future date, and the shares did not guarantee any right to future payment. [9]

The Court also held that the plaintiffs were not without a remedy and therefore did not have to resort to the *Criminal Code* for relief--they had brought the action appropriately within the oppression remedy framework and ***625** there was therefore no need to provide a further remedy under the *Criminal Code's* criminal interest rate provision. [10]

In coming to these conclusions, the Court took instruction from the *Garland, Boyd* and *Smith* decisions, acknowledging that courts have previously considered that the issuance of shares could fall within the definition of "interest". However, Gans J. specifically referred to the Court of Appeal in *Boyd* that emphasized the importance in deciding each case on its own particular facts. Gans J. was clear in that his decision on this case does not determine whether shares are categorically excluded from section 347 of the *Criminal Code,* but rather decides that they are not included in this specific instance only. [11]

4. FUTURE IMPLICATIONS

Higher-risk borrowers often encourage investors to lend money by promising to issue shares at a discount or even just a nominal cost--a so-called "equity sweetener" or "equity kicker." As seen in past jurisprudence, under Canadian law, there is a risk that the issuance of those shares could offend the criminal interest rate provisions of section 347 of the *Criminal Code*.

As a result, a promise to issue those shares could be unenforceable, and a lender to whom the shares had been issued might be asked to return them for cancellation.

The *Bimman* decision addresses the issuance of shares in connection with shareholder loans--not loans provided by an arm's length lender. However, the Court's views about who is bearing the cost to issue shares at less than market prices and the absence of any payment obligation on the part of the borrower should apply equally to arm's length lending.

As made clear in *Bimman,* the Court's decision was based on the particular and specific circumstances of that case. Nonetheless, *Bimman* shows us that there are actual limits on how broad the definition of "interest" under the *Criminal Code* can be. Therefore, while the criminal rate risk still exists, it would appear that, as a result of this decision, the risk is diminishing.

Footnotes

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1 R.S.C. 1985, c. C-46, s. 347.

2 2015 ONSC 2313, 2015 CarswellOnt 5361, 41 B.L.R. (5th) 95 (Ont. S.C.J.) *[Bimman]*.

3 1998 CarswellOnt 4053, 1998 CarswellOnt 4054, [1998] 3 S.C.R. 112,40 O.R. (3d)479, 40 O.R. (3d) 479 (note), 129 C.C.C. (3d) 97, 20 C.R. (5th) 44, 165 D.L.R. (4th) 385, 49 M.P.L.R. (2d) 77, 231 N.R. 1,114 O.A.C. 1, [1998] S.C.J. No. 76 (S.C.C.) at paras. 23,25.

4 *Ibid.* at para. 30.

5 2001 BCSC 559, 2001 CarswellBC 861, 88 B.C.L.R. (3d) 183, 13 B.L.R. (3d) 156, [2001] 5 W.W.R. 492, [2001] B.C.T.C. 559, [2001] B.C.J. No. 739 (B.C. S.C.); affirmed 2002 BCCA 438, 2002 CarswellBC 1818, 27 B.L.R. (3d) 1, 167 C.C.C. (3d) 173, 216 D.L.R. (4th) 139, 171 B.C.A.C. 269, 280 W.A.C. 269, [2002] B.C.J. No. 1770 (B.C. C.A.).

6 *Boyd v. International Utility Structures Inc.,* 2002 BCCA 438, 2002 CarswellBC 1818,27 B.L.R. (3d) 1,167 C.C.C. (3d) 173, 216 D.L.R. (4th) 139, 171 B.C.A.C. 269, 280 W.A.C. 269, [2002] B.C.J. No. 1770 (B.C. C.A.) at para. 36.

7 1998 CarswellBC 2828, 58 B.C.L.R. (3d) 272, 43 B.L.R. (2d) 190, [1999] 6 W.W.R. 687, 116 B.C.A.C. 288, 190 W.A.C. 288, [1998] B.C.J. No. 2946 (B.C. C.A.).

8 *Ibid.* at paras. 17-18.

9 *Bimman, supra* note 2 at paras. 195-199.

10 *Ibid.* at para 201.

11 *Ibid.* at para. 195.