LEGAL ALERT

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Current Legal Developments Critical to Corporate Management

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

~ Marcus Tulius Cicero (106 – 43 BC)

COMMERCIAL PROPERTY AND LEASES

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

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

Section 8 of the *Interest Act* (Canada) (the "Act") prohibits mortgage lenders from charging a higher rate of interest after default than is charged before default or maturity. In its May 2016 decision in *Krayzel Corp v. Equitable Trust Co.* ("*Krayzel*"), the Supreme Court of Canada clarified the application of s. 8 to post-default interest rate increases structured as a discounted rate applicable to punctual payment rather than a higher rate or penalty charged after default.

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

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DIRECTORS' AND OFFICERS' LIABILITY

Employees cannot claim against directors for failing to stop fraud

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

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

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

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Intention

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

Substance over form

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

> [w]hat counts is how the impugned term operates, and the consequences it produces, irrespective of the label used. If its effect is to impose a higher rate on arrears than on money not in arrears, then s. 8 is offended.

Minority opinion

The minority of three judges differed from the majority in its interpretation of the mortgage terms as well as the application of s. 8. The minority reasoned that the interest rate on the principal was 25 percent throughout the entire term of the mortgage and this rate was not triggered by default or maturity.

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

Commercial purpose

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

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

Significance

In this decision, the majority of the Supreme Court has made it clear that substance prevails over form, and discounts for prompt payment fall within the ambit of the s. 8 prohibition. Any mortgage term, however structured or labelled, that has *the effect* of increasing the rate of interest after default or maturity, will offend s. 8.

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

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

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

In a welcome decision for directors and officers, the court concluded that directors and officers did not owe fiduciary or other duties to the employee in such a situation.

Facts

In November 2013, a not-for-profit organization, the Ontario Psychological Association ("OPA"), terminated the employment of one of its employees who had had responsibility for the day-to-day administration of the OPA's finances. The OPA alleged that the employee had abused her role and misappropriated in excess of $1.6 million over a ten-year period.

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

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counterclaim against the OPA's directors and officers alleging (amongst other things) that they were responsible for supervising, directing and managing her, and that they owed the employee a duty of care and a fiduciary obligation.

The employee further alleged that the directors and officers were obligated to indemnify her or contribute to any damages award made against her in the event she was found responsible for misappropriating the OPA's funds.

Motion to strike

The OPA moved to strike the counterclaim for contribution and indemnity against the directors and officers on the basis that it disclosed no reasonable cause of action. The OPA argued that directors and officers do not owe employees a duty to protect them from their own wrongdoing.

No fiduciary duty

In striking the claim for contribution and indemnity relating to the alleged fiduciary duty owed to the employee, the court reviewed the *Ontario Business Corporations Act* as interpreted by the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise*.

The court noted that the statutory fiduciary duty of directors and officers (otherwise known as a duty of loyalty) is expressly owed to the corporation; the legislation makes no mention of third parties, such as employees. The court therefore concluded that only where the interests of the employees are the same as, stand in conjunction with, and do not harm or may advance the interests of the corporation, may an officer or director look beyond the interests of the corporation to those of the employees or others.

In considering whether a common law fiduciary duty was a valid basis for the employee's claim for contribution and indemnity, the court noted that as with the statutory duty,

> it is not possible that a director carrying out his or her duties as a director can be said to have a duty to an employee who has through fraud, deceit, conspiracy, negligence or negligent misrepresentation, breach of contract or breach of trust, harmed and damaged the corporation such that he or she becomes responsible for the wrong-doing and failures of the employee.

No duty of care

The court noted that unlike the statutory fiduciary duty, the statutory duty of care — which requires directors and officers to be diligent in supervising and managing the corporation's affairs — is not owed solely to the corporation and, thus, may form the basis for liability to other stakeholders.

The court therefore looked to the common-law duty of care to determine whether a claim for contribution and indemnity could be made by the employee against the OPA's directors and officers. The court noted that there may be circumstances where a director or officer may owe a duty of care to an employee, such as where the director or officer was directly implicated and personally involved in decisions or actions which impacted on the safety or treatment of the employee in the workplace.

In this case, no duty of care was owed to the employee. The employee's claims were founded on the idea that directors and officers owe a duty to employees to ensure that they do not improperly and illegally abscond with money that belongs to their employer.

Policy

The court rejected this argument, determining it was not demonstrative of a "legitimate interest" on the part of the employee because stealing money is contrary to the law, whatever the cause of action used to express it. Further, as a matter of policy, there was simply no basis to say that an officer and director should be duty-bound to save harmless an employee who has defrauded or otherwise improperly made off with money belonging to the corporation.

To argue otherwise would be to allow the employee to benefit from his or her own wrong-doing. The court also noted that finding a duty of care to protect employees from their own wrong-doing could work to the detriment of the corporation, as it would be disruptive to the organization. The court remarked that it is doubtful that many individuals would agree to assume this responsibility and serve as a director or officer.

Significance

Although officers and directors may owe duties to their employees, it is clear that they will not be responsible for saving harmless an employee who has defrauded the corporation or otherwise improperly made off with money belonging to the organization. While this case was focused on fraud as the method of wrong-doing, where the employee's misconduct takes a different form — such as breach of contract or breach of trust — the court's comments in this case may be helpful, and should be considered to determine whether analogous policy reasons can be raised to further limit the scope of the duties of directors and officers.

REFERENCES: *Ontario Psychological Assn. v. Mardonet*, 2016 ONSC 4528, 2016 CarswellOnt 11918 (Ont. S.C.J.); *Ontario Business Corporations Act*, R.S.O. 1990, c. B.16, s. 134; *People's Department Stores Ltd. (1992) Inc., Re*, 2004 SCC 68, 2004 CarswellQue 2862, 2004 CarswellQue 2863 (*sub nom.* Peoples Department Stores Inc. (Trustee of) v. Wise) (S.C.C.).