The Test for Unconscionability in Loan Agreements

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Not surprisingly, borrowers often view certain terms in loan and credit agreements as harsh, over-reaching or unusually generous for the lender. But at what point does a specific term cross the line? When does it reach the stage of being considered unconscionable?

In *Phoenix*[1], the Ontario Court of Appeal was called upon to interpret the calculation of a bonus payable to a subordinated lender [**Alterinvest**] under a loan agreement upon the occurrence of several different triggering events, one of which was a sale of any of the borrowers.[2]

At issue were, among other things, (1) the base amount upon which the 1% bonus would be calculated, and (2) whether the provisions of the Loan Agreement were unenforceable due to unconscionability, or as contravening the criminal interest rate provisions in Section 347 of the *Criminal Code*.

The original principal amount of Alterinvest's loan was only $2.25 million, and the purchase price under a sale agreement negotiated by the borrower [**Phoenix Interactive**] with a purchaser exceeded $92.5 million. At stake were several hundred thousand dollars in the amount of the bonus payment that was triggered. Phoenix Interactive was not willing to pay the bonus to Alterinvest because the fee would be disproportionate to the amount outstanding on the loan, and sought relief from the Court on the grounds that the bonus provision was both unconscionable and contrary to Section 347.[3]

The Court concluded that the bonus was to be calculated in accordance with the clear terms of the Loan Agreement on the whole consideration received by the borrower on the sale. It refused to allow the borrower to benefit from a pre-sale internal reorganization, stated to be for dividend purposes and involving several tax minimization manoeuvres, to reduce the sale proceeds upon which the bonus was calculated.

In *Phoenix*, the Court reconfirmed its earlier decision in *Titus*[4] that the conditions required to establish the defence of unconscionability in the enforcement of a document were as follows:

(a) a grossly unfair and improvident transaction;

(b) a victim's lack of independent legal advice or other suitable advice;

(c) an overwhelming imbalance in bargaining power caused by the victim's ignorance of business, illiteracy, ignorance of the language of the bargain, blindness, deafness, illness, senility, or similar disability; and

(d) the other party's knowingly taking advantage of this vulnerability.[5]

This defence raised by the borrower was quickly dismissed by the Court, as the Court determined that Phoenix Interactive had simply not met the required test. The fact that the principal of the borrower was a sophisticated business woman who fully understood the

nature of the terms and effect of the bonus provision was key to the Court's dismissal of this defence. The records even showed that the principal had, during the course of the negotiations of the Loan Agreement, made amendments to Section 4.6(a) which changes had then been accepted by Alterinvest.[6]

Ultimately, the Court would not allow the borrower to avoid its obligations which were clearly established under the loan agreement and which the borrower may view as a bad bargain on the basis of unconscionability.

The Court also concluded that the bonus provision and the Loan Agreement itself did not contravene Section 347, and the borrower could not render them illegal by virtue of making a voluntary prepayment to reduce the principal amount of the loan just days before the bonus became payable.

At the end of the day, Alterinvest arguably received a bit of a windfall and a high overall return on its loan, due to the large purchase price on the sale transaction. Any other result however would have involved a rather stretched interpretation of the clear terms of the loan agreement.

Phoenix is an important confirmation by the appellate court that the clear language of a loan agreement, that reflects the reasonable expectations of the parties at the time the agreement was entered into, will be upheld. An Application for Leave to Appeal to the Supreme Court of Canada was filed by Phoenix Interactive on March 28, 2018 but no decision has been released yet on that application.

[1]*Phoenix Interactive Design Inc. v. Alterinvest II Fund L.P., 420 D.L.R. (4th) 335* ***[Phoenix]***.

[2]Section 4.6 (a) of the relevant loan agreement read as follows:

"If any of the following events occur: if 50% or more of any Borrower (consolidated assets or shares) is sold …, then a bonus of 1% of the net proceeds received by the shareholder, after transaction costs, … becomes due and payable. Notwithstanding any repayment of the Credit Facilities, the bonus referred to herein will remain in full force and effect until the Maturity Date … so that in the event of sale … the Borrower's obligations to pay the bonus will survive prepayment.".

[3]Phoenix, at para. 8.

[4]*Titus v. William F. Cooke Enterprises Inc.*, 2007 ONCA 573 [**Titus**].

[5]Titus, at para. 38.

[6]Phoenix, at para. 41.

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