COURT OF APPEAL FOR ONTARIO

CITATION: Phoenix Interactive Design Inc. v. Alterinvest II Fund L.P.,
2018 ONCA 98
DATE: 20180202
DOCKET: C62718

Pepall, Lauwers and Huscroft, JJ.A.

BETWEEN

Phoenix Interactive Design Inc. and
1932780 Ontario Inc.

Applicants (Respondents/
Appellants by way of cross-appeal)

and

Alterinvest II Fund L.P. by its General Partner,
Business Development Bank of Canada

Respondent (Appellant/
Respondent by way of cross-appeal)

George Benchetrit and Michael Kril-Mascarin, for the appellant/respondent by way of cross-appeal

Raymond F. Leach and Michael A. Polvere, for the respondents/appellants by way of cross-appeal

Heard: May 24, 2017

On appeal from the judgment of Justice Johanne N. Morissette of the Superior Court of Justice, dated August 31, 2016, with reasons reported at 2016 ONSC 5442, 61 B.L.R. (5th) 237.

Pepall J.A.:

A. INTRODUCTION

[1] This appeal involves the principles applicable to the calculation of a bonus that the respondents promised to pay to the appellant on the sale of the respondents' company. The applications judge determined that the bonus payable amounted to $242,552.79 and not $888,462.78 as claimed by the appellant. She dismissed the respondents' claim that no bonus was payable because it contravened the criminal rate of interest found in s. 347 of the *Criminal Code*, R.S.C. 1985, c. C-46; was unconscionable; and was *ultra vires* the objects of the appellant, the Business Development Bank of Canada ("BDC").

[2] The appellant appealed from her decision and the respondents cross-appealed. For the reasons that follow, I would allow the appeal in part and dismiss the cross-appeal.

B. BACKGROUND FACTS

[3] BDC and other financial institutions established the appellant, Alterinvest II Fund L.P. ("ALP"), to provide subordinate debt and equity financing to small and medium sized businesses in Canada. The respondent, Phoenix Interactive Design Inc. ("Phoenix"), was seeking such financing. It was in the business of developing, distributing, and supporting automated teller machine and bank branch automation software. Kyle MacDonald was the founder of Phoenix, and its President and Chief

Executive Officer. She was also the principal of the respondent, 1932780 Ontario Inc. (“193”), (together with Phoenix, the “Phoenix parties”), which was formed in March 2015 as the amalgam of a number of predecessor companies.

[4] In November 2010, ALP offered Phoenix and 193’s predecessors a loan for $2.25 million with a November 23, 2015 maturity date. The purpose of the loan was to refinance an existing loan of $1.25 million and to meet Phoenix’s working capital needs with additional financing of $1 million. ALP, Phoenix and 193’s predecessors entered into a loan agreement on February 16, 2011. The loan had a fixed rate of interest of 12.8% per annum and monthly royalties payable commencing in February 2011.

[5] In the loan agreement, Phoenix and 193’s predecessors were described as the “Borrowers”. The parties agreed that ALP would be paid a bonus if any of the Borrowers were sold. Specifically, the bonus provision, contained in s. 4.6(a) of the loan agreement, stated:

> If any of the following events occur: <u>if 50% or more of any Borrower (consolidated assets or shares) is sold</u> or merged with an unrelated company; if there is a change of control of any Borrower; or if any Borrower goes public prior to the Maturity Date or extended maturity date of the Credit Facilities, <u>then a bonus of 1% of the net proceeds received by the shareholder, after transaction costs,</u> determined as at the closing date of such transaction <u>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</u> (or any amended maturity date agreed by the Bank)

> so that in the event of sale, IPO, or similar transaction the Borrower's obligation to pay the bonus will survive prepayment. [Emphasis added.]

[6] Accordingly, the bonus was 1% of the net proceeds of sale after transaction costs and was payable notwithstanding any prepayment of the loan. The bonus would remain in force until the maturity date, that is, November 23, 2015.

[7] Paragraph 8.1 of the loan agreement precluded a sale or reorganization of any of the Borrowers without ALP's consent.

[8] In the fall of 2014, Diebold Inc. ("Diebold") approached Phoenix regarding a possible purchase of the company. In February 2015, MacDonald met with ALP to advise that negotiations were underway for the sale of Phoenix. She also advised that the Phoenix parties were not willing to pay ALP the bonus in accordance with the loan agreement because she believed that the fee would be disproportionate to the amount outstanding on the loan. ALP disagreed and responded by confirming that it would seek payment of the bonus. On March 5, 2015, Phoenix paid the full amount of $408,944.66 that was outstanding under the loan agreement for principal, fees, and royalties. However, that amount did not include any sum on account of the bonus.

[9] Prior to the closing of the stock purchase transaction, 193's predecessor companies amalgamated to form a new company, 1926723 Ontario Inc. ("Targetco"). Phoenix Interactive International Inc. ("Holdco"), which was owned by MacDonald, held all the shares in Targetco. Targetco issued dividends totaling

$50 million on March 10 and 11, 2015. In satisfaction of the dividends, Targetco issued promissory notes totaling $50 million to Holdco.

[10] On March 13, 2015, Diebold bought Phoenix for $92.5 million. The $50 million debt under the promissory notes from the pre-closing reorganization, plus an additional $5.125 million of debt (largely representing income tax liabilities arising from the reorganization), formed part of the purchase price and were repaid by the purchaser on the date of closing.

[11] The parties were unable to agree on the amount of the bonus payable to ALP. The Phoenix parties argued that the bonus calculation should not include the $55.125 million, whereas ALP argued that those funds formed part of the proceeds of sale and therefore should be included in the bonus calculation.

[12] BDC commenced an application against the Phoenix parties and MacDonald seeking information on the sale price, in order to calculate the bonus owed to BDC, and a declaration that the bonus was payable. The Phoenix parties then commenced an application for a declaration that: the bonus contravened the criminal rate of interest found in s. 347 of the *Criminal Code*; was unconscionable; and was *ultra vires* the objects of BDC. Ultimately, $975,000 was ordered to be paid into court as security for the Phoenix parties' obligations with respect to the bonus, interest, and costs.

C. APPLICATIONS JUDGE'S DECISION

[13] The applications judge dismissed the Phoenix parties' application. She also dismissed BDC's request that the bonus be based on the $92.5 million proceeds of sale less the transaction costs.

[14] Dealing first with the interest rate, the applications judge rejected the Phoenix parties' argument that once they paid off the loan, there was a zero balance and therefore an infinite annual interest rate that was usurious. She held that payment of the bonus was required regardless of any prepayment, and, because the bonus was still owing, there was not a zero balance in the loan account. In addition, relying on *Garland v. Consumer's Gas*, [1998] 3 S.C.R. 112 and *Pegelder Construction Co. v. Dancorp*, [1998] 3 S.C.R. 90, she concluded that the prepayment, a voluntary act of the debtor, could not give rise to an illegality. She accepted the evidence of ALP's expert that the applicable maximum rate of interest was 26.9%. As such, the payment of the bonus was never contrary to s. 347 of the *Criminal Code*, which prohibits interest rates in excess of 60%.

[15] The applications judge also rejected the Phoenix parties' argument that the bonus was unconscionable. She concluded that the conditions required to establish unconscionability as outlined in *Titus v. William F. Cooke Enterprises Inc.*, 2007 ONCA 573, 284 D.L.R. (4th) 734, at para. 38, were not present. These conditions are as follows:

> (a) a grossly unfair and improvident transaction;
>
> (b) a victim's lack of independent legal advice or other suitable advice;
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> (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.

[16] She also found the bonus was not *ultra vires* BDC's objects, because BDC had the statutory power to make loans and investments, determine and charge interest, and determine employee remuneration.

[17] Lastly, the applications judge addressed the calculation of the bonus and whether the $55.125 million characterized as "certified indebtedness" represented proceeds of sale. She determined that that sum was not to be included in the calculation of the bonus. She observed that the bonus was to be activated on transfer to an unrelated company. It was not payable if the Borrowers undertook a reorganization with a related company. If the reorganization had arisen a year prior to the sale, there would have been no complaint from BDC. She reasoned that Phoenix made a transfer to a related company to pay dividends to MacDonald for her efforts as a key employee and to achieve tax efficiency, not to deny ALP the bonus. Additionally, in her view, the issue of consent did not apply to the pre-sale transaction, which was for dividend purposes.

[18] The applications judge also deducted from the bonus calculation $9 million in income taxes payable by Phoenix and $604,063 for professional fees paid to Deloitte, who had advised Phoenix during the sale to Diebold. She held that the fees related to the structuring of the sale of the business and as such should be deducted from the bonus calculation.

[19] The applications judge therefore ordered the Phoenix parties to pay $242,552.79 to BDC, representing a 1% bonus based on net proceeds of sale of $24,255,279.

[20] ALP appeals from the applications judge's decision and the Phoenix parties cross-appeal.

D. ISSUES

[21] There are four issues to consider:

(i) should the bonus calculation include the sum of $55.125 million?

(ii) is the bonus contrary to s. 347 of the *Criminal Code*?

(iii) is the bonus unconscionable?

(iv) is the bonus *ultra vires* BDC's legislated mandate?

[22] For the reasons that follow, I would answer issue 1 in the affirmative, and issues 2 to 4 in the negative.

E. ANALYSIS

(1) Should the bonus calculation include the sum of $55.125 million?

[23] ALP submits that the sum of $55.125 million should not have been subtracted from the $92.5 million purchase price for the purposes of calculating the bonus.

[24] I agree. In my view, the applications judge erred in deducting this amount from the sale proceeds. She erred for two reasons.

[25] First, the purchase price between the Phoenix parties and Diebold was $92.5 million. Phoenix conceded that the $55.125 million debt was repaid by the purchaser and was received by Phoenix on the closing of the sale to the purchaser. The applications judge failed to consider the terms of the purchase agreement. Omitting this figure from the calculation of the bonus ignores the purchase agreement terms.

[26] Second, the establishment of the debt of $55.125 million was created by the Phoenix parties as part of the pre-sale reorganization. No such reorganization was permitted under paragraph 8.1 of the loan agreement absent ALP's consent. No such consent was requested or received. Indeed, MacDonald stated that she had forgotten that the provisions requiring ALP's consent were in the loan agreement. A party is precluded from taking advantage of and benefitting from a state of affairs

caused by its own wrongdoing: *Barclays' Bank PLC v. Metcalfe & Mansfield Alternative Investments VII Corp.*, 2013 ONCA 494, at para. 149.

[27] The fact that the transaction was stated to be for dividend purposes with a related company is immaterial. The reference to an unrelated company in the loan agreement went to the nature of the sale transaction that would trigger the payment of the bonus. It was speculative to suggest that if the indebtedness had arisen a year earlier, there would have been no complaint from ALP. Moreover, as evident from the underlying documentation, the reorganization was clearly part of the purchase transaction. The Phoenix parties acknowledged that the $55.125 million was paid to them on the closing of the sale transaction from the sale consideration received from the purchaser. At its heart, that sum formed part of the proceeds of disposition on account of the sale to the purchaser. I agree with ALP that it would be a strange result if Phoenix's obligation to pay the bonus was reduced or eliminated due to their tax minimization manoeuvres, which contravened the terms of the loan agreement, did not actually reduce the amount they received, and formed part of the consideration for the sale to the purchaser.

[28] The applications judge's treatment of the remaining deductions is also inconsistent with her analysis. The bonus provision in the loan agreement provided for a payment equal to 1% of net proceeds after transaction costs. ALP accepted that adjustments for working capital and legal fees were appropriate deductions for the purposes of calculating the quantum of the bonus. However, it

disputed the deductions for professional fees and income taxes arising from the sale to Diebold in that the former included fees unrelated to the sale transaction and the latter did not constitute transaction costs as described in the loan agreement. The applications judge, having concluded that the $55.125 million was part of the pre-sale transaction and therefore did not form part of the proceeds of sale, nonetheless permitted the professional fees and income taxes relating to the pre-sale transaction to be deducted from the bonus calculation.

[29] The applications judge's conclusion was inconsistent with the result. Having reversed her conclusion, I would uphold her decision on the professional fees and income taxes; these all formed part of the costs of the transaction with Diebold.

[30] As such, the net proceeds amounted to $79,380,048,[1] 1% of which is $793,800.48.

(2) Is the bonus contrary to s. 347 of the *Criminal Code*?

[31] The Phoenix parties submit that the bonus was contrary to s. 347 of the *Criminal Code*. Specifically, they take issue with the applications judge's conclusion that the outstanding loan amount did not have a zero balance when Diebold bought Phoenix because the bonus payment was still owing. The Phoenix

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[1] This amount reflects the gross purchase price paid by Diebold for Phoenix of $92.5 million, less the sum of the following amounts found by the trial judge, at para. 57 of her reasons, to represent each respective deduction: $2.8 million for working capital, $625,000 for working capital post-closing, $228,722 for transaction costs, $604,063 for professional fees, and $8,862,167 for income taxes.

parties concede that the account cannot be zero if an obligation exists to pay an amount in the future. However, they argue that the bonus payment was not an existing obligation because it was based on a future event – the sale of Phoenix – that was uncertain at the time the loan was prepaid.

[32] The Phoenix parties go on to challenge the applications judge's treatment of their voluntary prepayment of the outstanding indebtedness based on the "voluntariness principle" identified in *Garland* and *Degelder*. This principle suggests that a legal credit agreement does not become illegal as a result of a voluntary prepayment. The Phoenix parties argue that the voluntariness principle is inapplicable to the present case. This is because the bonus payment was not outstanding, accrued, due, or owing at the time of the prepayment and only became payable on the sale of Phoenix. At that time, no debt was outstanding.

[33] I disagree with these submissions. At para. 25 of her reasons, the applications judge correctly decided that the loan agreement required payment of the bonus regardless of any prepayment in advance of the loan's maturity date. Therefore, the bonus was owing and there was no zero balance. This conclusion is based on the applications judge's reliance on s. 4.6(a) of the loan agreement, which states that the "obligation to pay the bonus will survive prepayment."

[34] Furthermore, the prepayment was made on March 5, mere days before the Phoenix sale closed on March 13. The Phoenix parties cannot fairly argue that the obligation to pay the bonus was some uncertain future obligation.

[35] At para. 24 of *Degelder*, the Supreme Court held that “a transaction which was legal when entered into cannot become illegal under s. 347 through a voluntary act of the debtor.” As the applications judge correctly identified at para. 28 of her reasons, where the prepayment is within the control of the borrower and not required by the lender, that prepayment will be considered voluntary and cannot render a legal loan agreement illegal.

[36] In the case at bar, Phoenix made a voluntary prepayment during the term of the loan. This payment was not required by ALP; it was entirely within the control of Phoenix. The Phoenix parties cannot rely on the prepayment to argue that when Phoenix was subsequently sold, the bonus was illegal because ALP purported to charge an effective annual interest rate that was infinite on a loan balance of zero. The loan balance was only zero at that time *because* of the prepayment. It would be a bizarre result if the Phoenix parties’ obligation to pay the bonus was rendered illegal by their own decision to prepay the loan. The applications judge did not err in her treatment of this issue.

(3) Is the bonus unconscionable?

[37] Next, the Phoenix parties submit that the applications judge erred by relying on the four-part test for unconscionability identified in *Titus*. They submit that the applicable test is that identified by the British Columbia Court of Appeal in *Morrison v. Coast Finance Ltd.* (1965), 55 D.L.R. (2d) 710 (B.C. C.A.). The *Morrison* test consists of two elements: (a) an inequality in the position of the parties, arising out of the ignorance, need or distress of the weaker party; and (b) the substantial unfairness of the bargain that is obtained by the stronger party. The Phoenix parties argue that this error was significant because *Morrison* does not require an "overwhelming imbalance" in power, nor does it link inequality in bargaining power to independent legal advice.

[38] I disagree that the applications judge erred in applying the test identified in *Titus* rather than the Phoenix parties' preferred test of *Morrison*. I say this for two reasons.

[39] First, *Titus* is the law in Ontario. It was decided in 2007 by this court, and most recently re-affirmed as the leading case on the test for unconscionability in Ontario in *Kielb v. National Money Mart Co*., 2017 ONCA 356, 66 B.L.R. (5th) 39. This court has not endorsed the 1965 *Morrison* test and lower courts in Ontario have primarily employed the *Titus* test since that case was decided: see *e.g. Girxti v. Kingston (City)*, 2010 ONSC 5161; *John Deere Financial Inc. v. 1232291 Ontario*

Inc., 2015 ONSC 7467; *Arisoft Inc. v. Ali*, 2015 ONSC 7540 (Div. Ct.); *Kilislian v. Copper Creek GP Inc.*, 2015 ONSC 7072; and *Grenier v. Algonquin College of Applied Arts and Technology*, 2014 ONSC 1984.

[40] Second, even if I were to accept that the test for unconscionability as articulated in *Morrison* applied, which I do not, the Phoenix parties have failed to show that it has been met. An inequality in the bargaining positions of the parties to an agreement is an element of both the four-step test from *Titus* and the two-step test from *Morrison*.

[41] At para. 40, the applications judge considered this element and concluded that MacDonald was a "sophisticated business woman", who had "the benefit of independent legal advice" and "fully understood the nature of the terms and effect of the bonus provision". These findings are well-supported by the record. For example, when negotiating the loan agreement, MacDonald made changes to s. 4.6(a), such that the bonus was amended from "1% of the value of the borrowing companies … at the closing date" to "1% of the net proceeds received by the shareholder, after transaction costs". ALP accepted these changes. They are an example of MacDonald's sophistication and bargaining power.

[42] I would not give effect to this ground of appeal.

(4) Is the bonus *ultra vires* BDC's legislated mandate?

[43] Finally, the Phoenix parties submit that the applications judge erred in finding that the bonus was not *ultra vires*. They argue that she failed to consider whether BDC's exercise of its statutory powers was in accordance with its objects. They submit that BDC may only structure loans on terms that are in accordance with the objects set out in ss. 4(1) and 4(2) of its enabling legislation, the *Business Development Bank of Canada Act*, S.C. 1995, c. 28 (the "*BDC Act*"). These objects are to "support Canadian entrepreneurship by … raising funds or capital" and to "give particular consideration to the needs of small and medium-sized businesses". The Phoenix parties further submit that the bonus provision did not advance BDC's objects because the bonus constituted a "cash grab" that was detrimental to Canadian entrepreneurship.

[44] In my view, the applications judge was correct in concluding that the bonus provision in the loan agreement was not *ultra vires* BDC's mandate. BDC must exercise its powers in accordance with the objects set out in the *BDC Act*. However, in this case these objects were not violated.

[45] Subsections 14(1)(a) and 22(b) of the *BDC Act* provide BDC with the power to "make loans and investments" and "determine and charge interest and any other form of compensation for services [it] provides in the exercise of its powers under this Act". A plain reading of these provisions indicates that Parliament conferred

broad discretion upon BDC in the exercise of its powers under the *BDC Act*. It was open for BDC to negotiate the rate of return and loan structure that it did. As the applications judge observed at para. 45:

> By extending the loan to the applicants, BDC supported a Canadian entrepreneur by providing her with financial services to assist her to raise working capital which allowed her to ultimately sell her business for over $92 million.

I would decline to give effect to the respondent's cross-appeal on this issue.

F. DISPOSITION

[46] In conclusion, I would allow the appeal of ALP, with the exception of its appeal of the issue of deduction of professional fees and taxes, and would dismiss the cross-appeal of the Phoenix parties. I would vary the applications judge's order to order that ALP is entitled to a bonus of $793,800.48 rather than $242,552.79.

[47] The parties did not reach an agreement on the costs of the appeal. In the event of success, ALP requested its full costs of $23,000, on the basis that the loan agreement so provides. The Phoenix parties submitted that this court should exercise its discretion to grant costs on a partial indemnity scale in the amount of $16,000. Given that ALP was not entirely successful, I would grant ALP costs of $20,000, inclusive of disbursements and applicable tax.

[48] The parties did reach an agreement on the costs below. Both parties agreed that the successful party would be entitled to an order of $160,000, inclusive of

disbursements and applicable tax for their costs below. I would therefore order that the Phoenix parties pay ALP $160,000 inclusive of disbursements and applicable tax.

Released:

"GH"
"FEB -2 2018"

"S.E. Pepall J.A."
"I agree P. Lauwers J.A."
"I agree Grant Huscroft J.A."