

DEFAULT INTEREST -THE DOCTRINE OF PENALTIES REVISITED

Date: 13 July 2016

Finance Alert

By: Alan S. Maclean, Adam Moore

OVERVIEW

Recent developments in the law of penalties mean that lenders should carefully review how their default interest provisions operate and whether the amount claimed as default interest can be justified as a genuine pre-estimate of loss.

The decision in *Sayde Developments Pty Ltd v Arab Bank Australia Limited [2016] NSWDC 76* is a timely reminder of the principles a court will apply to determine if default interest charge under a commercial loan agreement is a penalty.

BACKGROUND

The borrower made a number of late interest payments under the loan agreement and the financier charged default interest at 2% above the fixed rate of 8.54% per annum on the whole principal outstanding, rather than on the amount of the late interest payments for the period that the interest payments were outstanding.

ISSUE

The case considered whether charging default interest on the whole outstanding principal amount (rather than the overdue amount) was extravagant and unconscionable in comparison to the greatest loss likely to be incurred by the financier and was therefore liable to be set aside as a penalty.

PRINCIPLES

In determining if the default interest charged was a penalty the Court applied the following principles:

- whether the payment in question is a penalty or liquidated damages based on a genuine pre-estimate must be assessed objectively and prospectively at the time the relevant contract containing the alleged offending stipulation is entered into and not at the time of the breach
- a court must undertake this assessment based on the construction of the terms of the contract and surrounding circumstances at the time of entry into the contract. A court will have regard to expert testimony in relation to the financier's cost of funds and recovery and administration costs

- if a sum stipulated for payment is extravagant and unconscionable in amount when compared to the greatest loss that could conceivably have followed from the breach or condition giving rise to the payment, it is likely to be a penalty
- the legitimate commercial interests sought to be protected by the bargain reached by the parties will be taken into account
- a presumption arises that there is a penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others trifling damage".

DECISION

The Court held that the default interest payments made to the financier were penalties and unenforceable and were repayable to the borrower together with interest.

In coming to this conclusion the Court found that imposing default interest on the whole outstanding amount was extravagant and unconscionable and exceeded the greatest loss that could have proven to have resulted from the failure to make the interest payments on time and therefore was not a genuine pre-estimate of damage.

REVIEW

We recommend you take the time to review any default interest clauses contained in your finance and security documents to determine if default interest is charged:

- only on due but unpaid amounts
- on the whole amount outstanding if an event of default subsists
- retrospectively prior to the due date
- and/or with compounding and/or capitalisation if unpaid when due.

If you cannot objectively justify the default interest charge imposed based on your likely greatest conceivable loss (assessed by reference to your recovery and administration costs and cost of funds), it may be time to re-assess and modify your default interest provisions.

DRAFTING OPTIONS

There are structuring and drafting techniques which can be utilised to improve the likelihood of a payment of default interest withstanding an attack as a penalty. These techniques include:

- confining the amount on which default interest accrues to amounts which are due but unpaid and imposing an increased default interest charge which is not extravagant or unconscionable (increased interest rate term)
- structuring the default interest clause to act as an incentive for prompt payment, such as where a higher rate of interest applies that is reduced to a lower rate where punctual payment is made (concessional interest rate term). The current law is that a properly drafted concessional interest rate term cannot be a penalty; whereas an increased interest rate term can be a penalty: see *Kellas-Sharpe v PSAL Ltd*.

Intermediate appellant courts are bound by this distinction until the High Court decides to abolish the distinction in light of its decision in *Andrews v ANZ Bank* that the penalties doctrine can apply to a pre-agreed payment for a failure to satisfy a condition (regardless of whether it amounts to a breach of contract)

- the inclusion of an immediate (and automatic) acceleration of the loan upon a payment default occurring so that default interest can accrue on the accelerated amount rather than on the unpaid amount
- structuring any default interest charge as a fee for conferring a contractual benefit, being a conditional waiver of default (ie. a waiver of a default resulting from the failure to pay moneys when due). This follows the finding of the court in *Paciocco v ANZ Bank* that a fee for an additional benefit may not be a penalty

OTHER REMEDIES AVAILABLE

Finally, although this Legal Insight deals with the doctrine of penalties, default interest provisions may also be set aside as unjust in *New South Wales under the Contracts Review Act 1980 (NSW)* or as unconscionable under section 12CB of the *ASIC Act 2001 (Cth)* or equivalent State Fair Trading legislation. From 12 November 2016, a default interest provision may potentially be declared unfair and set aside under the unfair contracts regime in sections 12BF- 12BM of the *ASIC Act 2001 (Cth)* if it is contained in a "small business contract" which is a "standard form contract".

KEY CONTACTS



ALAN S. MACLEAN
PARTNER

MELBOURNE
+61.3.9205.2025
ALAN.MACLEAN@KLGATES.COM



ADAM MOORE
SPECIAL COUNSEL

SYDNEY
+61.2.9513.2506
ADAM.MOORE@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.