DAVIS LAWYERS

Legal Insights

PENALTIES IN LOAN TRANSACTIONS

1. Introduction

A contractual term which has a punitive character may be deemed a 'penalty' and can be unenforceable. It is important to understand what clauses in your agreements may be subject to the doctrine of penalties and how this can impact your contractual rights.

2. What is a penalty?

The doctrine of penalties may apply to a clause which imposes a collateral obligation on the failure of a primary obligation and that secondary obligation causes detriment. In general terms, this can apply to clauses which impose an additional obligation, such as to pay an extra fee or a higher interest rate, on the occurrence or non-occurrence of an event, such as the obligation to make a monthly loan repayment. If the additional obligation is 'extravagant or unconscionable' and not a genuine pre-estimate of loss that will flow to the innocent party, then the clause could be considered a penalty.

In *Paciocco v ANZ Banking Group Ltd* (2016) 258 CLR 525, the High Court of Australia confirmed the test for whether the secondary obligation a penalty is if the obligation imposes a detriment on the party in breach that is "out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation." Determining legitimate interests can include considerations of economic interests, reputation, performance of third-party obligations, risks of the transaction and business interests.

If a contractual provision is deemed a penalty, it will be void and unenforceable at law and the Court may be asked to impose a replacement provision.

3. What clauses may be penalties?

Whether a clause operates as a penalty or not will depend on the circumstances of each individual matter. In some cases, the following provisions have been considered penalties by the Court:

- Early termination fees;
- Late payment fees;
- Accelerated payments;
- Default interest rates;
- Transfer of property on default; and
- Indemnities.

In finance documentation, charging fees on top of monthly interest (*Andrews v ANZ Banking Group Ltd* [2018] FCA 70) and capitalisation of interest clauses (*Kellas-Sharpe v PSAL Ltd* [2012] QCA 371) were not been considered penalties in the circumstances of the respective case.

4. Penalties and default interest rates

Loan documentation will often provide for two different interest rates – one lower and one higher. Since the doctrine of penalties can apply where a secondary obligation arises on the occurrence or non-occurrence of an event, application of default interest rates as penalties is often questioned. The issue of default interest rates and penalties have been considered in various cases such as:

- Arab Bank of Australia Ltd v Sayde Developments Pty Ltd (2016) 93 NSWLR 231: a default interest rate of 2% on a $6.825 million loan = not a penalty;
- PT Thiess Contractors Indonesia v PT Arutmin Indonesia [2015] QSC 123: interest rate of 10.4% per annum increased to 18% per annum if amount remained unpaid = not a penalty; and
- Beil Mansell (No 2)[2006] 2 Qd R 499: interest rate of 16% increased to 25% on default = penalty. The court considered a 9% increase was extravagant and not modest.
- Love v Quantum Asset Management Pty Ltd ([2017 WASC 167) – the interest rate was 9.75% per annum, however, after the default occurred, the interest rate rose to 4.43% per month (being 53 .16 % per annum). Quantum gave evidence of the factors that it took into account in determining the interest charged to Love Properties. These were the credit report on Love Properties, the number of writs and default judgments, the fact that Love Properties was in default with the existing lender and the loan application involved a subdivision that was in litigation. The decision was that the high interest imposed by Quantum was not a penalty, in circumstances where:

    (i) the facility was high risk and in the short term money market;

    (ii) Quantum had explained its manner of assessing risk, its targeted return, the restrictions under which it operates in terms of a finite pool of funds and the need for a certain level of return to remain profitable;

    (iii) Quantum also gave evidence that its annualised return during period A (52.68% pa when substantial establishment and other fees were added to interest) was approximately consistent with its annualised return during period B (53.16% pa comprising interest only; and

    (iv) Quantum adduced evidence which persuaded the Court that the facility, together with its applicable interest rate was never intended to punish Love Properties for their default and it was dependent on the risk/financial position of Love Properties

Courts are therefore willing to accept a differential interest rate or payment where the amount is reasonable and modest to take into account the increased risks and costs associated with a default or breach. Curts will not lightly interfere with the bargain struck between the parties and requires good reason to attract judicial intervention to set aside the bargains upon which parties of full capacity have agreed. That is why the law on penalties is expressed as an exceptional rule and descriptors such as ‘extravagant’ and ‘out of all proportion’ are used in its application.

Interest rates have therefore traditionally been drafted to provide for a standard rate and a concessional rate and this approach has been upheld by the Courts. In Kowalczuk v Accom Finance Pty Ltd (2008) 77 NSWLR 205 [162] the court considered that the doctrine of penalties may not apply where the mortgage is drafted so that the borrower agrees to pay a particular standard interest rate but where the lender agrees to accept a lower rate of interest provided there is no breach or default. Drafting the two interest rates this way acts as an incentive, instead for punctual payment instead of a penalty for failure of payment (David Securities Pty Ltd v Commonwealth Bank of Australia (1990) 93 ALR 271, 298). Therefore, while a standard rate / default rate and standard rate / concessional rate provide the same practical result for a lender, Court support the standard and concessional rate definitions and drafting in loan documentation.

5. Drafting considerations

It is important to be aware of which contractual provisions may be subject to the doctrine of penalties, and if so, whether they impose an obligation that is extravagant and not a genuine pre-estimate of loss. Exceptions to the doctrine of penalties include whether there is a reciprocal right, option for alternative performance and concessions.

DAVIS LAWYERS
Phone: 07 3367 8888
Email: enquiries@davislawyers.com.au
Mail: PO Box 277
Ashgrove QLD 4060

Potential drafting considerations may include:

- Drafting terms to fit within the exceptions, such as having standard and concessional interest rates;
- Including a breakdown of any additional payment required and noting the reasons it is a genuine pre-estimate of loss; and
- Ensuring any additional payment or interest rate is reasonable and does not increase by a significant amount on default.

Please note that your specific circumstances and contractual arrangements will influence what terms or amounts may be reasonable in each matter. You should also be aware that while a secondary obligation may not fall within the penalties doctrine, it may still be subject to other requirements or limitations under common law, the *National Consumer Credit Protection Act 2009* (Cth) or *Competition and Consumer Act 2010* (Cth)

6. Takeaways

A wide variety of contractual provisions can be deemed penalties and this can have a significant negative impact on your rights under a contract, and especially for lenders under financing arrangements. It is therefore crucial for parties to understand what type of clauses may be subject to the penalties regime and ensure relevant terms, remedies and amounts are drafted appropriately. We strongly recommend contacting our office prior to entering the contract (where possible), if you have any concerns about penalties or your rights and options.

DISCLAIMER

This document does not constitute legal advice and should not be relied upon as such. It is intended only to provide a summary and general overview on matters of interest and it is not intended to be comprehensive. You should seek legal or other professional advice before acting or relying on any of the content.

DAVIS LAWYERS
Phone: 07 3367 8888
Email: enquiries@davislawyers.com.au
Mail: PO Box 277
Ashgrove QLD 4060