

Article Information

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Are the interest, fees, costs and charges in your loan agreements penalty clauses?

Typically, parties to a contract would seek to ensure that the obligors are performing their obligations under the contract. This duty is usually protected by way of payment of a specific sum for any breaches. However, the doctrine of penalties asserts that this sum can not be extravagant or unconscionable and must be proportionate to the actual perceived damage or loss which may be suffered. If a clause is drafted in excess of this pre-estimate, it may be struck down as a penalty and made void to the extent that it exceeds the actual perceived loss.

What is a penalty?

A penalty is a clause in a commercial contract which demands that a certain sum be paid in damages for failure to fulfil an obligation in a contract by an obligor. A sum which is characterised as a penalty would be 'extravagant and unconscionable in comparison with the greatest loss that could conceivably be proved to have followed from the breach'^[1]. This means that the sum demanded must be a genuine pre-estimate of the potential loss that could be suffered in order to avoid being read down as a penalty. Relief to such recourse is determined upon equitable principles which refuse to give effect to clauses which are unreasonable and unconscionable.

As considered in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1914]^[2], one must cogitate on the following questions in order to determine whether or not a clause is considered a penalty:

1. Is the sum extravagant and unconscionable in comparison to the greatest conceivable loss. This must be a sum which is deemed 'out of all proportion' in order to be constitute penalty. ^[3]
2. Is the sum for non-payment and if so, the sum can not be greater than what is ought to be paid.
3. Is the sum to protect commercial interests or would a court find it to be oppressive and detrimental to borrowers.

Types of Penalties

The law of penalties is not limited to a sum of money and can extend to clauses which require payment in the form of a transfer of land or the surrender of a right. ^[4] A study of significant court decisions provides guidance in determining whether or not a clause or fee may be considered a penalty.

Fees to Secure Obligations

The landmark case of *Andrews v Australia and New Zealand Banking Group Ltd* (2011) is instructive on clarifying whether the penalty doctrine is applicable in circumstances where a fee is not triggered by a breach of the contract.^[5] It was unanimously held that there is no requirement for a penalty to arise out of a breach of the contract. In drafting loan documents, it must be considered whether fees are payable for the provision of further services or to secure an obligation owed. The latter would be struck down as a penalty, while a fee for further services, even if substantial, is not considered a penalty in the eyes of the law.

Late Payment Fees

Late payment fees are enforceable penalties on the assumption that their sum is commensurate to the interest which need be protected. The decision of *Paciocco v Australia and New Zealand Banking Group Limited* [2016] considered whether a credit card late payment fee constitutes as an unenforceable penalty.^[6] The majority found that late payment fees were not penal and that their primary purpose was to protect the commercial interests of the bank. It was confirmed that “the sum agreed was commensurate with the interest protected by the bargain”.^[7] Hence, in contemplating the sum of late payment fees, it is important to ensure that it is proportionate to the interests to be protected.

Acceleration Clauses

An acceleration clause is a provision which allows a lender to demand payment of all outstanding debt on a loan if a borrower’s obligations are not met. The appeal of *Cafe du Liban Pty Ltd v Bespoke Garage Pty Ltd* [2018] considered this in the instance of a chattel-hire contract whereby the issue was whether an acceleration clause could be struck down as a penalty.^[8] It was determined that if the predominant purpose of the clause is to punish an obligor for bringing about termination of a contract within a specified time period this would be considered penal. Additionally, the acceleration clause must not propose the payment of a sum which is “out of all proportion to the protection of the legitimate interest”.^[9] Hence, in ensuring that an acceleration clause is enforceable, it is important to consider its predominant purpose in light of the sum demanded.

Higher and Lower Interest Rates

A common practice in loan agreement is for the facility to contain both a higher and lower interest rate. A higher interest rate is triggered in an instance whereby there has been an event of default in the contract. *Golden J Wealth Pty Ltd v AC Holdings Co Pty Ltd* (2019) discussed whether an obligation to pay interest at a higher rate would be considered an ‘unenforceable penalty’.^[10] This was rejected on the basis that a higher interest rate is not an unreasonable provision to include to protect the commercial interests of the business.^[11] Rather, the Court ruled that this tiered interest provision is a reflection of an appropriate commercial decision made by Golden J Wealth in protecting their own commercial interests.

Factors to consider when drafting loan documents

Prior to drafting documents, lenders should take the following factors into consideration:

- The sum of the expected fee - this would require the lender or the lender’s representatives to consider the greatest loss which may be incurred in comparison to the sum stipulated in the contract. This must be based on a genuine pre-estimate of the loss that the lender may incur.
- The nature of the fee - if the fee is for a non payment or to secure an obligation it may be considered a penalty. The fee should be either for an additional obligation or to reasonably protect the commercial interests of the party and thus due consideration must be given to the purpose of the clause.
- Drafting of the clauses - in drafting an enforceable clause it is important to frame the provision around the protection of commercial interests. All clauses or fees should be drafted with this in mind in order to give validity and enforceability to the clause. The contract should also make direct reference to the genuine pre-estimate of loss in their drafting.

Conclusion

In conclusion, lenders should consider the purpose and substance of their penalty clause in order to ensure enforceability. It is important that lenders take into consideration whilst drafting their documents that the recourse is not extravagant and unconscionable. It must be a genuine pre-estimate of the lender’s potential loss if the obligors breach the contract. Otherwise, a court may find it to be oppressive and detrimental to borrowers. The doctrines of penalties is a complex area of the law and it is important for lenders to seek legal advice prior to drafting their loan documents, among other things.

^[1] AMEV-UDC Finance Ltd v Austin [1986] HCA 63.

^[2] Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] 1 AC 79 [80].

^[3] Ringrow Pty Ltd v BP Australia Pty Ltd [2005] HCA 71.

^[4] Wollondilly Shire Council v Picton Power Lines Pty Ltd (1994)33 NSWLR 551.

^[5] Andrews v Australia and New Zealand Banking Group Limited [2012] HCA 30.

[\[6\]](#) Paciocco v Australia and New Zealand Banking Group Limited [2016] HCA 28.

[\[7\]](#) Paciocco v Australia and New Zealand Banking Group Limited [2016] HCA 28 [270].

[\[8\]](#) Cafe du Liban Pty Ltd v Bespoke Garage Pty Ltd [2018] NSWCA 234.

[\[9\]](#) Cafe du Liban Pty Ltd v Bespoke Garage Pty Ltd [2018] NSWCA 234 [15].

[\[10\]](#) Golden J Wealth Pty Ltd v AC Holdings Co Pty Ltd [2019] NSWSC 1342.

[\[11\]](#) O’Dea v Allstates Leasing System (WA) Pty Ltd (1983) 152 CLR 359 [366].