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Higher interest rates in commercial lending and interest rate cap under the National Consumer Credit Protection Act

When lenders charge higher interest rates in commercial lending, the question as to whether these rates constitute 'penalties' often arises. This article provides a case summary of Quantum Asset Management Pty Ltd v Love Properties (WA) Pty Ltd [2017] and Yarra Capital Group Pty Ltd v Sklash Pty Ltd [2006] which found that the higher interest rates (both above 50% p.a.) were not out-of-proportion, did not act as punishments and therefore were not penalties. This article also compares the interest rate cap of 48% in consumer lending.

What is a penalty?

A penalty is an amount paid for the failure to fulfil a contractual obligation 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] For further information about penalties read our article: *Are the interest, fees, cost and charges in your loan agreements penalty clauses?*.

Higher Interest Rates in Commercial Lending: Case Studies

The question of whether higher interest rates charged by a lender constitutes a penalty is discussed in the cases of *Quantum Asset Management Pty Ltd v Love Properties (WA) Pty Ltd*[2] and *Yarra Capital Group Pty Ltd v Sklash Pty Ltd*.[3]

***Quantum Asset Management Pty Ltd v Love Properties (WA) Pty Ltd* [2017] WASC 167**

Quantum Asset Management Pty Ltd (**Lender**) provided a short-term loan facility to Love Properties Pty Ltd (**Borrower**) secured by second registered mortgages over properties owned by the Borrower and Mr Love. The Lender agreed to advance $245,000 for a term of seven months. Under the loan facility, a higher rate of 14.75% per annum was payable for the first 4 months of the loan (**Period A**) unless the Borrower was not in default where they would pay a lower rate of 9.75% per annum. If the Borrower failed to repay the loan in 4 months, then the interest rate would jump to 4.43% per month (53.16% per annum) until full repayment (**Period B**). The Borrower defaulted on the loan and the Lender commenced proceedings.

At first instance, the Court granted a summary judgement in favour of the Lender, ordering the Borrower to pay over $660,000 plus interest at a daily rate of $952.31 and costs. The Borrower argued that the increase interest from Period A to Period B (being from 9.75% per annum to 53.16% per annum) invoked the penalty principle and therefore the facility was unenforceable.

On appeal, the Court asked: did the inclusion of the Period B interest rate have a purpose other than to punish the Borrower in the event of late payment? Does the Lender have an interest that explains the Period B interest rate?

The Court found in the affirmative for the following reasons (among others)[4]:

1. The nature of the facility was high risk and in the short-term money market;
2. Both parties were experienced and commercially sophisticated;
3. The Lender 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. The Lender explained why this particular loan had added risk which led it to seek a higher return than usual;
4. The Lender needed to protect its interest in receiving repayment on time. It had an interest in maintaining its targeted return and in pursuing opportunities to reinvest funds in the short-term market and at high interest rates; and
5. The annualised Period B rate was only slightly more than the annualised blended (fees and interest) Period A return of 52.68% per annum. The Period B rate of 53.16% per annum was not exorbitant or extravagant in those circumstances.

Ultimately, the Court held that the Period B rates had a legitimate purpose of protecting the Lender's interests, were not out of proportion to that interest and cannot be said to only operate as a punishment. The Court dismissed the appeal.

Yarra Capital Group Pty Ltd v Sklash Pty Ltd [2006] VSCA 109

Yarra Capital Group Pty Ltd (**Borrower**) entered into a series of short-term loans with Sklash Pty Ltd (**Lender**). As an example, one loan was for $100,000 for a period of two months and there was a one-off fee of $20,000 (which annualised approximately 120% of the principal). Upon expiry of the term, there was a daily default fee of $328.50 for each day that the loan remained outstanding (which annualised approximately 120% of the principal). A second loan was for $115,000 for a period of two months with a one-off fee of $10,000 (which annualised 52% of the principal) and a daily default charge of $450 (which annualised at 143%). The Borrower argued that the default interest comprised a penalty.

The Master granted summary judgment in favour of the Lender. The Borrower appealed. The Court of Appeal did not consider it reasonably arguable that the default provisions were so out of proportion with loss as to be characterised as oppressive, for the following reasons (among others):[5]

1. The loans were intended to be for short terms;
2. The loans were essentially unsecured and one would expect high rates of interest. The annualisation of the default rate expressed as a percentage of the principal unfairly exaggerates the default provision;
3. The amount of the fee indicates the expected earnings during the period of the term and reflects the minimum loss the Lender was likely to suffer; and
4. It would be difficult and expensive to determine the quantum of damage that might arise by reason of breach given the market in which the parties operated. As the rate was agreed by both parties, it precluded the need for a complex examination.

The Court did not find that the default fees of the Lender's short-term loans constituted penalties.

Key Takeaway for Lenders

In essence, the Court will determine on a case-by-case basis whether a higher interest rate charged by a lender constitutes a penalty. The Court will generally consider the following factors (among other things) :

1. The nature and risk of the loan facility;
2. The term of the loan;
3. Whether the parties are experienced and commercially aware; and
4. The interests that the lender is required to protect.

Interest Rate Caps in Consumer Lending: *National Consumer Credit Protection Act*

In contrast, for consumer lending, the *National Consumer Credit Protection Act* 2009 (Cth) *('**NCCP**')* provides that a credit provider must not enter into a credit contract if the annual cost rate of the contract exceeds 48%.[6] If credit is provided to a consumer with an interest rate of greater than 48%, the consumer is not liable to pay any fees or charges to the creditor in relation to the credit assistance.[7] If the consumer has already paid fees or charges to the creditor, the consumer may recover as a debt due to the consumer.[8]

Summary

- A penalty is an amount paid for the failure to fulfil a contractual obligation by an obligor;
- In the two cases outlined above with respect to commercial lending, the Court generally found that the higher interest rates charged by the respective lenders (both over 50% p.a.) were not penalties as they were both short-term and high risk commercial loans;
- In determining whether a higher interest rate charged is a penalty, the Court will consider each case on its own merits but will generally look at factors including nature and risk of loan, term of loan, whether the parties are commercially aware and the lender's interests; and

- In contrast, for consumer lending, the *NCCP* has an interest rate cap of 48%.

For further information relating to higher interest rates and penalty clauses, please contact Banking and Finance Partner, Greg Conomos.

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

[2] [2017] WASC 167.

[3] [2006] VSCA 109.

[4] *Quantum Asset Management Pty Ltd v Love Properties (WA) Pty Ltd* [2017] WASC 167 [81]-[91].

[5] *Yarra Capital Group Pty Ltd v Sklash Pty Ltd* [2006] VSCA 109 [15]-[17],[22] (Chernov J).

[6] Schedule 4 Division 4A section 32A(1) of the *Consumer Credit Legislation Amendment (Enhancements) Act 2012* which amends the *National Consumer Credit Protection Act* 2009 (Cth).

[7] *Consumer Credit Legislation Amendment (Enhancements) Act 2012* (Cth) s 32A(3)(a).

[8] Ibid s 32A(3)(b).