

Banking & Finance Brief June 2009

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Penalties - The When, What and Importance of Penalties

The recent Court of Appeal decision in *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Limited* provides a timely reminder of the law surrounding the “doctrine of penalties”.

When does a penalty arise?

Generally the issue arises where a contract term provides for the payment of an agreed sum of money by way of (liquidated) damages if the contract is breached.

Whether a contract term is a penalty is often decided by looking at the purpose of the term. Is it a genuine pre-estimate of the damage arising from the breach, or is it designed as a deterrent (threat) to ensure that one party meets its obligations under the contract? If it is a deterrent then, as a result of the UK decision of *Dunlop Pneumatic Tyre Company Limited v New Garage & Motor Co Limited*, it is likely to be a penalty as the agreed sum is not a genuine pre-estimate of the damage suffered.

What is a penalty?

The test in considering if a contract term is a penalty rather than a genuine pre-estimate of loss will depend on the circumstances in each case. Each case is judged on its own merits at the time the contract is entered into, not at the time of the breach.

The doctrine of penalties can extend beyond claims for money to include claims for property.

The *Dunlop* case sets out some important factors that a court will consider:

- What is the intention and effect of the contract term, regardless of any agreement by the parties on what constitutes “liquidated damages”?
- Are the damages payable a genuine pre-estimate of the loss? It will be a penalty if they are extravagant / unconscionable in comparison to the greatest loss that could have resulted from the breach.
- Is one lump sum payable by way of compensation whether the event is a single event or one of several events (some serious some not serious)? If so then the term is likely to be considered a penalty.

Why is it important?

An agreement for payment of agreed (liquidated) damages following on a breach of contract sets out the basis for the calculation of damages.

If the contract term is a genuine pre-estimate of the damage arising from the breach, there is no need to prove the damages in court. This can be useful where a pre-estimate and/or calculation of damages is difficult.

If the contract term is a penalty, while a claim can still be brought, it must be for unliquidated damages that require evidence and can often result in a reduced claim.

The current position

The Interstar decision confirms the law of penalties set out by the High Court in *Ringrow v BP Australia*. In *Ringrow*, the High Court held that a penalty had to be "extravagant and unconscionable in amount". It is not enough that the term is lacking in proportion – that is the amount payable under the term may be more than the absolute maximum loss that could flow from it - it must be "out of all proportion".

The *Ringrow* and *Interstar* decisions also indicate that a clause can only be classified as a penalty if it applies following a breach of the contract. Where one party agrees to pay the other a sum of money on the occurrence of a specified event that is not a breach of the contract, it could perhaps be argued it is not a penalty.

Practical Application for banking and finance

There are 2 main areas where the doctrine of penalties may apply:

- Default interest rates charged by the lender and by implication the circumstances surrounding when the lender can charge such interest rates. Borrowers / mortgagors may argue that the lender's default rate is a penalty. In such cases the court will assess each default interest rate on its merits.
- Fees and charges, often described as "risk fees" or "success fees", payable by the borrower to the lender on the occurrence, or non occurrence of certain events. The lender will need to show the fees and charges are approximate to its loss arising from the borrower's default. A lump sum payment may constitute penalty.

Possible strategies to reduce penalty claims

Some suggestions on possible ways to best reduce penalty claims:

- Refer to a fee or charge as consideration for the provision of something by the lender, not a sum being imposed for a breach.
- The amount due as a result of a breach should be close but not necessarily equal to the genuine estimate of damages likely be caused by the breach.
- Minimise the imposition or charging of liquidated damages for trivial breaches of contract.
- Have the parties to the contract expressly agree that the liquidated damages are not extravagant and unconscionable and are a genuine pre-estimate of loss.

By Rafe Nottage, Senior Associate

Recent Cases

Bank of Western Australia v Salmon (No 2) [2009] NSWSC 226

This case illustrates how a statement by a bank manager may be used to allege that one of its security documents is not enforceable.

Mr Salmon claimed his bank manager told him that his guarantee would not be called upon until the real property securing the loan was sold and asserted that the guarantee was unenforceable because of that representation or because it was unjust under the *Contracts Review Act*.

The Court found no evidence to corroborate Mr Salmon's allegation that the representation was made and found that all the contemporaneous documentation favoured the bank officer's version of events.

Judgment was ordered in favour of the bank.

Commonwealth Bank of Australia v Serobian [2009] NSWSC 302

Section 38(1) of the *Conveyancing Act 1919* (NSW) provides that "Every deed, whether or not affecting property, shall be signed as well as sealed, and shall be attested by at least one witness not being a party to the deed; but no particular form of words shall be requisite for the attestation".

Reliant upon that section the defendants argued that the mortgage they gave to the Bank was void or liable to be set aside because their signatures were witnessed by an officer of the bank.

The Court dismissed this argument and held that a bank officer witnessing the signing of documents does so in a personal capacity and not as a representative of the bank. Further, even if the mortgage was not witnessed in the prescribed manner, it was registered on title and created an indefeasible interest in the land in favour of the bank.

Valstar v Silversmith [2009] NSWCA 80

Can changes to security documents render them unenforceable?

Here the respondents (two directors of a company) had been discharged from their obligations as guarantors by reason of variations to their company's mortgage made without their consent. The company entered into a loan with Valstar in 2003. After that time, two variations were made on the mortgage and these variations were endorsed by the respondents as guarantors. In October 2004, both respondents resigned as directors of the company. Sometime later, a third variation was made on the mortgage, which neither of the respondents signed. A fourth variation was then made, and was signed by one of the respondents in his capacity as company secretary. Finally, a fifth variation was made (which increased the principal sum of the mortgage and also increased the interest rate), which was signed by neither respondent.

In 2006, the company defaulted on its mortgage. Property which was put up as security was sold but there was a shortfall so Valstar commenced proceedings against the respondents as guarantors.

One principle that was relied upon as a defence by the respondents is known as the *Ankar* principle. This is the principle that states that any departure by the creditor from the suretyship contract which is not obviously and without inquiry quite unsubstantial, will discharge the surety from liability, whether it injures him or not, for it constitutes an alteration in the surety's obligations. Such an alteration takes place when the creditor agrees to a variation of the principal contract or to an extension of time within which the debtor may comply with that contract. The creditor's agreement with the debtor thereby alters the nature of the surety's obligations without the surety's consent.

Valstar submitted two arguments against this defence: the first, that since the respondents were liable as principals under the mortgage, and since the *Ankar* principle is available only to sureties, the respondents could not rely on the *Ankar* principle to discharge them from their liabilities; and the second, that by providing that the Mortgage was to take effect as if entered into by the guarantors, a "principal debtor's clause" in the mortgage prevented the *Ankar* principle operating.

The court found that neither of these arguments could be sustained. The first could not be sustained because Valstar, in their first instance trial, had unambiguously alleged that the respondents were liable to the appellant as guarantors. However the court suggested that had Valstar argued their case differently (by pleading that the respondents were also liable as principals) then the outcome might have been different. The court found that the second argument could not be sustained because a "principal debtor's clause" in a mortgage does not have the effect of excluding the *Ankar* principle where the appellant agrees to advance further moneys to the company pursuant to the terms of the Mortgage. The court ultimately found for the respondents, emphasising that the very point of the equitable *Ankar* principle is to discharge sureties from obligations by reason of agreements or other transactions to which they were not parties, as occurred in this case.

In this case, the court considered whether variations made to a principle loan agreement without the consent of the guarantors had the effect of releasing the guarantors from their obligations. Much weight was given to the principle expounded in the High Court's decision in *Ankar Pty Ltd & Arnick Holdings Ltd v National Westminster Finance (Australia) Ltd* (1987) 162 CLR 549. In essence, the *Ankar* principle provides that conduct of the creditor, in the absence of consent, will discharge the surety if it affects the surety's rights in a way that is not insubstantial. This was held to be applicable here, and as a consequence the lender was unable to call upon the guarantees given prior to the variation of the loan agreement.

The lender attempted to avoid the application of the *Ankar* principle by alleging that the guarantors were also liable as principle debtors, whereas *Ankar* applied only to sureties. A clause in the loan agreement stipulated that the mortgage was to take effect as if entered into by the guarantors as a further mortgagor. However, the court dismissed the notion that this required the guarantors to be regarded for all purposes as principal debtors so as to avoid the operation of the *Ankar* principle. Ultimately, the lender had pleaded only their liability as guarantors. The court did consider that the case may have taken a different course if the lender had pleaded the liability of the respondents as principals, but it was considered dubious that the clause in question would have provided grounds for this.

Merim Pty Ltd v Style Pty Ltd (2009) 255 ALR 63

This case related to an application by Merim Pty Ltd to inspect the books of Style Pty Ltd under a provision of the Corporations Act 2001. Merim, a member of Style, sought to investigate, among other things, whether directors and officers of Style had exercised their powers reasonably, in good faith and for a proper purpose consistent with their statutory and fiduciary duties. This followed a downturn in Style's revenue and its failure to respond satisfactorily to Merim's requests for information. Merim successfully obtained the desired order. However, the court demonstrated that it will be careful to limit the scope of the order only to those documents falling within categories for which a sufficient case for investigation has been established.

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