-SUPREME COURT OF QUEENSLAND

CITATION:	*Beil & Anor v Pacific View (Qld) Pty Ltd & Ors* [2006] QSC 199
PARTIES:	**DESMOND THOMAS BEIL & DAJAD PTY LTD (ACN 009 979 284)** (plaintiff/applicant) **v** **PACIFIC VIEW (QLD) PTY LTD (ACN 057 301 907)** (first defendant) and **GARY FRANCIS JOHNSTONE** (second defendant) and **KAY ELIZABETH JOHNSTONE** (third defendant) and **NEIL RAYMOND MANSELL** (fourth defendant/respondent) and **FAY CATHERINE MANSELL** (fifth defendant/respondent) and **STEVE MICHAEL PROWSE** (sixth defendant) and **LEE-ANNE PATRICIA PROWSE** (seventh defendant) and **GHERK PTY LTD (ACN 050 408 958)** (eighth defendant) and **PARKLANDS BLUE METAL PTY LTD (ACN 010 471 548)** **(**ninth defendant/respondent)
FILE NO:	BS1494 of 2001
DIVISION:	Trial
PROCEEDING:	Trial
ORIGINATING COURT:	Supreme Court of Queensland
DELIVERED ON:	18 August 2006
DELIVERED AT:	Brisbane
HEARING DATE:	7 August 2006

JUDGE: Chesterman J

ORDER: **Judgment for the plaintiff against the fourth, fifth and ninth defendants in the sum of $166,661.95.**

CATCHWORDS: CONTRACTS – GENERAL CONTRACTUAL PRINCIPLES – CONSTRUCTION AND INTERPRETATION OF CONTRACTS – PENALTIES AND LIQUIDATED DAMAGES – GENERAL PRINCIPLES – mortgage granted by first defendant in favour of plaintiff with interest to accrue at 10% per annum – second to ninth defendants gave guarantees to support repayment of the loan – mortgage varied by later agreement with interest to accrue at 16% per annum and on default at 25% per annum – construction – penalties – whether provision for default rate is unenforceable as a penalty

Beil & Anor v Pacific View (Qld) Pty Ltd & Ors [2003] QSC 43, cited
Burton v Slattery (1725) 2 ER 648, considered
Cine Bes Filmcilik ve Yapimcilik v United International Pictures [2003] EWCA Civ 1669, cited
David Securities Pty Ltd v Commonwealth Bank of Australia (1990) 23 FCR 1, followed
Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd [1915] AC 79, applied
General Credit & Discount Co v Glegg (1883) 22 Ch D 549, considered
Lady Holles v Wyse (1693) 23 ER 787, cited
Lordsvale Finance plc v Bank of Zambia [1996] QB 752, followed
Murray v Leisure Play Plc [2005] EWCA Civ 963, cited
Ringrow Pty Ltd v BP Australia Ltd (2005) 80 ALJR 219, followed
Robophone Facilities Ltd v Blank [1966] 1 WLR 1428, considered
Wallingford v Mutual Society (1880) 5 App Cas 685, considered

COUNSEL: Mr M Martin for the plaintiffs
Mr L Kelly SC with him Mr G Coveney for the fourth, fifth and ninth defendants
No appearance for the first to third and sixth to eighth defendants

SOLICITORS: North Coast Law for the plaintiffs
CBD Lawyers & Corporate Advisors for the fourth, fifth and ninth defendants
No appearance for the first to third and sixth to eighth defendants

[1] The plaintiffs owned two vacant blocks of land situated on the Sunshine Coast which had been approved for high rise development. In 1993 they transferred the

land to the first defendant for a consideration of $425,000. It mortgaged the land in favour of the plaintiffs to secure payment of the purchase price. $175,000 only of the price was to bear interest at ten per cent. The first defendant intended to construct home units on the land and sell them for a profit. The plaintiffs became shareholders in the first defendant so that they could participate in the profits. Repayment of the loan was due by 31 December 1995.

[2] The development was unsuccessful and the anticipated profits did not eventuate. The mortgage to the plaintiffs was subordinated to a mortgage securing moneys borrowed to finance the development. As units were constructed and sold the plaintiffs gave partial releases of the mortgage to allow the buyers to get clear title.

[3] On 23 November 1995 the plaintiffs and the first defendant varied the mortgage. The variation was registered on 29 November 1995. By cl 1 of the varied mortgage:

> 'The parties acknowledge and agree that as at the 14th November 1995 the amount of $425,000 … remains outstanding with respect to [principal] and the amount of $80,808 … is outstanding with respect to interest under the Mortgage.'

[4] By cl 2 the plaintiffs and first defendant agreed:

> 'The mortgage is to be varied from the 14th November 1995 as follows:-
>
> (a) The balance outstanding as at the 14th November 1995 is $505,808 …;
>
> (b) Interest shall be paid on the outstanding [principal] from time to time calculated from the 14th November 1995 to the date of repayment … at the rate of 10% per annum. Subject to clause (e), [principal] and interest shall be paid in accordance with Clause (c);
>
> (c) The parties acknowledge that [the first defendant] intends to construct a high rise building unit development on the Land (the Construction) and after Construction, intends to sell the individual building units … progressively repaying:
>
> (i) Firstly, any monies outstanding to a first registered mortgagee;
>
> (ii) Secondly, in payment of any interest outstanding to [the plaintiffs] …
>
> (iii) Thirdly in payment for any [principal] outstanding to [the plaintiffs] …
>
> (d) …

> (e) [The first defendant] shall be in default … and all monies outstanding, including interest shall become repayable on demand in the event that:-
>
> (i) Substantial commencement of the building unit project has not proceeded by the 31st August 1996 …
>
> (ii) All of the monies including interest are not repaid by [the first defendant] to [the plaintiffs] on or before the 30th June 1997'.

[5] The rate of interest payable remained at ten per cent.

[6] At about this time the second to ninth defendants executed a guarantee to support the repayment of the loan by the first defendant. The second, third, sixth, seventh and eighth defendants all had an interest in the first defendant by which they intended to profit from the development. The fourth and fifth defendants became shareholders in the first defendant at about the time of the variation and they too became guarantors. The ninth defendant is a company owned and controlled by the fourth and fifth defendants (who are husband and wife).

[7] The guarantee recited that:

> 'The [plaintiffs have] at the request of the guarantor lent to [the first defendant] … ("the borrower") a loan … the details of which are set forth in a Bill of Mortgage No. L790161F as varied ("the deed").'

And:

> 'The guarantor has agreed to guarantee to the [plaintiffs] the due performance by the borrower of the whole obligations of the borrower and has agreed to indemnify the [plaintiffs] in respect of any default on the part of the borrower'.

By cl 4 the guarantors:

> '… jointly and severally [guarantee] to the [plaintiffs] the due performance by the borrower of the obligations of the borrower set forth in the deed including but without prejudice to the foregoing generality the obligations concerning payment, repayment and interest.'

By cl 5 it was agreed that:

> 'The guarantee shall be a continuing guarantee for the purpose of securing the performance of the whole obligations of the borrower in the deed notwithstanding any partial performance thereof.'

By cl 6 the guarantors agreed that they should:

> '… not be released in whole or in part from [their] obligations … by virtue of the following namely:

…

(d) any variation to the terms of the deed.'

[8] In October 1997 the mortgage was again varied by agreement between the plaintiffs and the first defendant as and from 1 September 1997. By the variation the parties acknowledged that as at that date the following amounts remained outstanding under the mortgage:

(a)	Principal	$425,000.00
(b)	Outstanding interest to 13 November 1996	$131,388.80
(c)	Outstanding interest from 13 November 1996 to 31 August 1997	$44,358.67
(d)	Penalty interest for delayed payment	$50,000.00
	Total	$650,747.47

The parties further agreed that interest at the rate of ten per cent was to be calculated and paid on the principal and outstanding amounts of interest. The date for repayment was set for 4 April 1998. The moneys were not paid.

[9] On 8 September 2000 the plaintiffs and the first defendant made a separate agreement. It provided:

'Whereas: -

A The Lender has made available to the Borrower certain loan facilities to assist the Borrower in the development of a strata title building known as Beachside, Buddina;

B The terms of that Loan Agreement have been varied and amended between the parties from time to time the latest amendment thereof being set form in a Form 13 Amendment dated 24 October 1997 ("the latest loan document");

C The Lender has certain mortgage security over the said building known as Beachside, Buddina and the strata title lots therein remaining in the ownership of the Borrower;

D The Lender is to release the security on the sale of the remaining lots and the parties are to set forth in writing the arrangements in respect of the repayment of the balance of the loan.

Therefore it is agreed and declared as follows:

1. The amount outstanding by the Borrower to the Lender as at 21 July 2000 is agreed between the parties to be $761,936.00.

2. The Lender will release the balance of the lots within the development (those lots being Lot 6 on BUP 106576, Lot 7 on

BUP 106576, Lot 14 on BUP 106576, Lot 17 on BUP 106576 and Lot 24 on BUP 106575) provided:

(a) the sales of these remaining lots take place contemporaneously with each other and;

(b) the Lender receives not less than $540,000.00 in reduction of the loan;

(c) the Borrower places not less than $1,000,000.00 E-Banc Trade dollars at settlement in an account in name of the Borrower but for which the Lender must be a signatory before any withdrawals therefrom can be made; and

(d) the Borrower provides to the Lender an irrevocable undertaking from the Trade Exchange to the effect that the signing arrangements on the account will not vary without the consent of the Lender.

3. Interest will accrue on the loan at the rate of 16% from 21 July 2000 until repayment. Interest will be calculated on a monthly basis on the last day of each month and the interest accrued will be added to the capital of the loan at the time of calculation at the end of each month.

4. Repayment of the loan will take place not later than 31 December 2000.

5. In the event of any failure to repay the loan on the due date the interest charged on the loan by the Lender to the Borrower will increase to 25% per annum.

6. The borrower acknowledges that certain guarantees have been provided to the Lender in connection with the loan and undertakes to the Lender that each guarantor has been separately advised of the terms of this agreement and that the guarantee is not released until full repayment of the loan.'

[10] The loan was not repaid on 31 December 2000. On 6 March 2003 Holmes J (as her Honour then was) gave judgment for the plaintiffs against the first, second, third, fourth, fifth, eighth and ninth defendants in the amount of $761,936 for principal and interest in the sum of $319,972: see [2003] QSC 43. Interest was calculated on the basis of a simple rate of interest at 16 per cent. Her Honour gave leave to defend the claim for compound interest at 25 per cent.

[11] The plaintiffs had discontinued its action against the seventh and eighth defendants. They have come to an accommodation of some sort with all the defendants other than the fourth, fifth and ninth defendants. They satisfied the judgment pronounced by Holmes J by paying $1,081,908 to the plaintiffs on 24 April 2003. The defendants resist the claim which the plaintiffs have now brought to recover additional interest.

[12] The defendants (as I will call the fourth, fifth and ninth defendants) contend that cl 5 of the agreement of 8 September 2000 ('the agreement') is unenforceable because it is a penalty. They accept that they are liable to pay interest at the rate of 16 per cent calculated on monthly rests on the amount outstanding after the satisfaction of the judgment.

[13] Before dealing with the authorities something should be said about the facts. Mr Beil gave evidence for the plaintiffs. His testimony was most unsatisfactory. He was deliberately evasive to the point of dishonesty. Nothing turns upon that observation for the parties' rights are to be determined by the written agreement, but two points of significance emerged from his evidence.

[14] The first is the plaintiffs did not expect that the first defendant would be in a position to pay the amount promised by the due date, 31 December 2000. It follows that there was no increase in risk after that day when the first defendant did make default than there was when the agreement was made in September. The event which transformed the obligation to pay interest from one at 16 per cent to one at 25 per cent was one which the plaintiffs foresaw and expected when they agreed that 16 per cent was an appropriate rate of return on their outstanding loan. The second point is that when the defendants became shareholders in the first defendant and guarantors of its indebtedness they were represented to the plaintiffs as being people of substantial financial worth. The representation was obviously true as their satisfaction of the judgment demonstrates. When the agreement was made the plaintiffs expected that the defendants would be good for the first defendant's default.

[15] There is no explanation for the delay between 31 December 2000 when the money was due and March 2003 when summary judgment was sought and obtained. Nor is there any explanation advanced for the further delay of three years in bringing this short trial on for a hearing.

[16] The interest rate under the mortgage and variations to it was 10 per cent. It became 16 per cent in the agreement and was to become 25 per cent in the event of default. According to Mr Van Homrigh's report the indicator lending rates for the period January 2000 to January 2001 for small businesses ranged from 8.7 per cent for term loans to 10.1 per cent for small overdrafts. The variable interest rate for an unsecured term loan at December 2000 was 13.5 per cent. It was 11.85 per cent for a fixed unsecured term loan. Note these were for unsecured loans. Depending on circumstances of borrower and security offered a margin on top of the indicated rates may have been imposed by some lenders. I note from the schedule attached to Mr Van Homrigh's report that for the year in question the rate of interest charged on credit card debt was 16.7 per cent.

[17] Evidence was led from Mr Schultz, an experienced financier with extensive knowledge of lending to developers, particularly by second mortgagees who lend what has been called 'mezzanine finance'. It is, by its nature, riskier than lending by a financial institution, which lenders secure their positions by first registered mortgages at the least. The 'mezzanine' financiers are subordinated to those mortgages and depend upon the success of the development for their repayment. As Mr Schultz picturesquely put it such a financier is 'betting the farm' on the outcome of the development.

[18] Mr Schultz' evidence was:

> 'Mezzanine financing is … risky.
>
> … Mezzanine financiers typically take a second mortgage over the land to be developed. However, once construction begins, there is generally so much debt on the project that the value of the land is largely immaterial … The mezzanine financier is generally totally subordinated to the interests of the [first mortgagee].
>
> … Prior to committing finance to a project, a full risk analysis is performed.
>
> … The function of the … analysis is to ascertain … whether a project is viable … and … if it is, what the appropriate pricing level is having regard to the risk.
>
> … A non-exhaustive list of the factors considered when performing a risk analysis … include:
>
> the developer
>
> …
>
> the project …
>
> …
>
> [I]f a project is viable, the risk analysis will be the guide for what is an appropriate rate of interest …'

[19] Mr Schultz concluded:

> '… [A]n increase in rate from 16% to 25% within 3 months appears to bear no correlation whatsoever to the earlier risk analysis …
>
> … In my experience the typical default rates for these types of loans are in the range of 2% to 4%. This increase is intended to cover the significant additional costs of managing the continuing risk of exposure which are incurred in a default situation.
>
> … In 40 years the highest default rate I have encountered was in the order of 5%. I have never encountered a default rate increase of 9% …'

[20] The plaintiffs called evidence from Mr Maynes, a forensic accountant, who could give limited evidence about interest rates. He was not a financier and had no first-hand knowledge of development or mezzanine finance. He could say only that the National Australia Bank lent money to his practice at a rate of 7.9 per cent which would increase to 14.6 per cent should he default in making payments pursuant to the loan agreement. Nothing was proved about the risk of that particular transaction or what security was offered or what amount was borrowed.

[21] Mr Maynes had also made some superficial enquiries of a company which he identified only as Asset Loan Co which lends money for periods from one to six months at interest rates on first mortgage from 30 per cent to 47.4 per cent per annum. Should it lend on second mortgage it charges interest rates of between 36 per cent and 71.4 per cent per annum. Should a borrower default it is charged an additional 60 per cent per annum. That company has its place of business on the Gold Coast and was described as a 'lender of last resort'. Other epithets come to mind.

[22] I do not consider that Mr Maynes' evidence is of any assistance in determining the reasonableness of the rate of interest specified in the agreement with which I am concerned.

[23] The defendants' counsel submit that cl 5 of the agreement 'contravenes the rule recognised for over 300 years … that, if a mortgagee wishes to stipulate for a higher rate of interest in default of punctual payment he … must reserve the higher rate as interest payable under the mortgage and provide for its reduction in case of punctual payment'. The earliest case cited is *Lady Holles v Wyse* (1693) 23 ER 787. The rule was certainly recognised *Wallingford v Mutual Society* (1880) 5 App Cas 685 at 702:

> 'The form adopted long since … in mortgages, was when you wished to reserve in reality interest at 4 per cent., to reserve the interest by contract at 5 per cent., but to mitigate the severity of that contract in the event of the money being paid by a certain day. It is not a penalty on non-payment (though it seems a fine distinction) when you say that your contract shall be made for interest at 5 per cent. to be reduced, in the event of your punctual payment, to 4 per cent.; but it is a relaxation of the terms of that original contract, not taking it by way of penalty at all … If that definite and fixed time were exceeded, then the original contract revived in all its force. Sometimes mortgage deeds, being somewhat unskilfully drawn, interest at 4 per cent. was reserved by the contract to be raised to 5 per cent. if there was non-payment at a particular day; and although that brings the case to an extremely fine and nice distinction, it all the better illustrates the rule which has been applied at all times by the Courts, with reference to this question of penalty.'

[24] The authors of *Fisher & Lightwoods Law of Mortgage* (2nd Australian edition) say (at [3-18]):

> 'It is a well settled, if not an intelligible, rule that if the mortgagee wishes to stipulate for a higher rate of interest in default of punctual payment he must reserve the higher rate as the interest payable under the mortgage and provide for its reduction in case of punctual payment: *Strode v Parker* (1694) 2 Vern 316; 23 ER 804. An agreement to pay a higher rate for non-payment at the appointed time is considered to be a penalty against which equity may give relief: *Wallingford v Mutual Soc* (1880) 5 App Cas 685 …
>
> Lord Eldon criticised this distinction as preferring form over substance as early as 1802: *Seton v Slade* (1802) … 32 ER 108 at

> 111. The distinction is now too well entrenched to be altered: *Meredith* (1916) 32 LQR 420; *O'Dea v All States Leasing System (WA) Pty Ltd* (1983) 152 CLR 359 at 366-7; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 23 FCR 1 at 29 …'

[25] The starting point in any consideration of the law concerning penalties is, of course, the judgment of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79. His Lordship said (at 86-87) by way of 'various propositions … deducible from the decisions which rank as authoritative':

> '2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage …
>
> 3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach …
>
> 4. To assist this task of construction various tests have been suggested, which … may prove helpful, or even conclusive. Such are:
>
> (a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach …
>
> (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid … This though one of the most ancient instances is truly a corollary to the last test …'

[26] Lord Dunedin's second illustration appears entirely apposite. The loss the plaintiffs would suffer in the event that the first defendant defaulted, as it did, in repaying the loan on 31 December 2000 was the sum that should have been paid with accruing interest at the agreed rate of 16 per cent. The event of default did not increase the plaintiffs' loss.

[27] Moreover the interest rate payable on default is, on its face, exorbitant. Twenty-five per cent is a very high rate of interest though the circumstances in some cases may justify it. In this case nothing is put forward by way of justification. The rate is 9 per cent above that which the parties thought it fit to recompense the plaintiffs for the use of their money. That substantial increase is not underwritten by any increase in risk beyond that which was foreseen when the agreement was made. The plaintiffs at all times knew, or expected, that the defendants, if not the other guarantors, would make good the first defendant's default if called on to do so. The default rate of interest is more than double the indicator lending rates to small business for unsecured loans which were prevailing at the time. The rate of 16 per cent, about which no complaint is made, is itself a very substantial rate when

compared with the indicator rates. Mr Schultz' evidence suggests that the default rate, being 9 per cent above the ordinary rate, is excessive.

[28] Mr Van Homrigh calculated the effect on the nominal rate of interest by the obligation to compound it on monthly rests. By calculating interest on a monthly basis a nominal rate of 25 per cent becomes in effect 28.07 per cent per annum.

[29] No evidence was led by the plaintiffs to indicate that they would suffer a loss, in addition to the loss of interest at 16 per cent should the loan not have been repaid on the due date of 31 December 2000. There was no evidence that the increase in interest rates by 9 per cent was in any way a pre-estimate of any such loss. If one looked only at the terms of the agreement one would conclude that the plaintiffs' loss in the event of default was the principal and interest on that principal at 16 per cent being the amount which the first defendant should have paid. If by reason of the default the plaintiffs should have suffered some further, additional loss, not arising from the circumstances of the contract but within the contemplation of the parties, an onus of proof rested on the plaintiffs to establish that special loss and that it was within the defendant's contemplation, or at least the first defendant's contemplation.

[30] This was made clear by the judgment of Diplock LJ in *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428 at 1447-8:

> 'The onus of showing that such a stipulation is a "penalty clause" lies upon the party who is sued upon it. The terms of the clause may themselves be sufficient to give rise to the inference that it is not a genuine estimate of damage likely to be suffered but is a penalty … Thus it may seem … that the stipulated sum is extravagantly greater than any loss which is liable to result from the breach in the ordinary course of things, i.e., the damages recoverable under the so-called "first rule" in *Hadley v Baxendale*. This would give rise to the prima facie inference that the stipulated sum was a penalty. But the plaintiff may be able to show that owing to special circumstances outside "the ordinary course of things" a breach in those special circumstances would be liable to cause him a greater loss of which the stipulated sum does represent a genuine estimate. In the absence of any special clause … this enhanced loss … would not be recoverable … as damages for the breach under the so-called "second rule" … unless knowledge of the special circumstances had been brought home to the defendant at the time of the contract' (footnotes omitted).

[31] As I say no attempt was made to prove the existence of special circumstances or that they were brought to the attention of the first defendant.

[32] Notwithstanding the confidence with which the authors of *Fisher & Lightwood* expressed the rule there are reported cases in which an increase in the rate of interest made payable on the default in repaying the loan has been upheld and not regarded as a penalty.

[33] In *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 23 FCR 1 (reversed on other grounds (1992) 175 CLR 353) a loan agreement provided that if

the borrower failed to pay an amount on its due date the borrower should on demand pay interest on the overdue amount at a rate of 1.5 per cent in addition to the interest rate ordinarily payable. The court thought (at 30) that there was 'a long line of authority which indicates that the additional interest will not be considered as a penalty, but rather as a liquidated satisfaction fixed and agreed on by the parties as compensation for the lender being kept from his money.' The 'line of authority' consisted of two cases, one decided in Ireland in 1725 (*Burton v Slattery* (1725) 2 ER 648) and *General Credit & Discount Co v Glegg* (1883) 22 Ch D 549, and two nineteenth century Canadian cases. I would not myself place much reliance upon an Irish case of such antiquity. *Glegg* is unsatisfactory. No reasons were given for the conclusion which was, in any case, that the contract in question was not one 'for paying additional interest' but was a contract 'to pay commission … a thing wholly separate from the contract to pay interest.'

[34] The authorities on this point were thoroughly and helpfully analysed by Colman J in *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752, who noted (at 762) that in *Wallingford* Lord Hatherley had 'repeated … the rule that, at least in mortgages, an increase in the rate of interest upon default was treated as a penalty …'. He went on (at 762-763):

> 'The speeches in *Dunlop Pneumatic* … show that whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether, at the time the contract was entered into, the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for the breach. That the contractual function is deterrent rather than compensatory can be deduced by comparing the amount that would be payable on breach with the loss that might be sustained if breach occurred.'

[35] Colman J reviewed cases in England, America and Canada as well as *David Securities* in his consideration of whether a requirement that a defaulting borrower pay an additional one per cent interest was unenforceable as a penalty. He concluded (at 766-767):

> 'While fully accepting that the English authorities can hardly be described … as a "long line of authority" … and that none of those authorities is notable for its clarity of analysis … at least on three occasions since 1725 the courts have been prepared to enforce increased rates of interest … where the increase applied as from the date of default. …
>
> In my judgment, weak as the English authorities are, there is every reason in principle for adopting the course which they suggest, and for confining protection of the creditor by means of designation of default interest provisions as penalties to retrospectively operating provisions. If the increased rate of interest applies only from the date of default or thereafter, there is no justification for striking down as a penalty a term providing for a modest increase in the rate. I say nothing about exceptionally large increases. In such cases it may be possible to deduce that the dominant function is in terrorem the borrower. But nobody could seriously suggest that a 1% rate

> increase could be so. It is … consistent only with an increase in the consideration for the loan by reason of the increased credit risk represented by a borrower in default.'

[36] That judgment has won the approval of the Court of Appeal on two subsequent occasions: *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 and *Murray v Leisure Play Plc* [2005] EWCA Civ 963.

[37] Accepting Colman J's analysis it would appear that the contractual function of cl 5 of the agreement, fixing interest at 25 per cent on default, is deterrent rather than compensatory. It is a substantial inducement to the first defendant (and the guarantors) to pay on time. I have already mentioned the fact that on default the plaintiff suffered no loss greater than that for which they would have been compensated by payment of interest at 16 per cent.

[38] The High Court most recently reviewed the relevant principles in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 80 ALJR 219. The court confirmed (at [10]) that:

> 'The law of penalties, in its standard application, is attracted where a contract stipulates that on breach the contract-breaker will pay an agreed sum which exceeds what can be regarded as a genuine pre-estimate of the damage likely to be caused by the breach.'

Their Honours then quoted the speech of Lord Dunedin including paras 4(a) and (b) which I earlier set out and continued (at [12]):

> 'The formulation has endured for 90 years. It has been applied countless times in this and other courts. In these circumstances, the present appeal afforded no occasion for a general consideration of Lord Dunedin's tests to determine whether any particular feature of Australian conditions, any change in the nature of penalties or any element in the contemporary market-place suggests the need for a new formulation. It is therefore proper to proceed on the basis that *Dunlop Pneumatic* … continues to express the law applicable in this country …' (footnotes omitted).

[39] The court went on (at [27]) to say:

> 'The principles of law relating to penalties require only that the money stipulated to be paid on breach or the property stipulated to be transferred on breach will produce for the payee or transferee advantages significantly greater than the advantages which would flow from a genuine pre-estimate of damage'.

The court emphasised that before a payment required by contract can be regarded as a penalty (at [32]):

> '… the propounded penalty must be judged "extravagant and unconscionable in amount". It is not enough that it should be lacking in proportion. It must be "out of all proportion".'

[40] *Ringrow* was a case involving not a money payment but an obligatory transfer of property as a consequence of a contractual breach. The court pointed out (at [21])

that in such cases Lord Dunedin's exposition requires a different approach. In 'typical penalty cases' the court compares what would be recoverable as liquidated damages with the sums stipulated for what is payable on breach.

[41] I am concerned with a 'typical penalty case'. I think I should accept what was said by the court in *David Securities* and by Colman J in *Lordsvale Finance* as correct. Clause 5 of the agreement will not therefore be a penalty merely because it stipulates for a higher rate of interest to be paid in the event of default. If, however, the increase is other than modest and cannot be explained by the greater risk to the lender in recovering his loan by reason of the default, or the cost of administering the loan in default, then the increase will not be justifiable. If, to adapt the language of *Ringrow*, the increase in interest will yield the lender a significant advantage over what his loss can genuinely be seen to be, the obligation to pay the increased interest will be a penalty.

[42] I have, I think, made it clear that in my opinion the increase in interest to be paid in the event of default is extravagant and, indeed, exorbitant. It cannot be described as modest. The increase is nine per cent where there is no discernible increase in risk over that which existed when the agreement was made. Clause 5 constitutes a penalty and is unenforceable.

[43] The plaintiffs are entitled to judgment for an amount which represents interest on $761,936 at 16 per cent per annum on monthly rests from 21 July 2000 to 24 April 2003 when the sum of $319,972 was paid on account of interest, and interest on the balance at the same rate and on the same rests until the date of judgment. The parties can calculate the amount.