SUPREME COURT OF QUEENSLAND

CITATION:	*Kellas-Sharpe & Ors v PSAL Limited* [2012] QCA 371
PARTIES:	**WENDY KELLAS-SHARPE** (first appellant) **GOLDIWAY PTY LTD** ACN 075 755 074 (second appellant) **OPM HOLDINGS QLD PTY LTD** ACN 118 505 641 (third appellant) **v** **PSAL LIMITED** ACN 118 825 120 (respondent)
FILE NO/S:	Appeal No 2828 of 2012 SC No 3700 of 2011
DIVISION:	Court of Appeal
PROCEEDING:	General Civil Appeal
ORIGINATING COURT:	Supreme Court at Brisbane
DELIVERED ON:	21 December 2012
DELIVERED AT:	Brisbane
HEARING DATE:	4 September 2012
JUDGES:	Margaret McMurdo P, Gotterson JA and Fryberg J Separate reasons for judgment of each member of the Court, each concurring as to the orders made
ORDERS:	**1. Appeal dismissed.** **2. Appellants to pay the respondent's costs of the appeal on the standard basis.**
CATCHWORDS:	CONTRACTS – CONSTRUCTION AND INTERPRETATION OF CONTRACTS – PENALTIES AND LIQUIDATED DAMAGES – GENERAL PRINCIPLES – where appellants and respondents entered into a loan agreement – where the standard rate of interest was 7.5 per cent per month but, while the borrower is not in default, the concessional rate of interest at 4 per cent per month applies – where the appellants argue that the rule that a concessional rate of interest for prompt payment is not a penalty ought to be discarded and not applied – whether the clause is a penalty with the consequence that the interest rate provision is void

Australian Securities and Investments Commission Act 2001 (Cth), s 12CC
Property Law Act 1974 (Qld), s 84

Accom Finance Pty Ltd v Mars Pty Ltd (2007) 13 BPR 24; [2007] NSWSC 726, cited
Acron Pacific Ltd v Offshore Oil NL (1985) 157 CLR 514; [1985] HCA 63, cited
Andrews v Australia and New Zealand Banking Group Ltd (2012) 86 ALJR 1002; (2012) 290 ALR 595; [2012] HCA 30, cited
Astley v Weldon (1801) 2 Bos & P 346; (1801) 126 ER 1318; [1801] EngR 108, cited
Bay Bon Investments Pty Ltd v Selvarajah [2008] NSWSC 1251, cited
Beil v Mansell (No 2) [2006] 2 Qd R 499; [2006] QSC 199, cited
Brett v Barr Smith (1919) 26 CLR 87; [1919] HCA 4, cited
David Securities Pty Ltd v Commonwealth Bank of Australia (1990) 23 FCR 1; (1990) 93 ALR 271; [1990] FCA 148, considered
Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79; [1914] UKHL 1, cited
Export Credits Guarantee Department v Universal Oil Products Co [1983] 1 WLR 399; [1983] 2 All ER 205, cited
Farah Constructions Pty Ltd v Say-Dee Pty Ltd (2007) 230 CLR 89; [2007] HCA 22, cited
Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd (2008) 257 ALR 292; [2008] NSWCA 310, cited
Kowalczuk v Accom Finance Pty Ltd (2008) 77 NSWLR 205; [2008] NSWCA 343, cited
O'Dea v Allstates Leasing System (WA) Pty Ltd (1983) 152 CLR 359; [1983] HCA 3, cited
Ringrow Pty Ltd v BP Australia Pty Ltd (2005) 224 CLR 656; [2005] HCA 71, cited
Seton v Slade (1802) 32 ER 108; (1802) Ves Jun 265; [1802] EngR 267, cited
Summer Hill Business Estate Pty Ltd v Equititrust Ltd [2011] NSWCA 149, cited
Wallingford v Mutual Society (1880) 5 App Cas 685, cited

COUNSEL: A J H Morris QC, with J P Murphy, for the appellants
M Cooke for the respondent

SOLICITORS: Porter Davies Lawyers for the appellants
Michael Sing Lawyers Pty Ltd for the respondent

[1] **MARGARET McMURDO P:** The loan agreement at the centre of this appeal provides that the standard rate of interest is 7.5 per cent per month but, while the borrower is not in default, the concessional rate of interest at 4 per cent per month applies. This appeal raises the interesting question of whether such a clause is a penalty with the consequence that the interest rate provision is void.

[2] In *David Securities Pty Ltd v Commonwealth Bank of Australia*,[1] Lockhart, Beaumont and Gummow JJ discussed the "well-known, if not much praised, distinction" between a clause providing an incentive for prompt payment and a penalty clause where the rate of interest is increased for failing to make prompt payment.[2] Their Honours referred to Mr Meredith's 1916 article, "A Nicety in the Law of Mortgage"[3] and added:

> "The distinction has been criticised as preferring form to substance, in contradiction of the preference of equity for substance over form. In *Seton v Slade* (1802) 7 Ves Jun 265 at 273–4 ; 32 ER 108 at 111, Lord Eldon LC expressed his dissatisfaction with what was already understood to be the law, in the following passage:
>
> 'So in the instance of a mortgage with interest at 5 per cent and a condition to take 4, if regularly paid; or at 4 per cent, with a condition for 5, if not regularly paid. At Law you might in that case recover the 5 per cent for it is the legal interest. But this Court regards the 5 per cent as a penalty for securing the 4; and time is no farther the essence, than that if it is not paid at the time, the party may be relieved from paying the 5 per cent by paying the 4 per cent and putting the other party in the same condition, as if the 4 per cent had been paid; that is, by paying him interest upon the 4 per cent as if it had been received at the time. So in this Court, before Courts of Law dealt with a bond, under a penalty, as they do now. Time was of the essence there: but this Court relieved against the penalty long before a Court of Law; and there are many other instances.'
>
> However anomalous, the distinction between an increase in the rate of interest (which attracts the doctrine concerning penalties), and a covenant offering an incentive by reduction of the rate upon prompt payment (which does not attract the doctrine) is well established: *O'Dea v Allstates Leasing System (WA) Pty Ltd, supra* (CLR at 366-7); *Acron Pacific Ltd v Offshore Oil NL, supra* (CLR at 518, 520); Fisher and Lightwood's *Law of Mortgage*, 10th ed, 1988, pp 47–8, 654; Sykes, *The Law of Securities*, 4th ed, 1986, pp 68–9. See also *Brett v Barr Smith* (1919) 26 CLR 87 at 94–5."[4]

[3] The appellant's contentions which criticise this long-established semantic distinction are, therefore, not new. But those in the commercial world have acted upon it for centuries. It is not for this Court to gainsay the long line of authority which supports the distinction. In any case, I am unpersuaded that the distinction has caused injustice in this case.

[4] I agree with Gotterson JA's reasons for dismissing the appeal with costs.

[5] **GOTTERSON JA**: The appellants who were the defendants in proceedings initiated by the respondent in the Supreme Court appeal against final orders made in the proceedings on 8 March 2012. There is no cross-appeal. The proceedings arose from a loan transaction.

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1 (1990) 93 ALR 271.
2 Above, 298.
3 (1916) 32 LQR 420.
4 (1990) 93 ALR 271, 298-299.

Circumstances of the loan transaction

[6] The first appellant, Wendy Kellas-Sharpe, is a registered nurse and experienced investor. Companies with which she was associated would borrow and lend money and make investments with borrowed money. She negotiated a contract dated 29 October 2009 by which the second appellant, Goldiway Pty Ltd, ("Goldiway"), a company of which she was the sole director, agreed to purchase from Receivers appointed by a mortgagee rural land at Cooroibah with an area of about 2.84 hectares.

[7] The contract price was $1 million. Deposits amounting to $100,000 were required to be paid. Settlement was to occur 45 days from the contract date, on 14 December 2009. The contract was not subject to finance. When an anticipated source of funding for the balance purchase price, namely, the repayment of a loan owed to another family company, became apparently unforthcoming, Ms Kellas-Sharpe sought external funding. Attempts to obtain a loan from bank and non-bank lenders through a Sydney finance broker proved unsuccessful.

[8] In early December 2009, a different mortgage broker introduced Ms Kellas-Sharpe to the respondent, PSAL Limited ("PSAL"). It is an unlisted public company which since 2006 has had a core business of providing short term finance to business and investment client borrowers. After it had received a revised finance application form, PSAL issued a formal letter of offer of a mortgage loan on 15 December 2009. The offer was accepted on the same day by Ms Kellas-Sharpe and Goldiway as borrowers and by another of her companies, the third appellant, OPM Holdings Qld Pty Ltd ("OPM"), as guarantor. The agreement was then formally documented.

[9] Meanwhile, the date for settlement was extended by agreement. The loan documentation was executed on 17 December 2009. The funds were advanced and settlement took place on that same day.

The loan agreement

[10] The Loan Agreement is dated 17 December 2009. The parties to it are PSAL as the Lender and Ms Kellas-Sharpe and Goldiway as the Borrower. The Principal Sum to be advanced was $1,139,368 which the Borrower was to apply to the following authorised purposes:

Business and investment	$1,000,000
Prepayment of two months interest (payable in advance)	$91,149
Loan establishment costs (including legal fees)	$48,219

[11] The Repayment Date is expressed to be two months after the date on which the Principal Sum is advanced to the Borrower. [5] That day was 16 February 2010. The following Repayment method is prescribed:

> "Two (2) months interest must be pre-paid on the Advance Date.
>
> The Borrower must repay the outstanding Debt on the Repayment Date. If the Debt is not paid by the Repayment Date, the Borrower must thereafter pay interest at the Interest Rate on a monthly basis as directed by the Lender, but this sentence is not to be taken as a consent by the Lender to extend the term of the Facility."[6]

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5 Commercial Details Schedule; and Supplementary AB p 75.

6 *Ibid*.

[12] Clause 4 of the Loan Agreement concerns interest. It contains the following provisions:

> "4.1 **Interest before Repayment date**
>
> The Borrower must pay interest to the Lender as specified as the repayment method in the Reference Schedule, at the Interest Rate on the outstanding balance of the Debt during the period from the Advance Date to the Date when the Debt is repaid in full.
>
> 4.2 **Calculation**
>
> For the purposes of clause 4.1, interest shall be:
>
> (a) payable at the Interest Rate;
>
> (b) calculated daily on the balance outstanding of the Debt at that time;
>
> (c) charged to the Loan Account on the last day of each month;
>
> (d) accrue from day to day and will be calculated on the basis of a year of 365 days; and
>
> (e) payable at such times as may be agreed between the Lender and the Borrower in writing, or failing agreement, on demand.
>
> 4.3 **Capitalisation of interest**
>
> If any payment of interest required to be paid under this Agreement or any part of it is not paid on the due date, the interest in arrears may, at the election of the Lender (without prejudice to other Rights of the Lender) be capitalised and be immediately added to the Debt and shall bear interest accordingly from the day when the interest is capitalised."[7]

[13] The term "Interest Rate" used in clause 4 is defined in Schedules to the Loan Agreement to mean:

> "The standard rate of 7.50% per month, but while the Borrower is not in default under the Facility, the Lender will accept interest at the concessional rate of 4. 00% per month.
>
> If the Borrower after the Advance Date fails within 3 Business Days to take all action requested of it by the Lender to facilitate the registration of the Lender's interest in any Security, the interest rate payable by the Borrower will be 3.50% per month higher than interest rate which would otherwise prevail."[8]

[14] This definition contains the expression "not in default". Whilst neither it nor the expression "in default" is defined in the Loan Agreement, clause 9.1 thereof contains an extensive list of circumstances which constitute Events of Default, including circumstances which might arise otherwise than through any act or neglect on the part of the Borrower.

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7 Supplementary AB 53-54.

8 Supplementary AB 75.

[15] The Loan Agreement required provision of security by way of registered mortgages over the land at Cooroibah and over other land owned by Goldiway at Killarney and by OPM at Browns Plains as well as a Deed of Guarantee and Indemnity executed by OPM, Deeds of Charge granted by Goldiway and OPM and certain chattel securities. The securities were duly given.

Repayment history

[16] The Borrower failed to repay any of the Principal sum on or before the Repayment Date. On 22 February 2010 PSAL made written demand for payment of that sum and on 18 March 2010 it gave written notice as required by s 84 of the *Property Law Act* 1974 (Qld) prior to exercise of the power of sale conferred by the collateral bills of mortgage. Unsuccessful efforts were made by the Borrower to source funds elsewhere in order to refinance and then to renegotiate the PSAL facility.

[17] Allowing for several relatively small and irregularly made payments in mid 2010 and a payment of $689,368 on 24 December 2010, at the commencement of the proceedings on 4 May 2011, PSAL claimed that the Borrower indebtedness at 20 April 2011 was $1,745,166.25. That figure had been derived by PSAL by calculating interest after the Repayment Date at the "Standard Rate of 7.5 per cent per month" which PSAL identified as having components of "Normal Interest" at 4 per cent per month and "Default Interest" at 3.5 per cent per month, and capitalising all interest in accordance with clause 4.3 of the Loan Agreement.

Proceedings

[18] By its Claim filed on 4 May 2011, PSAL sought the sum of $1,745,166.25, interest at the rate of 7.5 per cent per month on that sum from 20 April 2011, recovery of the mortgaged lands at Cooroibah and Browns Plains, and costs. The Defence alleged that the provisions in the Loan Agreement requiring payment of interest at the rates set out in the definition of the term "Interest Rate", constituted a penalty and were therefore void. It also alleged that PSAL had engaged in unconscionable conduct in providing the facility and also with respect to attempts by the appellants to negotiate a "payout" of the facility in October and November 2010. The defendants, appellants in this appeal, sought by way of counterclaim, orders that the interest provisions in the Loan Agreement and collateral bills of mortgage be read and construed as if the Interest Rate was "Two per cent (2%) per calendar month" and as if the provision for capitalisation of interest was deleted from them.

[19] After a trial over three days in February this year, the learned trial judge published reasons for judgment on 28 February 2012 in which he indicated that he proposed to make a declaration that the provisions in the Loan Agreement were unconscionable in so far as they provided for an interest rate of 7.5 per cent per calendar month and for "capitalisation of unpaid interest and payment of interest on unpaid interest", and to make orders that the Loan Agreement and the collateral bills of mortgage be read and construed as if the capitalisation provision was deleted from them and they contained the following definition in the "Commercial Details" Schedule:

> "Interest Rate: The standard rate of 5% per month, but while the Borrower is not in default under the Facility, the Lender will accept interest at a concessional rate of 4% per month."[9]

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9 Reasons [124]; AB 1038.

[20] The learned judge also indicated that he proposed to make consequential orders for calculation of outstanding indebtedness at 1 March 2012 in accordance with the interest provisions for which the declaration and other orders he proposed would provide, for release of the mortgages and other securities upon payment of the outstanding indebtedness so calculated together with interest at 5 per cent per month thereon, until the date of payment, and in default of payment of the outstanding indebtedness within 28 days of the date of the orders, for recovery of possession and entry of a money judgment in favour of PSAL.

[21] In his reasons, his Honour explained that he declined to find that the interest rate structure for which the definition of "Interest Rate" provides is a penalty under the penalty doctrine.[10] He applied the rule that an interest rate provision in which a higher rate is specified with punctual payment at a lower rate being a sufficient discharge of the obligation to pay interest, is not a penalty. Consistently with this rule, he held that the interest rate provision here is not a penalty.[11]

[22] Before his Honour, the appellants had acknowledged that if he applied the rule, it was not open to him to find the interest rate provision to be void as a penalty.[12] Although strictly it was unnecessary for him to do so, he proceeded to indicate the findings that he would have made had he not applied the rule. His frame of reference was to ask whether the appellants here, had discharged the onus of showing that the 7.5 per cent per month rate was a penalty. Adopting principles which White J of the New South Wales Supreme Court had assembled from other authorities in *Bay Bon Investments Pty Ltd v Selvarajah*,[13] his Honour enquired into whether that rate was a genuine pre-estimate of the loss that PSAL might suffer by being kept out of its money after the Repayment Date or, instead, was in the nature of a punishment.[14] After a detailed examination of the evidence, he expressed his findings on the matter as follows:

> "… The four per cent concessional rate of interest was sufficient to cover PSAL's cost of borrowing and overheads. It did not seek to compensate PSAL for the cost of administering a loan in default. More importantly, it did not seek to compensate PSAL for the risk to it in recovering its loan after a default in repayment. I am not persuaded that the 7.5 per cent interest rate was not a genuine pre-estimate of the loss that PSAL might suffer as a result of breach. This included the risk of a capital loss in addition to the loss of interest in the event that the security given to it proved inadequate to pay the balance of the loan. Having regard to the loss that PSAL was likely to suffer by being kept out of its money and the other categories of loss that it would be likely to suffer in the event of a default, the defendants have failed to prove that the 7.5 per cent interest rate was not a genuine pre-estimate of loss. I decline to find that the provision in relation to the interest rate is void as a penalty."[15]

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10 In *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 290 ALR 595, in which judgment was delivered after the hearing of this appeal, the High Court repudiated the proposition advanced in *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* [2008] NSWCA 310, (2008) 257 ALR 292, that the penalty doctrine is a rule of law not of equity and held that it continues to be an equitable doctrine.

11 Reasons [68]; AB 1019.

12 Reasons [69]; AB 1019.

13 [2008] NSWSC 1251 at [47], [48].

14 Reasons [60], [71]; AB 1016, 1019-1020.

15 Reasons [74]; AB 1021.

[23] However, the learned judge did find that PSAL's conduct had been unconscionable in terms of s 12CC of the *Australian Securities and Investments Commission Act* 2001 (Cth) ("ASIC Act") and s 51AC of the *Trade Practices Act* 1974 (Cth) ("TPA") in continuing to charge the rate of 7.5 per cent per month capitalised monthly, for an extenuated period when, by mid-2010, the loan had ceased to be a short term one. In his Honour's view "To continue to capitalise interest at such a rate for a period of months and years is irreconcilable with what is right and reasonable."[16]

[24] The published reasons for judgment invited submissions as to the forms of orders that ought to be made and the disposition of costs. Final orders were made by the learned judge on 8 March 2012.[17] By then, the indebtedness at 1 March 2012 had been recalculated in accordance with the published reasons as being the amount of $1,366,330.95 which included interest of $233,583.34. An order was made that the recalculated amount be paid on or before 4 pm on 28 March 2012 and that should it not be paid, then PSAL might enter into possession and recover the mortgaged land at Cooroibah and Browns Plains. Provision was also made for entry of a money judgment in the event of non-payment by that date. The appellants were ordered to pay PSAL's costs of the proceedings on an indemnity basis.

The appeal

[25] By a notice of appeal filed on 26 March 2012, the appellants appealed against the final orders. The substantive orders sought be the appellants on appeal are a declaration that the "Interest Rate Provision" in the Loan Agreement and the collateral bills of mortgage is void as a penalty and an order that the appellants pay to PSAL "within 28 days of the order, an amount of money equal to the principal outstanding at the date of the Court's judgment plus simple interest on the principal owing from time to time at 2% per annum (sic) or, alternatively, a rate determined by the Court".

[26] In the appellant's written outline of submissions, the interest rate sought was modified to be "simple interest at a rate equal to (PSAL's) cost of funds". During the course of the hearing, the cost of funds equivalent rate was particularised as being either 2 per cent per month or 25 per cent per annum.[18] Senior counsel for the appellants indicated that the rationale for these interest rates was that if the appellants were to seek equity in having the Interest Rate Provision declared void as a penalty, they must do equity. That, the appellants submit, requires no more of them than to ensure that PSAL is not out of pocket.[19] They further submit that that outcome would be achieved by adopting a cost of funds-based interest rate. His Honour had found that the cost to PSAL of the funds borrowed and used by it to make this loan, was 28.5 per cent per annum.[20] Hence the submission was made for rates of interest of that general order.

[27] It may be noted that prior to the hearing of the appeal, the appellants applied twice for an order staying the final orders for recovery of possession. Each application was refused with reasons.[21]

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16 Reasons [115]; AB 1036.
17 AB 1039-1041.
18 Transcript 1-21 LL35-55.
19 Transcript 1-18 LL30-45.
20 Reasons [52]; AB 1014.
21 [2012] QCA 94; [2012] QCA 135.

Grounds of appeal

[28] The grounds of appeal as stated in the notice of appeal are as follows:

> "(a) The Learned Judge erred in law when he held that the interest rate provision in the Loan Agreement between the Respondent and the First Appellant and Second Appellant ("the Interest Rate Provision") was not subject to the equitable jurisdiction to relieve against penalties.
>
> (b) The Learned Judge erred in failing to hold that the Interest Rate Provision provided for a penalty and was therefore void."[22]

[29] These two grounds are closely interrelated. The first of them complains of error in holding that the "Interest Rate Provision", that is to say, the interest rate structure in the definition of "Interest Rate", is not a penalty for the purposes of the penalty doctrine. The second ground develops upon the first. It is to the effect that the learned judge erred in not holding the Interest Rate Provision to be a penalty and therefore void.

[30] Central to the first ground is the issue whether his Honour was correct in following and applying the interest rate structure rule. The second ground gives rise to the further issues of whether the Interest Rate Provision is a penalty for the purposes of the doctrine and, if it is void as a penalty, at what rate ought interest have been paid on the loan. The appellant's written outline of submissions and oral submissions at the hearing were devoted to those issues.

[31] It remains to note that these grounds of appeal do not challenge any of his Honour's findings with respect to statutory unconscionability. Nor do they allege error in the remedies granted which are reflected in the orders his Honour made in consequence of those findings. In addition, there is no challenge to the conclusion that had he not applied the rule, he would not have found the rate of 7.5 per cent per month to be a penalty or to the findings that underpin it.

Ground of appeal (a)

[32] The learned judge described the rule that he applied as "well-established" in Australian law.[23] His use of that epithet is justified. In *Brett v Barr Smith*,[24] Isaacs J, citing Lord Hatherley's exposition of it in *Wallingford v Mutual Society*,[25] referred to the rule as "firmly established".[26] His Lordship had said:

> "The other question which was much argued before your Lordships was the question of penalty. I apprehend that there again the case is quite clear. The illustration of the form adopted in mortgages is a very good illustration, I think, of what the true principle is. The form adopted long since—I do not know whether it is still continued or not—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

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22 AB 1043.
23 Reasons [67]; AB 1018.
24 (1919) 26 CLR 87.
25 (1880) 5 App Cas 685 at 702.
26 At 94.

> 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, but a relaxation of your contract which you would merit and purchase by paying at a definite and fixed time. 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. If there had been indulgence at any time upon given terms, as long as those terms are observed, the indulgence lasts. When those terms are departed from the indulgence at once fails, and the original contract is revived in full force. …"

[33] Later, in *O'Dea v Allstates Leasing System (W.A.) Pty Ltd*,[27] Gibbs CJ stated that "…there is no penalty where it is agreed to charge a certain rate of interest on condition that if payment is made punctually the rate will be reduced…"[28] His Honour cited as authority for the rule the decision in *Astley v Weldon*[29] where Heath J had observed:[30]

> "… It is a well-known rule in equity, that if a mortgage covenant be to pay 5l. per cent. and if the interest be paid on certain days then to be reduced to 4l. per cent. the Court of Chancery will not relieve if the early day be suffered to pass without payment; but if the covenant be to pay 4l. per cent. and if the party do not pay at a certain time it shall be raised to 5l. there the Court of Chancery will relieve. …"

[34] In *Acron Pacific Ltd v Offshore Oil NL*,[31] Mason ACJ, Wilson, Brennan and Dawson JJ cited[32] that part of the judgment of Gibbs CJ in *O'Dea* which contains the statement which I have quoted in the course of enunciating the proposition that "there is no penalty if the provisions of the moratorium deed simply grant an indulgence for the payment of a debt that is due and payable."

[35] The rule has been recognised by intermediate courts of appeal in Australia. In *David Securities Pty Ltd v Commonwealth Bank of Australia*,[33] a Full Court of the Federal Court (Lockhart, Beaumont and Gummow JJ) described the distinction reflected in the rule as a "well-known, if not much praised".[34] They continued:

> "… A proviso in a contract of loan or mortgage may stipulate a reduction of the rate of interest if interest be paid punctually. This provides an incentive to punctual payment, time being of the essence.

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27 (1983) 152 CLR 359.
28 At 366-7.
29 (1801) 2 Bos & P 346; (1801) 126 ER 1318.
30 At 353; 1322-3.
31 (1985) 157 CLR 514.
32 At 518.
33 (1990) 23 FCR 1 (reversed on other grounds (1992) 175 CLR 353).
34 At p 29.

> On the other hand, a provision, that, if there be a failure in punctual payment, the rate of interest is increased with effect over the period in respect of which the interest is charged, has been regarded as a penalty. …"

[36] In *Kowalczuk v Accom Finance Pty Ltd*,[35] Campbell JA of the New South Wales Court of Appeal (with whom Hodgson and McColl JJA agreed) noted that there is a "conventional view that a properly drafted mortgage containing higher and lower rates does not attract the law of penalties at all".[36] His Honour explained[37] the rationale for his reference to a "properly drafted" mortgage. It is one that is drafted with the following consideration in mind:

> "…If the mortgage is drafted so that the borrower agrees to pay a particular rate of interest, but the lender agrees to accept a lower rate of interest in full satisfaction of the borrower's obligation to pay interest at that particular rate provided that the lower rate of interest is paid timeously (and, sometimes, provided that there is no breach of any other provision of the mortgage) that provision is not one that states the consequences of a breach of contract, and hence the law of penalties does not apply to it."[38]

[37] More recently, in *Summer Hill Business Estate Pty Ltd v Equititrust Ltd*,[39] Young JA of the New South Wales Court of Appeal explained that the reason why the mortgage before the Court there took the form that it did, was that, "…traditionally, making the lower rate the ordinary rate and setting a higher rate for late penalty might be set aside as a penalty in equity".[40]

[38] There are also Australian cases where the rule has been acknowledged at first instance. The decisions of Windeyer J in *Accom Finance Pty Ltd v Mars Pty Ltd*[41] and of Chesterman J in *Beil v Mansell (No 2)*[42] are examples. Moreover, the rule has long been recognised as such by the authors of the learned texts. W R Fisher in the *Law of Mortgage*, 2nd ed, published in 1868, expressed the rule[43] in terms which are virtually unchanged in Fisher & Lightwood's, *Law of Mortgage*, 2nd Australian ed (2005).[44] Both textbook expressions of the rule describe it as "well settled, if not … intelligible".

[39] At the commencement of the hearing of the appeal, senior counsel for the appellants invited this Court to consign the rule to history and not to apply it. Placing much reliance upon an article written by Mr Arthur C Meredith, barrister, and published in the *Law Quarterly Review*[45] in October 1916, he submitted that seemingly the rule had its origin by way of mistake in the very late 17th century, that the

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35 (2008) 77 NSWLR 205; [2008] NSWCA 343.
36 At [162].
37 *Ibid*.
38 That rationale may require re-expression in order to accommodate the decision of the High Court in *Andrews* which affirmed at [67], [68] that application of the penalty doctrine is not limited to penalties imposed upon breaches of contract.
39 [2011] NSWCA 149.
40 At [47].
41 [2007] NSWSC 726 at [55]; (2007) 13 BPR 24, 729.
42 At [2006] 2 Qd R 499 at [23], [24]; [2006] QSC 199.
43 At para 1683.
44 At para 3.18, cited by Young JA in *Summerhill* at [47] and quoted by Chesterman J in *Beil* at [24].
45 "*A Nicety in the Law of Mortgage*" (1916) 32 LQR 420.

distinction made by it had been ignored, even disparaged, by some eminent jurists during the following century or so,[46] but that, in the 19th century, it was apparently accepted by the Chancery judges and adopted by the text writers as settled law.[47]

[40] The Full Court of the Federal Court in *David Securities* referred to Mr Meredith's article and to criticism that is made of the rule that it prefers form to substance in contradiction of the preference of equity for substance over form.[48] Their Honours described the distinction between an increase in the rate of interest (which attracts the penalties doctrine) and a covenant offering an incentive by reduction of the rate upon prompt payment (which does not attract the doctrine) as "anomalous".[49] In *Brett*, Isaacs J categorised it as an "anomaly".[50] Yet the Full Court and Isaacs J regarded the rule as "well established"[51] and "firmly established"[52] respectively.

[41] I am of the view that it is not open to this Court to accept the invitation made on behalf of the appellants. Although the correctness of the rule appears never to have been affirmed after a deliberate examination of it by the High Court, it has been acknowledged more than once by members of that Court.

[42] Further, the rule has also been recognised by intermediate courts of appeal in Australia. The clear direction given by the High Court in *Farah Constructions Pty Ltd v Say-Dee Pty Ltd*[53] is that in relation to non-statutory law, intermediate appellate courts and trial judges in Australia should not depart from decisions in intermediate appellate courts in other jurisdictions within Australia unless they are convinced that the law as expounded in those decisions is plainly wrong.

[43] Despite the criticism that has been made of the rule, I am not convinced that it is plainly wrong. That criticism has tended to focus upon the distinction that the rule makes. The objection to the distinction underlying the criticism is centred upon its dependence upon form rather than upon substance. The provisions are differently expressed in form, yet in substance the same interest rate outcome results from them where payment is not punctual – the higher interest rate is charged.

[44] It is true that, from this perspective, the distinction made by the rule does contradict equity's preference for substance over form in a way that is anomolous. However, it is not as clear to me that the distinction ought to be abolished. I say that out of a concern for what the full consequences of an abolition of it might be. An immediate and necessary consequence would be to place the reduced (concessional) rate of interest type provision on the same footing as the increased rate of interest type provision for the purposes of the penalty doctrine.

[45] On one view of it, to place both provisions on the same footing would have the further consequence that each provision is to be treated as a penalty under the doctrine and therefore void. Just as the doctrine now treats as a penalty and void a provision in which the rate of interest is increased upon a failure to pay promptly –

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46 Exemplified by the dissatisfaction with it expressed by Lord Eldon in *Seton v Slade* (1802) 7 Ves Jun 265 at 273-274; 32 ER 108 at 111.

47 *Ibid* p 425.

48 At p 29.

49 *Ibid*.

50 At p 94.

51 At p 29.

52 At p 94.

53 (2007) 230 CLR 89 at 151-2.

independently of the actual rates of interest specified, their relativity with each other or their relationship to the lender's costs and potential loss exposure, so also a provision in which the reduced rate of interest is accepted for prompt payment would fall to be treated as a penalty and void – again, independently of the actual rates of interest specified, their relativity with each other or their relationship to the lender's costs and potential loss exposure.

[46] The point may fairly be made that to categorise the latter type of provision as a penalty and therefore void without regard for the actual rates of interest specified, their relativity with each other, or their relationship to the lender's costs and potential loss exposure would also be anomalous. One ought to guard against replacing one anomaly with another, particularly with an anomaly which would involve not giving any recognition to the fact that contemporary commercial lending covers a wide spectrum of lending for the short term as well as for the medium and long term by traditional large institutional lenders and as well by small specialised lending entities with different funding arrangements and risks.

[47] The point I have just mentioned would put in question an aspect of the rule beyond the mere distinction in form that it makes. It would challenge, if indirectly, the traditionally accepted limb of the rule that an increased interest rate type provision is always a penalty because by virtue of the increase, it operates in *terrorem* to enforce punctual payment. This limb has regard only for an actual difference in specified interest rates and not for the actual rates themselves, their relativity with each other or their relationship to the lender's costs and potential loss exposure.

[48] The appellant's submissions go so far as to urge this Court not only to abolish the distinction in the rule but also to abolish the limb of it which, as noted, treats an increased interest rate provision as necessarily being a penalty. Rather than having a rule which deals specifically with them, the submission proposes that all interest rate provisions be amenable to the penalty doctrine in a way which would regard the question whether the interest rate provision in any given case is a penalty as being a question of construction to be decided upon the terms and inherent circumstances of each particular contract. For this submission reference was made to the description of a penalty given by Lord Dunedin in *Dunlop Pnuematic Tyre Co Ltd v New Garage and Motor Co Ltd*[54] which the High Court was content to regard as continuing to express the law in *Ringrow Pty Ltd v BP Australia Pty Ltd*.[55] The appellants criticise the rule including the distinction it makes as dealing with interest rates differently from other money payments and inconsistently with Lord Dunedin's description of a penalty.

[49] The appellant's submissions do raise matters which give cause to question the appropriateness for contemporary times of the rule and the distinction it makes. However, for reasons which I have mentioned, this Court is constrained by authority to apply it. For these reasons, in my opinion, the learned judge did not err in applying the rule in the way that he did and in holding that, in accordance with that rule, the Interest Rate Provision is not a penalty. This ground of appeal therefore fails.

Ground (b)

[50] The failure of ground (a) precludes success for the appellants on Ground (b). In any event, even if Ground (a) had succeeded, it would have been difficult for the

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54 [1915] AC 79 at 86-87.

55 (2005) 224 CLR 656 at 663; [2005] HCA 71.

appellants to succeed on Ground (b) in circumstances where their grounds of appeal do not challenge his Honour's intimated finding that, judged by Lord Dunedin's description of it, the rate of 7.5 per cent per month is not a penalty.

[51] In submissions, the appellants did make reference not only to the rate of 7.5 per cent per month but also to an additional feature of the Interest Rate Provision which they said was indicative of a penalty, namely, that the concessionary rate of 4 per cent per month applies only "while the Borrower is not in default under the Facility". Two interpretative aspects to this clause arose in the course of the hearing. One was whether, in context, the word "Facility" took the meaning given to the word "Facility" in Schedule 1, namely, "the financial accommodation provided". The definitions in Schedule 1 are stated to apply unless context requires otherwise. To my mind, it is quite plain that in the relevant context, "the Facility" is intended to mean the terms of the Loan Agreement, and not the financial accommodation granted under it.

[52] The other interpretative aspect concerned whether the expression "the Borrower is not in default" means that the Borrower has not failed to make payment as required by the terms of the Loan Agreement or whether, adopting the list of Events of Default in clause 9.1, it means that an Event of Default has not occurred. By reference to the latter meaning, the appellants argued that the Interest Rate Provision is a penalty in that it would deny the concessionary rate of 4 per cent per month in a range of circumstances which might occur quite independently of any act or default on the part of the Borrower.

[53] Two points may be made about this argument. Firstly, in my view, the default to which the parties intended the expression to be referenced is one that occurs by virtue of an act or default on the part of the Borrower, the obvious example of which is a failure to pay moneys in accordance with the terms of the Loan Agreement. The words "Borrower is not in default" have a quite different connotation to those of the words "an Event of Default has not occurred". Secondly, the argument implicitly proposes that a contractual obligation to pay a sum of money upon the occurrence of an event for which the party who is to make the payment is not responsible, will be a penalty. As the decision of the House of Lords in *Export Credits Guarantee Department v Universal Oil Products Co*[56] shows, that proposition is not a sound one.

[54] For the foregoing reasons, Ground (b) also cannot succeed.

Disposition

[55] Given that both grounds of appeal fail, it follows that the appeal must be dismissed with costs.

Orders

[56] I would propose the following orders:

1. Appeal dismissed.
2. Appellants to pay the respondent's costs of the appeal on the standard basis.

[57] **FRYBERG J:** It is an unfortunate feature of the common law that from time to time judicial findings of fact, sometimes expressed with incautious generality,

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56 [1983] 1 WLR 399.

become elevated into rules of law. Something of the sort seems to have happened in the evolution of the so-called rule which is the subject of the present appeal. I agree with those who think the rule anomalous. It may express a practice which had some economic utility in the 19th century (although even that is far from clear), but it does not do so in the 21st.

[58] Modern approaches to the litigation of economic issues facilitate the resolution of many penalty issues and mitigate the need for rules of this type. Such issues are not insusceptible of proof, nor are they non-judiciable. There is much to be said for reconfiguring the law in this area.

[59] That said, I agree with Gotterson JA that it is not appropriate for this court to undertake that task in this case. As his Honour demonstrates, piecemeal reform may reduce fresh anomalies. Moreover existing practices are entrenched at intermediate appellate level throughout Australia and are reflected in considered decisions of substantial standing. If the problems are susceptible of judicial resolution, they should be examined nationally at the highest level.

[60] I concur in the orders proposed by Gottesron JA and his Honour's reasons for them.