ARAB BANK AUSTRALIA LTD v SAYDE DEVELOPMENTS PTY LTD*

[2016] NSWCA 328

Court of Appeal: Gleeson JA, Sackville AJA, McDougall J

9, 28 November 2016

Contracts — Construction — Penalties — Commercial loan facility — Whether default interest provision constituted penalty — Determination as at date contract made — Whether presumption that default interest a penalty — Whether default interest extravagant or unconscionable — Whether function of default interest only to punish — Whether pre-estimate of loss required.

A bank entered into a commercial loan facility agreement with a borrower for the sum of $6.825 million, the terms of which were renewed and renegotiated from time to time. The contract provided for additional interest to be payable if the borrower failed to make its monthly payments on time, at a default rate of 2%. Over the term of the loan the borrower failed to make several repayments on time and paid substantial payments to the bank as default interest. The borrower sued the bank to recover the default interest paid, claiming that it constituted a penalty.

At first instance the primary judge held that the default interest amounted to a penalty after determining, among other things, that there was a distinction between "major" and "minor" defaults, based on the number of days by which payment was overdue, and that the costs of managing "minor" defaults were already incorporated into the standard interest rate paid by the respondent.

Held (allowing the appeal): (1) The primary judge erred in concluding that the stipulated default interest amounted to a penalty on the basis of a distinction between minor and major defaults where no such distinction was made at the time the contracts were entered into, which was the relevant time at which to assess the conduct. ([1]; [12]; [19], [83]–[87])

(2) The stipulated default interest rate was not extravagant or unconscionable. ([94]–[95])

(3) Any presumption that the stipulated default interest was a penalty because the same amount was charged regardless of the amount overdue, was a weak one. The characterisation of the stipulation should be considered by reference to evidence, where available. ([1]; [12]; [100])

Paciocco v Australia & New Zealand Banking Group Ltd (2016) 90 ALJR 835; [2016] HCA 28, considered.

(4) The evidence did not support a contention that the costs of minor defaults were priced into the standard interest rate. ([1]; [12]; [82], [101])

(5) There was no basis for inferring that the bank's contractual rights provided a complete suite of remedies to protect itself against loss, such that the only function of the default interest was to punish. ([1]; [12]; [102]-[108])

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* [EDITORIAL NOTE: An application for special leave to appeal to the High Court was refused: [2017] HCASL 29.]

(6) The failure of the parties to attempt to pre-estimate the loss to one of them caused by breach on the part of the other did not mean that the default interest provision must be a penalty. ([1]; [12]; [109]–[110])

Andrews v Australia and New Zealand Banking Group Ltd (2012) 247 CLR 205; [2012] HCA 30; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28, applied.

Consideration of whether, if a contractual stipulation is to be characterised as a penalty, punishment must be the sole, or the predominant, purpose of that stipulation as discussed in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28.

CASES CITED

The following cases are cited in the judgments:

AMEV-UDC Finance Ltd v Austin (1986) 162 CLR 170; [1986] HCA 63

Andrews v Australia and New Zealand Banking Group Ltd (2012) 247 CLR 205; [2012] HCA 30

Cavendish Square Holding BV v El Makdessi [2016] 2 All ER 519; [2015] UKSC 67

Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Company Ltd [1915] AC 79

Imperial Tobacco Company (of Great Britain and Ireland) Ltd v Parslay [1936] 2 All ER 515

Lordsvale Finance plc v Bank of Zambia [1996] QB 752

Paciocco v Australia and New Zealand Banking Group Ltd (2014) 309 ALR 249; [2014] FCA 35

Paciocco v Australia and New Zealand Banking Group Ltd (2015) 236 FCR 199; [2015] FCAFC 50

Paciocco v Australia & New Zealand Banking Group Ltd (2016) 90 ALJR 835; [2016] HCA 28

Printing and Numerical Registering Company v Sampson (1875) LR 19 Eq 462

Ringrow Pty Ltd v BP Australia Pty Ltd (2005) 224 CLR 656; [2005] HCA 71

Sayde Developments Pty Ltd v Arab Bank Australia Ltd [2016] NSWDC 76

Wallis v Smith (1882) 21 Ch D 243

APPEAL

This was an appeal from a judgment of the District Court, which had found that a term of a commercial loan agreement constituted a penalty.

NC Hutley SC and *TD Castle*, for the appellant.

DR Pritchard SC and *AJ Macauley*, for the respondent.

Judgment reserved

28 November 2016

1 **GLEESON JA.** I agree with McDougall J.

2 **SACKVILLE AJA.** In *Cavendish Square Holding BV v El Makdessi*,[1] three members of the Supreme Court of the United Kingdom observed that:

> "[3] [t]he penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well, and which in the opinion of some should simply be demolished, and in the opinion of others should be reconstructed and extended."

3 The Supreme Court in that case rejected an argument that the so-called "penalty rule" should be judicially abolished as "antiquated, anomalous and unnecessary". Lords Neuberger and Sumption thought that there was a case for taking this course, but that judicial abolition was not the proper approach to a longstanding principle of English law which has counterparts in many common law and European jurisdictions.[2]

4 Lord Mance recognised that the penalty doctrine often involves making distinctions "which can appear narrow and which follow lines which can be difficult to define".[3] But his Lordship considered that these were not reasons to abandon the doctrine "which in its core exists to restrain exorbitant or unconscionable consequences following from breach".[4] Lord Mance also pointed out that the English and Scottish Law Commissions had not merely recommended that the penalty doctrine should be retained, but that it should be extended beyond breaches of contract to provisions punishing a party for non-observation of any contractual stipulation. This was precisely the step taken by the High Court in *Andrews v Australia and New Zealand Banking Group Ltd*.[5]

5 Lord Hodge recognised that although the penalty doctrine is often said to be aimed at preventing oppression of the weaker contracting party,[6] the application of the doctrine does not depend on any disparity of bargaining power between the parties.[7] His Lordship also acknowledged the criticism that the penalty doctrine promotes uncertainty in commercial dealings because the contracting parties may not be able to predict accurately "the judges' value judgment on whether a particular provision is exorbitant or unconscionable".[8] Moreover:

> "[259] … [p]arties save on transaction costs where they can avoid expensive litigation on the consequences of breach of contract. It has also been said that judges should be modest in their assumptions that they know about business".[9]

6 Notwithstanding these arguments against retention of the penalty doctrine, Lord Hodge was persuaded that the rule against penalties should remain, for three reasons.[10] First, there remain significant imbalances in negotiating power in the commercial world. Secondly, abolition of the rule would go against the

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1 [2016] 2 All ER 519; [2015] UKSC 67 at [3] (Lords Neuberger and Sumption; Lord Carnwath agreeing).
2 *Cavendish* at [36]–[39].
3 *Cavendish* at [162] (Lords Clarke and Toulson agreeing on this point).
4 *Cavendish* at [162].
5 (2012) 247 CLR 205; [2012] HCA 30.
6 *Cavendish* at [257], referring to *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 at 193–194; [1986] HCA 63 (Mason and Wilson JJ).
7 *Cavendish* at [257], citing *Imperial Tobacco Company (of Great Britain and Ireland) Ltd v Parslay* [1936] 2 All ER 515 at 523 (Lord Wright MR).
8 *Cavendish* at [259].
9 *Cavendish* at [259]. Curiously enough, Lord Hodge cited the late 19th century observations of Jessel MR in *Wallis v Smith* (1882) 21 Ch D 243 at 266 in support of the second sentence. Jessel MR was a famously strong proponent of the laissez-faire doctrine of freedom of contract; *Printing and Numerical Registering Company v Sampson* (1875) LR 19 Eq 462 at 465.
10 *Cavendish* at [262]–[266].

flow of legal developments nationally and internationally. Thirdly, contracting parties retain the ability to make "sensible arrangements to fix the consequences of a breach of contract and thus avoid expensive disputes".

7 The present case is a very good example of a contractual arrangement that should not attract the penalty doctrine. A corporation, apparently perfectly capable of acting in its own interests, borrows a large amount of money from a bank to assist with a commercial undertaking. The borrower agrees to pay additional interest in the event of default, for the period the default continues. There is no suggestion that the borrower has been misled or subjected to improper or unfair tactics. When the borrower defaults, it pays the additional interest and then seeks to recover the amount it has paid on the ground that the provision requiring payment of additional interest is a penalty and therefore unenforceable.

8 The dismissal of the borrower's claim (but only after an appeal) does not mean that the invocation of the penalty doctrine has not had adverse consequences. In recent times, cases involving the penalty doctrine have been conducted by reference to extensive expert evidence designed to enable the court to determine whether or not there was a justifiable commercial rationale for the imposition of the detriment alleged to be a penalty.[11] It is therefore not surprising that in the present case the parties considered it necessary to rely on expert reports to support their respective contentions.

9 Expert evidence is nearly always expensive to obtain, especially when it concerns financial practices and transactions. It is likely that the total costs generated in this case will prove to be not much less than the amount in dispute. More generally, as Lord Hodge indicated in *Cavendish*, the transaction costs associated with the penalty doctrine add to the overall costs of borrowing. Presumably the costs are ultimately passed on, in one form or another, to all borrowers.

10 In Australia, recent decisions of the High Court have both potentially expanded and contracted the scope of the doctrine.[12] Whether the result will be to increase or decrease the extent to which the doctrine is invoked is as yet uncertain. Whatever the outcome of the latest developments, however, the judgments in *Cavendish* indicate that there is at least an arguable case for re-evaluating the penalty doctrine.

11 Whether the doctrine should be retained, modified or abolished is a policy issue that in my view courts are ill-equipped to consider. As French CJ said in *Paciocco v Australia & New Zealand Banking Group Ltd*:[13]

> "[10] … It may be that in this country statutory law reform offers more promise than debates about the true reading of English legal history."

12 I agree with the orders proposed by McDougall J.

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[11] See, for example, the use made of expert evidence in the various stages of the litigation challenging late payment fees charged by a bank to customers: *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249; [2014] FCA 35 (Gordon J); *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199; [2015] FCAFC 50; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28.

[12] *Andrews* held that the penalty doctrine is not confined to cases where there has been a breach of contract and extends to provisions applying where a party does not observe a contractual stipulation. *Paciocco* limited the circumstances in which an agreed fee, payable if a debt is not discharged within a specified time, will be characterised as a penalty.

[13] (2016) 90 ALJR 835; [2016] HCA 28 at [10].

13 **McDOUGALL J.** On 7 October 2008, the appellant (the Bank) and the respondent (Sayde) entered into a "commercial loan facility" agreement, under which Sayde borrowed $6.825 million. That facility was a renewal of, or utilised to pay out, an earlier loan in the same amount. It was extended from time to time until 2 March 2010, when it was renegotiated. The renegotiated facility was extended from time to time until 17 June 2011, when it was again renegotiated. On 17 June 2011, the principal sum was increased to $7.05 million. The facility was repaid in full on 28 August 2013.

14 At all times, the terms of the contracts governing the commercial loan facility required Sayde to pay interest monthly, and provided for interest to be payable at a higher, or "default", rate if (among other things) those monthly payments were not made on time. Over the period from 7 October 2008 to 28 August 2013, Sayde paid in total $248,938.98 by way of what may conveniently be called "default interest".

15 Once the facility had been repaid, Sayde sued the Bank to recover the default interest that it had paid. It claimed that the default interest constituted a penalty, and sought repayment on a restitutionary basis.

16 The primary judge concluded that the default interest did amount to a penalty: *Sayde Developments Pty Ltd v Arab Bank Australia Ltd* [2016] NSWDC 76. Accordingly, he gave judgment in favour of Sayde for the amount of $248,938.98 together with interest. The Bank appeals from the whole of his Honour's decision.

The issues on the appeal

17 Stripped to their essentials, the issues arising on the Bank's three remaining grounds of appeal (one of the original four was not pressed) may be stated as that the primary judge erred:

(1) in finding that the relevant contractual provisions amounted to a penalty, because:
   (a) he took account of circumstances that arose only upon and after default in reaching that decision
   (b) in doing so, he relied on a distinction drawn by Sayde's expert between "major" and "minor" defaults
   (c) accordingly, he failed to decide the question looking forward, from the time each contract was made, and
   (d) he dismissed the concession made by Sayde's expert that the default interest margin was not unreasonable in the case of a "major default", and

(2) in preferring the evidence of Sayde's expert to that of the Bank's expert, to the extent that their evidence diverged.

18 Sayde relies on a notice of contention. It asserts that the decision of the primary judge may be upheld for the following reasons:

(1) the default interest is presumed to be a penalty, because the same amount was charged regardless of the actual amount overdue
(2) the costs associated with "minor" defaults (Sayde's defaults being, it said, of that character) were priced into the standard interest rate, and
(3) the Bank had the opportunity to recover any additional costs through other provisions of the contracts.

19 For the reasons that follow, I conclude that:

(1) the primary judge did err in concluding that the impugned contractual provisions amounted to a penalty. In my view, his Honour erred because, in accepting the distinction between minor and major defaults and using that as an essential step in his reasoning, he effectively considered the question at (and after) the date of breach and not at the date each of the contracts was made

(2) the issues raised by the notice of contention must be resolved against Sayde, and

(3) it is therefore not necessary to consider the ground of appeal relating to the primary judge's preference for the evidence of Sayde's expert.

Relevant contractual provisions

20 It is common ground that the terms of the various contracts for the commercial loan facility included, at all times, the then current version of the Bank's "General Terms for Commercial Products" (the General Terms). Two versions of those terms were proved, one dated March 2006 and one dated July 2010. If the wording of the relevant clauses differs between 2006 and 2010, the difference is immaterial. Accordingly, it is sufficient to set out the relevant clauses as they appear in the earlier version.

21 Clause 5 of the General Terms empowered the Bank to review the facility on each "review date". If, on any review, the Bank considered there had been a change in the credit risk or the value of the security property, the Bank could vary the terms of the facility.

22 It is convenient to note at this point that the various letters which, when accepted, documented the contractual basis of the extensions or renewals of the facility provided specifically for, among other things, variations in the interest rate (seemingly not limited to changes following a cl 5 review).

23 The General Terms provided, by cl 7, that unless the letter of offer indicated otherwise, the "Customer" was required to make monthly repayments in effect as stipulated in the letter of offer.

24 Clause 14 empowered the Bank to demand additional security if the balance owing exceeded the Bank's required loan to security percentage. If the Bank sought further security, Sayde was required to comply with the request. Clause 14.1 also empowered the Bank to reduce the loan amount, whereupon Sayde would be required to repay the relevant amount.

25 Clause 24 set out events of default, and cl 25 set out the consequences of default. I set them out so far as they are relevant.

"**24.** ***When is the* Customer *in default?***

In addition to any *events of default* under the *Letter of Offer* and the *Specific Facility Terms*, an event of default occurs under the *agreement* if any of the following events occur:

(a) the *Customer* does not pay on time any amount due under this *agreement* or another loan agreement the *customer* has with the *Bank*;

…

25. ***What can happen then?***

25.1 If an *event of default* occurs, the *Bank* may give the *Customer* a notice stating that an *event of default* has occurred.

If the *Customer* does not, or cannot, correct the *event of default* within any grace period given in the notice or required by law (or if an *event of default* has occurred again for a similar reason and continues to subsist at the end of that period), then, at the end of that period and without further notice to the

Customer, the *total amount owing* becomes immediately due for payment (to the extent it is not already due for payment).

The *Bank* may then sue the *Customer* for the *total amount owing*, or enforce any *security*, or do both."

26 Clause 26 dealt with higher interest charges in the event of default. I set it out:

"**26.** ***Higher interest charges***

26.1 If the *Customer* does not make a repayment due under clause 7 on time, then, from and *including* the day that repayment is due until but excluding the day it is paid in full, the *Bank* calculates Interest charges under clause 11.1 at the *default rate* set out in the *Letter of Offer*.

26.2 The *Customer's* obligation to pay on time is not cancelled by this clause."

27 The General Terms included an indemnity (cl 42) under which Sayde unconditionally and irrevocably indemnified the Bank against losses arising in connection with, among other things, an event of default or potential event of default. I set out that clause:

"**42.** ***Indemnities***

General Indemnity

42.1 The *Customer* unconditionally and irrevocably indemnifies the *Bank* against:

(a) all losses, liabilities, costs, expenses, *taxes* suffered or incurred by the *Bank* in connection with:

(i) an *event of default* or *potential event of default* or the exercise or attempted exercise by the *Bank* of any right or power arising from an *event of default* or *potential event of default*;

(ii) the failure by the *Customer* to drawdown a *drawing* for any reason (including a failure to satisfy a *condition precedent*); or

(iii) the failure of the *Customer* to make a:

(A) prepayment in accordance with a notice of prepayment;

(B) a repayment of a *drawing* or any part of a *drawing*; or

(C) a payment of any other amount due and payable under this *agreement*,

In any case, in accordance with the terms of this *agreement.*"

28 Each letter offering, extending or renewing the facility provided for various fees to be payable. Those fees included an "arrears letter fee" of \$20 (later \$35), "payable whenever the *Bank* sends the *Customer* an arrears letter in relation to the *Facility*".

29 It is not necessary to go further to the detail of various forms of the letters of offer. It is sufficient to note that throughout the whole period, however documented, the commercial loan facility was an interest-only facility, under which Sayde was required to make minimum monthly payments equal to the interest charged on the principal of the loan at the rate specified in the relevant letter. Each provided, further, that if the minimum monthly payments were not made, Sayde had to pay a further 2% interest (that is, if the stipulated rate were n/100, the default rate would be (n+2)/100).

The evidence

30 Mr Antonios Bassil, the principal of Sayde, gave evidence. Nothing relevant to the issues on appeal turns on his evidence.

31 The Bank called two witnesses of fact:

(1) Mr Alan Bateson, who was at the time the Bank's Senior Manager, Recoveries, and

(2) Mr Rocco Reitano, who was at the time a Manager, Recoveries.

32 In broad outline, the evidence of Messrs Bateson and Reitano was directed at proving the kinds and amounts of costs incurred by the Bank by reason of defaults. Mr Bateson's evidence, allowing for matters raised in cross-examination, was that those costs that could be quantified averaged about 5.81% per dollar of defaulting loan over the years from 2008 to 2014. He said that there were further costs that could not be quantified.

33 There was no serious challenge at trial to Mr Bateson's evidence. The primary judge considered him to be a truthful witness.

34 Each party called an expert witness. Sayde called Mr Victor John Fairley. The Bank called Mr Bruce Auty. The experts met and prepared a joint report, and gave evidence concurrently.

35 Sayde called an accountant, Mr David Mullins. His evidence proved the amount of default interest paid by Sayde over the period from 7 October 2008 to 21 June 2013, and interest thereon.

36 It was common ground between Messrs Fairley and Auty that the kinds of costs that the Bank could expect to incur, in the event of default, would include the following "main" (as Mr Fairley said) or "key" (as Mr Auty said) components:

(1) capital adequacy costs
(2) provisioning and reserve costs, and
(3) staff and general head office costs.

37 Each expert considered those costs elements in some detail. There were differences between them. For example, Mr Fairley thought that the cost of defaulting loans should be measured "against the whole book, not just the defaulting book" whereas Mr Auty appeared not to accept the relevance of this distinction.

38 Each expert accepted, further, that there was a significant practical distinction between loans less than 90 days past due and loans more than 90 days past due. That distinction formed the basis of Mr Fairley's categorisation of defaults as "major" (over 90 days) and "minor" (under 90 days) defaults. Mr Auty did not accept that this was a relevant categorisation.

39 The experts agreed that the Bank, like all banks, priced its loans according to a number of factors, including its assessment of the risk of default. Mr Fairley contended that the costs of managing "minor" defaults were in effect incorporated into the interest rate (to the extent that there was no specifically applicable cost recovery provision). Mr Auty did not agree. In his view the costs, even for a "minor" default, would vary considerably depending on the circumstances.

40 The primary judge preferred Mr Fairley's evidence to that of Mr Auty, to the extent that they differed. He gave reasons for doing so. Since in my view it does not matter which expert is preferred, it is unnecessary to consider whether his Honour erred in taking that approach. More importantly, his Honour's preference for Mr Fairley's evidence does not mean that this court cannot (or should not) consider for itself:

(1) what probative weight that evidence has, and
(2) what inferences ought be drawn from it.

The reasons of the primary judge

41 The primary judge set out the nature of the dispute and the evidence on which each party relied. Having done so, he turned to the parties' contentions as to the characterisation of the default interest provisions.

42 The primary judge referred to relevant authorities, including *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; [2012] HCA 30 and *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199; [2015] FCAFC 50. (The decision of the High Court on appeal from the full court of the Federal Court in the latter case had not been handed down at the time the primary judge gave judgment.)

43 The primary judge drew from the authorities (not limited to those to which I have just referred) the proposition that the characterisation of the impugned provision "is a matter to be determined objectively, and also prospectively, at the time the contract was entered into": at [129]. His Honour referred to the speech of Lord Dunedin in *Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Company Ltd* [1915] AC 79 at 86–87, where his Lordship set out, in a way that had come to be regarded as canonical in this area of the law, a test for determining whether a contractual stipulation is a penalty.

44 After referring to other authorities, the primary judge returned to the expert evidence. He noted at [135] that the experts "agreed that in the event of a major default, i.e. failure to make a payment due more than 90 days after the due date, the uplift in interest payable of 2% would not constitute a penalty". That seems to have been the case because, as his Honour noted at [138], and again as the experts had agreed, "significant other costs were incurred once a major default event occurred, which was not the case here".

45 At [139], the primary judge stated that "there is no evidence that persuades me that the 2% default interest provision here was a genuine pre-estimate of the cost to the bank of a breach by the plaintiff of failure to pay the monthly amount due on the due date". His Honour accepted Mr Fairley's proposition "that this was the cost of doing business for the bank".

46 The keys to the primary judge's conclusion are found at [140], [141] and [143]:

> "[140] I do not accept the defendant's submission set out at [91] above, that Mr Fairley's acknowledgment of the legitimacy of the 2% repricing in relation to major defaults, is sufficient for the bank's purposes, as the major defaults are causative of the greatest loss that could follow from the breach. That was just not the case here, where there was no major breach that occurred during the course of the various facilities. Rather, the uplift in interest rate was applied upon a late payment of monthly interest payments. The greatest loss for such a breach was the loss of the use of that month's interest payment for the time that it remained unpaid. By charging an additional 2% on the whole of the loan outstanding, for that period of time, it compensated the defendant in an extravagant way which could not have conceivably been a pre-estimate of the costs that it would incur as a result of that breach.
>
> [141] Applying the conventional test, the default interest imposed here by Cl 26.1, involving interest on the whole principal outstanding for the period during which default occurred, in respect of each late payment by the plaintiff during the term of each facility, satisfied the test of extravagance and unconscionability in the amount charged by the defendant in comparison with the greatest loss that could conceivably be proved to have followed from each breach, namely, late payment, but which did not constitute a major default, giving rise to other contractual consequences, namely, Notice of Default, acceleration of payment and the like.
>
> …
>
> [143] I do not accept the plaintiff's evidence to the effect that he never agreed to the penalty interest clause. That evidence relied on ex post facto deduction by him. However, looking at the matter prospectively, as I must, at the time the

facility was entered into, the imposition of the default interest rate on the whole amount of the principal outstanding was not a genuine pre-estimate of the cost to the defendant, emanating from the beach. It led to an extravagant return to ABAL by comparison to the greatest loss from that breach, and therefore constitutes a penalty."

The parties' submissions

47 The parties provided, and spoke to, very detailed written submissions. In what follows, I shall summarise those submissions for the purpose of indicating the major areas of contention. I acknowledge that this approach does some violence to the structure and detail of the submissions.

Submissions for the Bank

48 Mr Hutley of senior counsel, who appeared with Mr Castle of counsel for the Bank, submitted that the primary judge had erred because the approach that he took necessarily involved looking at the question at the time of breach, not at the time the contract was made (or at any of the times when the commercial loan facility was extended or renewed). That was so, Mr Hutley submitted, because at the time the contract was made, it could not be said that a particular breach, constituted by failure to pay interest on time, would be or become "major" or "minor" (accepting, but only for the purposes of the submission, the distinction drawn by Mr Fairley).

49 More fundamentally, Mr Hutley submitted, the distinction between "major" and "minor" breaches was not one based on or reflected in the contract documents, and was irrelevant to the analysis. That was so, Mr Hutley submitted, because categorisation of any breach (consisting of a failure to pay money on time) as "major" or "minor" depended necessarily on looking at what actually happened after the breach had occurred. He noted that neither Mr Bateson nor Mr Reitano accepted the distinction.

50 In those circumstances, Mr Hutley submitted, the primary judge's acceptance of the expert evidence, to the effect that the 2% default interest charge would not be a penalty in the event of a "major" breach, entitled the Bank to succeed. That was so, Mr Hutley submitted, because:

(1) the distinction between "minor" and "major" breaches was irrelevant, and

(2) in any event, even if the distinction were valid, it could not be said, at the time any of the contracts was made, whether a breach might turn out to be "minor" or "major".

51 Thus, Mr Hutley submitted the expert evidence necessarily led to the conclusion that the 2% default interest charge could not be said to be wholly disproportionate, or extravagant or unconscionable, compared to the greatest amount of loss that could possibly be foreseen to flow from a breach.

52 Mr Hutley submitted that "the foundational principle on which the court acts, to set aside a contractual provision as a penalty, is that the purpose, if not the only purpose, of that provision is to punish the defaulting party for failing to comply with its contractual obligations". Otherwise, he submitted, the parties should be left to their bargain, freely made, and to their risk allocation as embodied in their contracts.

53 In this case, Mr Hutley submitted the relevant stipulation, viewed objectively and at the time the contracts were made, was not a punishment. It was, rather, a stipulation designed to create "a greater degree of certainty as between the

Bank and the Customer in relation to the consequences of a payment default occurring".

54 Mr Hutley submitted that the primary judge had taken an unduly narrow approach to the question of the interests that could properly be protected by a stipulation of the kind in question. He noted that those losses, not necessarily limited to losses recoverable on breach of contract, extended well beyond the pecuniary losses that Mr Bateson had sought to calculate.

55 Mr Hutley attacked the other aspects of the reasoning of the primary judge: for example, his Honour's comment, set out at [45] above, that the Bank had not persuaded him that the default interest charge was a genuine pre-estimate of loss. Mr Hutley submitted that if and to the extent that the primary judge conducted his analysis on that basis, it both reversed the onus of proof and focused on an irrelevant question (because it was accepted in both *Andrews* and *Paciocco* (FCAFC) that the fact that a contractual stipulation was not a genuine pre-estimate of loss did not necessarily make it penal).

56 Mr Hutley's submissions addressed also the ground of appeal dealing with expert evidence. It is not necessary to summarise those submissions.

Submissions for Sayde

57 Mr Pritchard of senior counsel, who appeared with Mr Macauley of counsel for Sayde, sought to uphold the decision of the primary judge. He submitted that the primary judge had stated the correct test (that submission is correct), that the court should understand that the primary judge had applied that test, and that the references made by the primary judge to "minor" and "major" breaches were tangential to his reasoning process. Otherwise (and leaving aside the ground of appeal as to the preference expressed by the primary judge for Mr Fairley's evidence over that of Mr Auty), Mr Pritchard relied on the notice of contention.

58 First, Mr Pritchard submitted, there was a presumption that the stipulation was a penalty, "because, irrespective of the quantum of the overdue amount (be it $1 or $7.0m), the same sum of money is charged for each day the overdue balance is not cleared …". Accordingly, "the same sum is imposed irrespective of the nature of the default or whether it entailed trifling damage … or serious damage …".

59 Next, Mr Pritchard submitted (relying on the evidence of Mr Fairley), there were no additional costs likely to be incurred where the default was "minor". It will be seen that this submission relies on the validity of the distinction drawn by Mr Fairley, and, as well, on the validity of his opinion.

60 Mr Pritchard accepted that the experts (specifically, Mr Fairley) had conceded the validity of the 2% default interest charge in the event of "major" default. However, Mr Pritchard submitted, that concession did not have the significance that Mr Hutley attached to it.

61 Mr Pritchard submitted that in expressing the view he did, Mr Fairley was seeking to distinguish between those costs attributable to a "minor" default that were (in Mr Fairley's view) factored into the interest rate, and other costs, not factored into the interest rate and hence in principle recoverable, attributable to "major" defaults.

62 More fundamentally, Mr Pritchard submitted, a determination of the question, whether the default interest charge was a penalty, required attention to all the circumstances, including all relevant terms of the loan contracts. If Sayde were correct in submitting that the Bank was adequately protected

overall without the need to rely on the default interest charge, then (Mr Pritchard submitted) the concession made by Mr Fairley had no significance. That argument leads to the principal notice of contention point.

63 Mr Pritchard then turned to the third of the notice of contention points: that in any event, there were other terms of the contract that entitled the Bank to recover specific costs incurred by reason of default. Thus, he submitted, the default interest stipulation had no compensatory function.

64 Mr Pritchard submitted that the relevant contractual provisions gave the Bank a full panoply of remedies that it could rely upon to protect itself from loss. He submitted that the Bank could act immediately to reprice the loan, or to demand additional security. His submissions did not explain how, in the likely event that a customer had made a default in payment because it had no money to pay, or had chosen to deploy what money it had for other and more urgent purposes, the right to increase the interest rate was of any practical significance. Nor did they explain how a borrower in that hypothetical situation was likely to have available to it other substantial equity in any other property that might be available as security.

65 Further, Mr Pritchard submitted, the wideranging indemnity given by cl 42.1 (not limited to losses that might be recoverable as on breach of contract) gave the Bank all the protection that it required.

66 In those circumstances, Mr Pritchard submitted, the only inference available was that the default rate stipulation was intended to punish Sayde.

67 Mr Pritchard relied on calculations, apparently intended to show that, at least in the case of "minor" defaults, the maximum loss that could be quantified amounted to about 0.4% of each dollar of loan capital. This, he submitted, was a far cry from the 2% default rate. Mr Pritchard's submissions acknowledged, but did not really come to grips with, Mr Bateson's evidence as to provisioning costs (which was to the effect that such costs as were quantifiable had amounted to about 5.81% of the capital at risk).

68 Mr Hutley submitted in reply that there was no contractual warrant for confining the Bank to its discretionary remedies under the General Terms. Thus, Mr Hutley submitted, the fact that the Bank had alternative remedies available to it did not indicate that the default interest stipulation was penal in character.

Penalty: the applicable principles

69 The law relating to contractual penalties has been considered by the High Court of Australia in three recent cases:

(1) *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; [2005] HCA 71
(2) *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; [2012] HCA 30, and
(3) *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 90 ALJR 835; [2016] HCA 28.

70 Counsel's submissions ranged far beyond those cases. However, in my view, the disposition of this appeal need not go so far.

71 In *Ringrow*, the court (Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ) accepted at [12] that Lord Dunedin's speech in *Dunlop* set out "the principles governing the identification, proof and consequences of penalties in contractual stipulations", and that the decision in *Dunlop* "continues to express the law applicable in this country".

72 The relevant aspect of Lord Dunedin's speech (*Dunlop* at 86–87) reads as follows:

> "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 if applicable to the case under consideration 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 …
>
> (c) There is a presumption (but no more) that it is penalty when 'a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage'."

73 In *Andrews*, the court (French CJ, Gummow, Crennan, Kiefel and Bell JJ) referred to *Dunlop* at [69] and following. Nothing that their Honours there said cast any doubt on the position stated in *Ringrow*, to the effect that the principles identified by Lord Dunedin expressed the legal position in this country. That is perhaps not surprising, because the real point of the decision in *Andrews* was to identify that the equitable jurisdiction to relieve against penalties remained alive and well. It followed, in the court's view, that the penalty doctrine was not only applicable in the case of breach of contract. Since the present case involves a stipulation operative on breach of contract, that aspect of the decision in *Andrews* is of no significance.

74 I turn to the decision in *Paciocco*. In that case, the High Court held by majority (French CJ, Kiefel, Gageler and Keane JJ) that a late payment fee imposed by the respondent bank on its credit card customers was not a penalty. Their Honours gave separate reasons: Kiefel J (with whom French CJ agreed on this point), Gageler J and Keane J. The majority judgments paid close attention to the reasoning of Lord Dunedin in *Dunlop*. The following propositions emerge from the majority decision:

(1) Lord Dunedin's propositions were not "rules of law", but "distillations of principle": at [143] (Gageler J); compare at [32] (Kiefel J) and at [260] (Keane J).

(2) The essence of a penalty is that it is a collateral stipulation, the (or a predominant) purpose of which is to punish the borrower for breach, and thus to compel performance: at [29] (Kiefel J); at [127], [159], [166] (Gageler J); at [254], [259], [273] (Keane J).

(3) One way of testing whether the impugned stipulation is penal — intended to punish — is to inquire whether the sum that it stipulates

to be payable on breach (as I have indicated, the equitable origins and continuing equitable operation of the principle have no present relevance) is to ask whether the stipulated sum is extravagant or out of all proportion to, or unconscionable in comparison with, the maximum amount of damage that might be anticipated to follow from the breach: at [29], [54] (Kiefel J); at [158]–[162] (Gageler J); at [221] (Keane J).

(4) "Damage" in this sense is not limited to damages recoverable upon breach of contract, but may extend to damage, or losses, caused by the impairment of other legitimate commercial interests that were intended to be protected by the stipulation: at [33], [42]–[47] (Kiefel J); at [145], [160]–[162] (Gageler J); at [216], [283] (Keane J).

(5) The analysis is to be made at the time, and taking into account the circumstances applicable, when the contract was made; not at the time of breach; the analysis is prospective, not retrospective (or as is said in some judgments, is *ex ante*, not *ex post*): at [62] (Kiefel J); at [169] (Gageler J).

(6) Mere disproportion between the stipulated sum and the possible damage is not enough to indicate "penalty"; the disproportion must be such that it is unconscionable for the lender to rely on the stipulation: at [54] (Kiefel J); at [164] (Gageler J); at [221], [240], [279] (Keane J).

75 There are two remaining relevant points to be derived from the decision in *Paciocco*. The first is that the onus of proving that a contractual stipulation amounts to a penalty rests with the person asserting it. As Gageler J said in *Paciocco* at [167]:

> "[167] … The customers bore the evidentiary and persuasive onus throughout that inquiry."

76 The second point relates to the "presumption" identified by Lord Dunedin in *Dunlop* at his point 4(c). That presumption is the subject of the first ground stated in the notice of contention. As Keane J said in *Paciocco* at [265], that presumption is "a weak one". Further, as Gageler J said at [168], the invariable nature of the penalty compared to the amount overdue or the length of delay, although it cannot be ignored, is "only weakly indicative of the character of the late payment fee as a punishment".

Decision

77 I start by referring to a controversy that need not be decided. The controversy was whether, if a contractual stipulation is to be characterised as a penalty, punishment must be the only purpose of that stipulation, or whether it is sufficient that punishment be a predominant purpose. Mr Hutley contended for the former view; Mr Pritchard for the latter.

78 In *Paciocco*, Kiefel J (with whom French CJ agreed) referred to "the purpose" of the stipulation: could it be said to be to punish? Gageler J referred to punishment as being "the only purpose" of the stipulation. Keane J, by contrast, pointed to "predominant" purpose as being sufficient.

79 It is clear that Gageler J favoured a sole purpose test, and that Keane J favoured a predominant purpose test. I am by no means sure that what Kiefel J said should be read as indicating that her Honour, like Gageler J, regarded sole purpose as the applicable test. I think that, in referring to "the purpose", her

Honour intended to do no more than draw attention to the function that the impugned stipulation was intended to perform, in the overall context of the parties' contractual (and, it may be, wider commercial) relationship, for the purpose of asking if it amounts to a penalty.

80 The distinction is not relevant in this case. First, even if "predominant purpose" is the test, Sayde failed to show that the default interest charge was inserted into the contracts for loan predominantly for that reason. Second, in fact, Mr Pritchard's submissions effectively went so far as to say that no other purpose could be inferred. It must follow that, although he did not accept that Sayde had to satisfy a sole purpose test, his submissions nonetheless addressed it.

81 I return to the fundamental question. In my view, the primary judge was led into error by the expert evidence of Mr Fairley, that there was a significant distinction between "minor" and "major" defaults. That distinction finds no basis in the contractual documents. Nor was it one that Mr Bateson or Mr Reitano accepted. Their evidence was, in substance, that defaults were all treated as defaults no matter the duration of the default (where it was a default in payment of money).

82 Mr Fairley expressed the opinion that for "minor" defaults, the additional costs that the Bank was likely to incur were factored into the interest rate. For reasons that I shall give later, that opinion has no probative weight. It is a simple assertion, based on documents that do not give it any support. But even if the opinion had some probative weight, it could only be relevant if, at the time of making the various contracts, it was reasonable to expect that all breaches would be "minor".

83 At the time each of the contracts was made, the various obligations of Sayde as the Bank's customer were spelled out; but the character and consequences of any breach of any of those obligations was not. It could not be said, at the time any of the contracts was made, whether a breach of the obligation to make a monthly payment, on a specified day, of interest on the outstanding principal sum at the standard rate applicable might be only a "minor" breach, or instead might be (or become) a "major" breach.

84 Any characterisation of a default as "minor" or "major" necessarily requires a consideration of the actual nature and consequences (monetary or other) of the breach. Thus, it necessarily considers the question at and after the time of the default.

85 I accept, as Mr Pritchard submitted, that the primary judge directed himself that the question was to be considered at the time the contract (or each of the contracts) was made. I do not accept the subsequent submission, that this in fact is what the primary judge did. In my view, the key passages in his Honour's reasons make it clear that he did not. That is apparent from his Honour's reasons at [140], set out at [46] above:

> "[140] … there was no major breach that occurred during the course of the various facilities."

86 It is also apparent from his Honour's reasons at [138], where his Honour accepted Mr Fairley's evidence that the costs that are likely to be incurred by reason of "minor" defaults were factored into the interest rates. His Honour concluded that paragraph by stating:

> "[138] … As the experts agreed, significant other costs were incurred once a major default event occurred, which was not the case here."

87 In my view, Mr Fairley's irrelevant and erroneous distinction (one which had no basis in either the contract or, if it might be relevant, the Bank's practice), between "minor" and "major" breaches, diverted attention away from the real issue. More importantly, it diverted analysis to the wrong point in time. Mr Fairley's evidence, in that respect at least, was not helpful.

88 If the question is considered (as it must be) at the time each of the contracts was made, all that could be said was that if Sayde made default in payment, and that default continued, there might be a number of consequences. Those consequences could be foreseen to include (but not to be limited to) the following matters:

1. The Bank might decide to take no action (other than imposing the default interest charge), and to keep the facility alive.
2. Alternatively, the Bank might act under cl 25.1 of the General Terms, and give a notice of default; the consequence would be that if the default were not rectified, the whole amount of the facility would become due and payable.
3. If the Bank did not take that step, nonetheless it would be required to monitor the loan, with a view to deciding whether it should be classed as "impaired" for the purposes of the Australian Prudential Regulation Authority's Prudential Standard APS 220.
4. If the Bank determined that the facility were impaired, in accordance with APS 220, it would then need to consider and if appropriate make provision in its financial statements for the possible loss.

89 It is not in doubt that APS 220 applied. It is not in doubt that the Bank was obliged to follow, and did follow, that Prudential Standard. It was not in doubt that, if a loan were identified as impaired, the Bank was required to make provision for it. It is not in doubt (because this is plain on the face of APS 220) that a facility could be considered as "impaired" whether or not it was 90 days past due. The significance of this last point is that Mr Fairley appeared to consider that a default would not become "major" unless the loan were more than 90 days past due, or the Bank had earlier taken enforcement action under cl 25 of the General Terms.

90 As I have said, Mr Bateson's evidence identified, among other costs incurred by the Bank, the cost of provisions against impaired loans. He did this over the period from 2008 to 2014 by summarising the specific provisions made for defaulting loans over that period and calculating them as a percentage of the total amount in default. Over those years, he said, those provisions averaged 5.45% of the total amount in default (put another way, 5.45 cents for each dollar of principal in default).

91 Mr Pritchard sought to suggest that this was not a real cost. At one point, he sought to suggest that the real cost might only be the opportunity cost arising from the loss of use of the amount of the provision. That proposition had not been put to Mr Bateson, and in any event is incorrect. As Mr Bateson explained, the provisions are real. They are made either against current profits (in which case they reduce current profits, and the likely dividends to shareholders) or against capital (in which case they reduce the total amount of shareholders' funds available).

92 Mr Fairley gave no evidence that could support Mr Pritchard's submission. On the contrary, as I understand what he said, he supported the proposition that provisioning costs were real costs that could be attributed to payment defaults. The point of his evidence was not to deny the relevance of provisioning costs

but, rather, to suggest that they were relevant only to his suggested category of "major" defaults.

93 As I have said, Mr Bateson identified other costs. Again, Mr Fairley agreed that there were other costs (and so did Mr Auty).

94 I accept of course that evidence of costs actually incurred necessarily looks at the matter at and after the time of breach. However, as Gageler J said in *Paciocco* at [169], "evidence of the later occurrence of an event can be probative of the earlier probability of that event occurring".

95 In this case, it is not in doubt that the "event" in question — the need to make provision against bad or doubtful loans — was real, and was readily foreseeable at the time the various contracts were made. The precise quantum of those provisions — their relationship in percentage terms to the amount in default — could not be foreseen. Nonetheless, the actual amount of those provisions gives some indication that the stipulated default rate of 2% could not be regarded, even with the benefit of hindsight analysis, as extravagant or unconscionable. Viewing the matter prospectively, default might well lead to the need to make provision against bad or doubtful loans.

96 I referred earlier to Mr Fairley's opinion (for it could be no more) that, for "minor" defaults, the likely costs to the Bank were factored into the interest rate. He said, correctly, that the Bank graded risks, and assigned an interest rate to the customer depending on its risk grading. The Bank's risk grading methodology (as at November 2012, but nothing turns on this) was in evidence. The relevant passages on which Mr Fairley relied state:

> "As the Bank relies on internal risk estimates for making credit risk decisions, we have used APS 113 as guidance in developing a robust credit risk measurement framework. It should be noted that as ABAL is not an IRB accredited bank we are not required to comply with the IRB standards. However, the principles of APS 113 have been used as guidelines and the process developed to allow the Bank to converge toward those compliance standards.
>
> The measurement framework has taken into account the inherent default risk of an exposure counterparty and the contingent loss of a loan facility as two separate dimensions of risk. Those risk estimates manifest as the following parameters:
>
> Probability of Default (PD);
> Loss Given Default (LGD);
> Exposure at Default (EAD); and
> Effective Maturity (M).
>
> Typically, 'M' is embedded in the PD term structure (i.e. representing the default risk over the residual term of the loan/exposure). Altogether, the expression PD x LGD x EAD represents the expected loss (EL) for a given loan or exposure. The Basel II framework allows the EL to be decomposed into a pre-default estimate (PD), an at-default (EAD) and post-default (LGD) estimate. It should be noted that each of these 3 estimates are forward-looking, meaning that they attempt to measure the future EL (over a given time window) on a given exposure out of the evaluation date. Furthermore, EL should be interpreted as a portfolio-based estimation of loss attributed to a particular loan. It spreads the overall EL on a portfolio over a period (e.g. 12 months) across all the exposures in that portfolio. This measurement framework flows directly into the loan loss provisioning process."

97 There is nothing in that material which suggests that the costs that the Bank might incur by reason of a "minor" default were factored into the interest rate.

98 Mr Fairley was cross-examined on this point. It was put to him in substance that, for "minor" defaults, there was nothing in the Bank's material to show

that the likely costs of default were factored into the interest rate. He disagreed, but (to the extent that his answers were at all responsive), he did not identify any specific material. It is worth setting out this passage of the transcript, because in my view it shows that the statement that the primary judge appears to have found significant was no more than an unreasoned opinion said to be based (in a way that is unexplained) on a whole mass of material, and not tied to any particular document or section of a document:

> "CASTLE: You can't point to anywhere which shows that prior to a loan entering what we've called the black zone, that the additional capital adequacy costs, provisioning and reserve costs, staff and general head office costs in the sense used in your report in this discussion are taken into account by the bank when it assesses the original price of the loan. What do you say about that?
>
> WITNESS FAIRLEY: I disagree because my report here has a lot of appendices, [and] relates to all of the documentation that I was provided. That documentation includes volumes of information particularly around the risk rating system, the details of the factors that are invoiced, the experts that the bank had come in to work out probabilities, their analysis of things such as different segments associated with commercial property. It would — in the format that we have now, I am not able to go to the considerable amount of other material in the appendices and waste the time of going through to find these things. All I can say is that in the documentation is that information. What I have attempted to do in providing my report is to make that information, which is not easy to access for people who do not understand the system, try to provide a view which makes it easier to access. So my answer is I don't agree with that because my report is beyond one page, it considers a lot of material that had been provided by the Arab Bank in the documentation."

99 To the extent that this answer incorporates the Bank's risk grading methodology among the mass of material upon which apparently Mr Fairley relied, that is of no assistance. For the reasons I have given, when one reads the relevant section, it says nothing of the kind.

100 I turn to the notice of contention. The first ground relies on Lord Dunedin's presumption (expressed in his Lordship's point 4(c) in *Dunlop*). That is the "weak" presumption to which Gageler and Keane JJ referred in *Paciocco*. If there were no other evidence, the presumption might be of some value. However, where there is evidence, the characterisation of the stipulation should be considered by reference to that evidence.

101 The second ground is based on the finding of the primary judge (in terms based on Mr Fairley's evidence) that the costs of "minor" defaults were priced into the interest rate. For the reasons I have given, that ground is doubly fallacious. First, it depends on the "minor"/"major" distinction, which pays no regard to the terms of the contracts, and involves the fallacy of retrospective analysis. Second, Mr Fairley's unsubstantiated and unreasoned ipse dixit opinion lacked any probative force.

102 The third ground asserts in substance that the Bank had available to it the means of satisfaction of the consequences of any default. It is correct that if an arrears letter were sent out, there would be a cost recovery mechanism. Presumably, the Bank could add that stipulated cost to the principal of the loan. It is also correct that the Bank could make some estimate of loss, and add that to the principal of the loan.

103 However, the real point is: why should the Bank be compelled to work through its range of contractual remedies, rather than rely upon the agreed contractual consequence of a default in payment? Mr Pritchard pointed to no

authority that could support his submission. It is inconceivable that, in all the hundreds of cases that have dealt with penalties in the context of contracts for loan (bearing in mind the array of remedies that lenders are wont to require, and that the resources of boilerplate drafting are able to provide) the point would not have been raised at some stage. The silence in the authorities is telling.

104 The submission overlooks a number of points. One is that, within the confines of statutory encroachment, the doctrine of freedom of contract remains important: see Keane J in *Paciocco* at [220]. The contracts in this case were made between parties who, it may be assumed, were capable of understanding and protecting their respective interests. Those parties chose to provide for a default interest regime, and chose to make the Bank's various rights on default discretionary. They did not stipulate for any requirement that those rights be exhausted before the default interest rate could be applied.

105 Of course, the penalty doctrine is an exception to freedom of contract. That was recognised in *Paciocco*. But its very existence as an exception was seen to underline the need for, not mere disproportion, but extravagant or unconscionable disproportion, before it could be concluded that a particular stipulation was punitive, or penal, in character.

106 Finally, the argument overlooks harsh economic reality. We have moved well beyond the days when judges lived in (real or pretended) ignorance of the facts of commercial life. Twenty years ago, Colman J observed, in *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752 at 763 that:

> "… the borrower in default is not the same credit risk as the prospective borrower with whom the loan agreement was first negotiated. Merely for the pre-existing rate of interest to continue to accrue on the outstanding amount of the debt would not reflect the fact that the borrower no longer has a clean record. Given that money is more expensive for a less good credit risk than for a good credit risk, there would in principle seem to be no reason to deduce that a small rateable increase in interest charged prospectively upon default would have the dominant purpose of deterring default."

107 I accept, as Mr Pritchard submitted, that there are very significant distinctions to be made between the facts in *Lordsvale* and the facts in this case. Nonetheless, if I may say so, his Lordship's observations go beyond the particular facts. They express an economic reality to which the law must have regard. Keane J seems to have thought so. He cited that passage from *Lordsvale* in *Paciocco* at [263] and stated, at [264]:

> "[264] The common law's relatively recent acceptance of the economic reality that risky credit is more expensive credit has been accompanied by an appreciation of the nature of the relationship between the greater financial risk assumed by a bank by reason of late payments by customers and the costs to the bank's revenue stream associated with that increased risk."

108 When one takes those considerations into account, the basis for insisting (as is implicit in the third of the grounds of contention) that the Bank's contractual rights provide so complete a suite of remedies to protect itself against loss that, by inference, the only function of the default interest charge could be to punish, is seen to be non-existent.

109 There is one more matter to mention. That is the statement of the primary judge at [139] of his reasons, set out (so far as it is relevant) at [45] above. As I have noted, Mr Hutley submitted that in putting the matter this way, the primary judge asked himself the wrong question.

110 As I read his Honour's observation, it is no more than that there was no evidence of any attempt to strike a genuine pre-estimate of loss. It seems to be reasonably clear that if a contractual stipulation is, regarded objectively, a genuine pre-estimate of loss then it cannot be a penalty. It does not follow that because the parties did not attempt to pre-estimate the loss to one of them caused by breach on the part of the other, that a stipulation dealing with the consequences of breach must be a penalty. That is made clear by the decision in *Andrews*, and was affirmed in *Paciocco*.

111 As I have indicated, Gageler J in *Paciocco* confirmed that the onus — evidentiary and persuasive — of proving penalty rests on the party who asserts it. However, if the Bank had pleaded that the default interest charge was a genuine pre-estimate of loss, that would be a separate issue on which the Bank, the party asserting, would bear the onus of proof.

112 It is not necessary to take this point any further, because the essential issues on the appeal can be (and in my view should be) decided without reference to any possible error embodied in the reasons of the primary judge at [139].

Conclusion

113 In my view, the Bank's appeal must succeed. I propose the following orders:

(1) Appeal allowed with costs.

(2) Set aside the orders made by Mahony SC DCJ on 13 May 2016.

(3) In place of those orders, order that there be judgment for the defendant with costs.

Orders accordingly

Solicitors for the appellant: *Gadens*.

Solicitors for the respondent: *Somerville Legal*.

C BEMBRICK

Barrister