SUPREME COURT OF QUEENSLAND

CITATION:	*PSAL Ltd v Kellas-Sharpe & Ors* [2012] QSC 31
PARTIES:	**PSAL LIMITED ACN 118 825 120** (plaintiff) **v** **WENDY KELLAS-SHARPE** (first defendant) and **GOLDIWAY PTY LTD ACN 075 755 074** (second defendant) and **OPM HOLDINGS QLD PTY LTD ACN 118 505 641** (third defendant)
FILE NO:	BS 3700 of 2011
DIVISION:	Trial Division
PROCEEDING:	3700 of 2011
ORIGINATING COURT:	Supreme Court of Queensland
DELIVERED ON:	28 February 2012
DELIVERED AT:	Brisbane
HEARING DATE:	2, 3 and 10 February 2012
JUDGE:	Applegarth J

ORDERS:

1. **Declare the provisions of the Loan Agreement dated 17 December 2009 made between the plaintiff and the first and second defendants ("the Loan Agreement") insofar as its provisions require payment by the defendants of interest at a rate of 7.5 per cent per month and permit capitalisation of unpaid interest and payment of interest on unpaid interest to be unconscionable.**

2. **That the Loan Agreement and any collateral bills of mortgage be read and construed as if any reference to payment of interest on unpaid interest or capitalisation of interest were deleted from each of those documents.**

3. **That the Loan Agreement and any collateral bills of mortgage made between the plaintiff and the defendants be read and construed as if "Interest Rate" in the Schedule to the Loan Agreement entitled "Commercial Details" were deleted and the following substituted: "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."

4. Direct the plaintiff and the defendants calculate the debt outstanding to the plaintiff taking into account the interest rate provided for in the previous order, and any payments made by the defendants, as at 1 March 2012.

5. Upon payment by the defendants to the plaintiff of the sum so calculated, together with interest calculated thereon at the rate of five per cent per month to the date of payment, the plaintiff release any mortgages and other securities held by it over the defendants' property.

6. Failing such payment within 28 days of the date of these orders, the plaintiff recover possession of the land described in paragraphs 1, 2 and 3 of the Claim.

7. Failing such payment within 28 days of the date of these orders, judgment be entered for the plaintiff against each defendant for the balance of the loan account calculated in accordance with paragraph 3 above.

CATCHWORDS: CONTRACTS – GENERAL CONTRACTUAL PRINCIPLES – Doctrine against penalties – high interest short term loan – where agreement provided for higher rate of "standard interest" and lower rate of "concessional interest" while the borrower was not in default – whether interest rate provision is void as a penalty

TRADE PRACTICES AND RELATED MATTERS – UNCONSCIONABLE CONDUCT – *Trade Practices Act 1974* (Cth) and *Australian Securities and Investments Commission Act 2001* (Cth) – where loan agreement provided for "standard interest" of 7.5% per month and for enforcement costs to be added to loan balance – where loan agreement also provided for capitalisation of interest – whether interest rate provision unconscionable – whether exercise of entitlement to capitalise interest at 7.5% per month over a long period of time unconscionable

Australian Securities and Investments Commission Act 2001 (Cth) ss 12CC, 12GM
Contracts Review Act 1980 (NSW)
Trade Practices Act 1974 (Cth) ss 51AC, 87

Accom Finance Pty Ltd v Mars Pty Ltd (2007) 13 BPR 24,729; [2007] NSWSC 726 cited
Acron Pacific Ltd v Offshore Oil NL (1985) 157 CLR 514; [1985] HCA 63 cited
Asia Pacific International Pty Ltd v Dalrymple [2000] 2 Qd R 229 considered
Attorney-General (NSW) v World Best Holdings Ltd (2005) 63 NSWLR 557 cited
Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd (2003) 214 CLR 51; [2003] HCA 18 cited
Australian Securities and Investments Commission v National Exchange Pty Ltd (2005) 148 FCR 132; 56 ACSR 131 cited
Bay Bon Investments Pty Ltd v Selvarajah [2008] NSWSC 1251 followed
Beil v Mansell (No 2) [2006] 2 Qd R 499 followed
Bridge v Campbell Discount Co Ltd [1962] AC 600 cited
Canon Australia Pty Ltd v Patton (2007) 244 ALR 759; (2007) 29 ATPR 42-183 cited
Chen v Song [2005] NSWSC 19 considered
Chilcott v Homesec Finance Express Pty Ltd [2011] FCA 729 cited
David Securities Pty Ltd v Commonwealth Bank of Australia (1990) 23 FCR 1 cited
Hurley v McDonald's Australia Ltd (2000) 22 ATPR 41-741 cited
Kakavas v Crown Melbourne Ltd [2009] VSC 559 cited
Kowalczuk v Accom Finance Pty Ltd (2008) 77 NSWLR 205 considered
Lady Holles v Wyse (1693) 2 VERN 290; 23 ER 787 cited
Lordsvale Finance Plc v Bank of Zambia [1996] QB 752 cited
Marquis of Halifax v Higgens (1690) 2 VERN 134; 23 ER 694 cited
O'Dea v Allstates Leasing System (WA) Pty Ltd (1983) 152 CLR 359; [1983] HCA 3 cited
Perpetual Trustee Company Limited v Albert and Rose Khoshaba [2006] NSWCA 41 cited
Perpetual Trustees Australia Ltd v Schmidt [2010] VSC 67 cited
Ringrow Pty Ltd v BP Australia Pty Ltd (2005) 224 CLR 656; [2005] HCA 71 applied
Seton v Slade (1802) 7 Ves Jun 265; 32 ER 108 cited
Strode v Parker (1694) 2 VERN 316; 23 ER 805 cited
Summer Hill Business Estate v Equity Trust Ltd [2011] NSWCA 149 cited
Tonto Home Loans Australia Pty Ltd v Tavares [2011] NSWCA 389 cited
Wallingford v Mutual Society (1880) 5 App Cas 685 cited

COUNSEL: N M Cooke for the plaintiff
J P Murphy for the defendants

SOLICITORS: Galilee Solicitors for the plaintiff
Porter Davies for the first, second and third defendants

[1] On 17 December 2009 the plaintiff ("PSAL") and the first and second defendants entered into a Loan Agreement whereby PSAL agreed to lend those defendants $1,139,368 for a period of two months. The third defendant guaranteed the loan. The borrowers defaulted by failing to pay the sum of $1,139,368 (which included an interest component at a "concessional rate" of four per cent per month for the two month period of the loan). PSAL gave notices of its intention to exercise powers of sale over properties that secured obligations to it under the Loan Agreement, and in these proceedings it seeks recovery of possession of those properties. It also seeks payment of the balance of the Loan Agreement and interest pursuant to it at the "standard rate of 7.50% per month".

[2] The Loan Agreement relevantly defines "Interest Rate" as follows:

> "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."

[3] The defendants contend that the provision for payment of interest at this rate constitutes a penalty and is therefore void. They deny that they are obliged to pay the amount claimed by PSAL under the Loan Agreement or under the guarantee granted by the third defendant. By counterclaim the defendants seek orders that the Loan Agreement be varied. They allege that the conduct of PSAL in providing the facility referred to in the Loan Agreement was unconscionable. They also claim that certain alleged conduct of PSAL in connection with attempts by the defendants to negotiate a "payout" in October and November 2010 was unconscionable. They claim that this conduct contravened s 12CC of the *Australian Securities and Investments Commission Act* 2001 (Cth) ("the *ASIC Act*") and s 51AC of the *Trade Practices Act* 1974 (Cth) ("the *TPA*").

Particulars of unconscionability

[4] The defendants gave the following particulars of unconscionability in paragraph 38 of their defence and counterclaim:

> "(a) The plaintiffs was [sic] in a superior bargaining position to the defendants in that the second defendants [sic] were under pressure to secure finance to settle the purchase of the property at 396 Lake Cooroibah Drive, Cooroibah. The first defendant was the sole director of the second and third defendants.
>
> (b) The defendants were required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the plaintiff, namely:
>
> (i) The defendants provided the plaintiff with security by way of first registered mortgage over the property at 396 Lake Cooroibah Drive, Cooroibah.

(ii) The value of the property at 396 Lake Cooroibah Drive, Cooroibah at the time of the loan was $2.2 million.

(iii) The value of the property at 25 Willows Street, Killarney was $200,000.

(iv) The plaintiff ordinarily accepted an interest rate of 2% per month when offered security by way of first registered mortgage.

(v) Notwithstanding the plaintiff's usual practice, the defendants were required to pay interest at the rate of 4% per month and provide security over a number of other properties and chattels, particulars of which are set out in the 'Commercial Details' schedule attached to the Loan Agreement.

(c) The plaintiff has engaged in unfair tactics against the defendants in that they have refused to allow the defendants to discharge the Loan for payout figures specified by them and instead have increased the payout figures to an amount higher than the amount agreed to be accepted by them without justification."

[5] Paragraph 39 of the same pleading continued:

"39. Further or in the alternative:

(a) The plaintiff engaged in conduct whereby it unconscionably exploited the necessitous circumstances of the defendants in order to extort from them exorbitant interest rates, and in particular exorbitant capitalised interest rates, pursuant to the loan agreement:

(i) The interest rate payable pursuant to the Loan Agreement was 7.5% per month, but while the first and second defendants were not in default under the Loan Agreement, the plaintiff agreed to accept interest at the rate of 4.00% per month.

(ii) Pursuant to clause 4.3 of the Loan Agreement the interest was capitalised at the plaintiff's election.

(iii) Pursuant to clause 4.2 of the Loan Agreement the interest:

A. Calculated daily balances outstanding.

B. Accrue from day to day and be calculated on the basis of a year of 365 days.

C. Be charged on the last day of each month.

(b) The first and second defendants were in a vulnerable position and/or position of special disadvantage in relation to the plaintiff in that they were under pressure to secure finance to settle the purchase of the property at 396 Lake Cooroibah Drive, Cooroibah.

(c) The interest rate pursuant to the Loan Agreement:

(i) Took unfair advantage of the defendants.

(ii) Constituted unconscionable conduct by the plaintiff within the meaning of the Act and in breach of s. 12CA and/or 12CC of the Act.

(iii) Was not reasonable for the protection of the legitimate interests of the defendants.

(iv) Was a rate grossly in excess of that for which the plaintiff made similar loans."

Background

[6] The first defendant, Ms Kellas-Sharpe, is a registered nurse and investor. She and companies with which she was associated in 2009 were experienced in financial matters and in making investments. Companies with which she was associated would borrow and lend money. She was familiar with loan agreements that provided for higher and lower rates of interest, and which made provision for the lender to capitalise interest.

[7] Ms Kellas-Sharpe knew of a rural property at Lake Cooroibah about 15 kilometres north west of Noosa Heads. A member of her family had lent money to the owner of this property in 2006, and had a registered second mortgage over the property. The owner of the property defaulted under the first mortgage. The receivers and managers of the first mortgagee wished to exercise its power of sale. Ms Kellas-Sharpe had negotiations with them. She appreciated the development potential of the property. She negotiated a contract dated 29 October 2009 for Goldiway Pty Ltd ("Goldiway"), of which she was sole director, to purchase the property from the first mortgagee exercising its power of sale. The contract dated 29 October 2009 was to settle 45 days from the contract date. Goldiway agreed to pay $1,000,000 for the property and paid a non-refundable deposit of $100,000.

[8] The contract was not subject to finance. Ms Kellas-Sharpe hoped to obtain the funds to settle the contract from loan monies that were due to be repaid to another family company. However, it soon became obvious that these funds would not be repaid in time for settlement, and so within about two weeks of having signed the contract on 22 October 2009 Ms Kellas-Sharpe began to seek finance. She used a Sydney-based finance broker, and obtained some form of offer of finance at 11 per cent. However, that offer of finance was subject to obtaining valuations and these could not be undertaken before the Christmas break.

[9] Ms Kellas-Sharpe on behalf of Goldiway had obtained a valuation report dated 10 November 2009. However, this valuation apparently was not satisfactory for the purposes of obtaining finance from a bank or the non-bank lender which required additional valuations. Ms Kellas-Sharpe sought finance through other contacts without success. In early December she was introduced to another mortgage broker named Scott Wiley. The settlement date under the contract of 14 December 2009 was fast approaching, and Ms Kellas-Sharpe was keen to find a lender that would advance the necessary funds, lest Goldiway forfeit its deposit. She requested from Mr Wiley the cheapest interest rate possible. He advised her about PSAL, and told her that "their rates won't be kind", but they were likely to have the ability to settle in the required timeframe. Although Ms Kellas-Sharpe had not given up hope of obtaining a long term loan at that stage, her specific requirements were to seek out a lender that could settle in the required timeframe and provide a short term loan. She expected to be able to refinance with a long term funder who she hoped to find during the period of the short term loan.

PSAL

[10] PSAL is an unlisted public company that was formed in 2006. Its core business is short term finance to business and investment clients. It has few staff and offers the service of being able to assess applications and offer short term loans efficiently and quickly. Its processes include a three person "loan approval committee". Decisions on whether to approve or decline a loan are made by three directors. If any one director does not agree with the proposal then it is declined. Potential borrowers approach it either directly or through the borrower's mortgage broker. After PSAL obtains information from a potential borrower it creates a "Loan Estimate Summary" which is used as part of the company's loan approval process.

[11] The interest rate and other commercial terms upon which PSAL offers to lend depend upon the particular transaction. During the relevant time PSAL did not have a fixed rate of interest for all borrowers. However, many of the loans that it wrote at the relevant time had an interest rate of about 8.5 or 9 per cent per month and a "concessional rate" of five per cent per month.

[12] PSAL obtained funds to lend for short terms by itself borrowing money from investors. For the loan transaction in issue in these proceedings the bulk of the funds were borrowed from a private company at an interest rate of 30 per cent per annum. PSAL says that it adopted a "concessional rate" of four per cent per month for the subject loan (or 48 per cent per annum) on the basis that the 18 per cent difference between 30 per cent and 48 per cent was required to cover its overheads in running the company. PSAL's director, Mr Dormer, described the four per cent per month concessional rate as an "absolute bare minimum" provided the loan was maintained in good order. The higher rate of 7.5 per cent per month was adopted on the basis of a "3.5 per cent buffer" to cover underperforming loans and losses that arose in respect of them.

[13] Mr Flanders, a director of PSAL who was employed by it as a Loans Officer, and who dealt with brokers, was familiar with what he described as the "short term, high risk market". He described a monthly interest rate of 7.5 per cent as "roughly middle of the road". There was independent evidence of this. An expert report from Mr Garry Orange reported that interest rates ranging from 1.5 per cent to 12 per cent per month were evident in the market in which PSAL operates and that

an interest rate of 7.5 per cent as a "standard rate" (as distinct from a concessional rate) appeared to be a commercial rate in that market. Mr Orange was well-qualified to express an expert opinion. He has worked in the finance industry for almost 30 years and as an independent finance broker for the last 12 years. Mr Orange has chaired committees of the Mortgage and Finance Association of Australia and is a member of professional and industry organisations including the Credit Ombudsman Service. He explained that short term lending is a separate and established segment of the Australian commercial finance industry which provides customers with an alternative to traditional bank and non-bank finance when it is not readily available to borrowers. It differs from bridging finance which is a type of finance that enables businesses and investors to manage cash flow gaps. Bridging finance is provided by traditional lenders.

[14] Mr Orange explained that after the global financial crisis commenced in 2008-2009 many loan providers either ceased lending or priced themselves out of the market. At the time the subject loan was given, funding from traditional sources was limited across the market. Smaller banks had withdrawn from some market segments and other non-bank lenders had tightened their credit policies. Short term funders such as PSAL tend to fund loans from owners' capital or from investors with cash seeking a high return. The cost of funds in the short term lending market was not regulated by official cash rates but by the risk/return to investors and the availability of funds. Short term lending usually carries a higher risk to the lender in circumstances in which traditional funding is either not available to the borrower or has yet to be negotiated. A short term lender such as PSAL attempts to mitigate its risk but is still exposed to substantial risks. As a result, interest rates charged in the short term market in which PSAL operates are much higher than for a normal loan. The lender relies upon what Mr Orange described as the "end takeout position being achieved". Achieving this takeout is particularly important if the lender itself has used short term funding, as PSAL did in this case. Additional risk related to the property market and the length of time it might take to realise security. Mr Orange concluded that the interest rate of 7.5 per cent per month was a commercial rate in the relevant market for the "standard rate" and that the interest rate of four per cent per month for the concessional rate was also acceptable. The 3.5 per cent difference was said to be a reasonable amount to take account of costs associated with a default in repayment. These costs included the cost of possession and sale of secured property and other holding costs. Mr Orange also identified the fact that a lender may need to find alternative funding arrangements at a potentially significant cost. In the present case the primary security property was zoned "rural settlement" with development approval, and costs would be associated with maintaining approvals and the time taken to achieve a sale, which would be longer than a normal residential property given its location, size and condition.

[15] I accept Mr Orange's opinions and his evidence.

[16] The defendants called a forensic accountant, Mr Ponsonby, to give evidence about the likely interest rate or range of interest rates that may have applied to a bridging loan obtained in or about December 2009. Mr Ponsonby had no relevant experience in that market and his report was based upon discussions with individuals in the finance industry and retrospective searches of websites. His investigations of non-bank lending sources showed a substantial range. I do not consider that his information base, knowledge and experience of the short term lending market and the matters that bear upon interest rates that are charged in that market is as

substantial as that of Mr Orange. Mr Ponsonby acknowledged in cross-examination that it was possible that there were higher rates than his investigation had shown, and did not contest that interest rates for short term loans ranged as widely as 1.5 per cent to 12 per cent. His investigations had shown that the upper end of the range was an "Effective Rate" of 60.10 per cent per annum which was the equivalent of four per cent per month.

[17] I am satisfied, however, that at the relevant time short term interest rates ranged from 1.5 per cent to 12 per cent per month. The fact that PSAL's higher or "standard" rate of 7.5 per cent per month and its lower or concessional rate of four per cent per month fell within this range indicates that its rate was at a commercial rate in the relevant market. However this, and the fact that other entities in that market charged higher monthly interest rates, do not prove that its lending practices in this case were not unconscionable.

[18] Mr Dormer explained that PSAL arranges short term loans whereby its costs and the interest that will be payable during the short term of the loan are calculated and advanced together with the principal amount to be borrowed. This is because the people to whom it lends typically do not have the capacity to be able to prepay interest and costs at the start of the loan from their own funds. As a result, interest and costs are calculated in advance, and the borrower has an obligation to pay the sum that is the total of principal, interest and costs at the expiry of the loan period.

[19] PSAL's standard procedure was to give at least a few weeks notice before the expiry of the loan, advising that the loan was due for repayment on a particular date. If, however, the borrower was unable to perform its obligation to repay on the required date, a notice of default would be sent. PSAL would attempt to discuss with the borrower a plan to enable the loan to be paid out. For example, an expected settlement may be delayed, in which event the borrower would be required to pay the higher rate of interest for the period between the expiry of the loan and the date for settlement. I accept Mr Dormer's evidence that PSAL's objective was to have the loan repaid as soon as possible, rather than for it to remain in default.

[20] The higher or default rate of interest was adopted to take account of the risk of PSAL being unable to recover all or part of the loan monies advanced by it, and to thereby suffer a loss. Whether PSAL suffers a loss, and the extent of its loss will depend upon a number of factors. These include the borrower's ability to obtain refinance. Another factor is whether the borrower is able to pay at least interest during the extended period of the loan. Another factor is access to security, the quality of security and PSAL's ability to realise it. In a particular case PSAL may defer exercising a power to sell a property given as security to accord the borrower an opportunity to find a new financier. During any such period the amount due under the loan facility will typically increase, possibly by a significant amount depending upon the period and the capitalisation of interest. Depending upon the circumstances, including the borrower's ability to make repayments on account of interest obligations, after a period of months the loan balance may be substantially more than amount that was due for repayment at the end of the short period of the loan.

[21] A lender such as PSAL may hold sufficient security which, when realised, enables it to meet the then extent of the borrower's indebtedness, including recovery and other costs which are payable by the borrower in accordance with loan documentation. In

such an event it is possible to conceive of the lender in such a case as having made a handsome or substantial profit by being able to recover interest calculated at a monthly rate of 7.5 per cent per month in a case such as the present, or at the rate of 8.5 or 9 per cent per month being the typical higher rate or default rate of interest negotiated by PSAL. In other cases, however, PSAL will be unable to recover the amount loaned together with interest at the lower rate and will suffer a substantial loss compared to the position it would have been in had the loan been repaid on time, with the loan funds being repaid by PSAL to investors or used to finance a new loan to a new borrower.

[22] Some general evidence was given about the extent of PSAL's losses and the number of loans that went into default. This evidence did not allow any accurate calculation or assessment to be made of the "losses" that PSAL in fact experienced as a percentage of the monies that it had on loan. However, I accept that the 3.5 per cent difference between its higher and lower interest rate took account of the risk of losses being experienced by it upon loans that go into default. The evidence was that PSAL attempted to work with borrowers whose loans went into default and would attempt to negotiate a mutually agreed resolution, sometimes using mediators to negotiate a resolution in which PSAL would accept less than the amount that was owed to it. In this case, as in others, there was the potential for PSAL to make what the defendants' counsel characterised as a fortune in charging the higher default interest rate. The cynical view might be taken that a lender such as PSAL stands to make more money, on occasions, by a loan going into default during which period it will charge the higher default rate of interest than if the loan is performed whereupon it receives interest at a lower rate. However, I accept the evidence that PSAL's preference was for borrowers to pay their loans on time.

[23] Although the evidence given by PSAL was of a general kind, I accept that the higher rate of interest negotiated by it reflects the risk of default and the potential for PSAL to suffer substantial losses compared to the position it would be in if the loan agreement was performed according to its terms with the total amount of the loan being paid upon its expiry.

[24] The evidence indicates that PSAL competes with other short term funders and that mortgage brokers engaged by potential borrowers seek the most favourable terms that they can on behalf of their clients. Competition amongst short term funders is likely to constrain, to some extent, the interest rates that can be charged by them, and I accept the evidence of Mr Orange that the "standard rate" of 7.5 per cent per month and the concessional rate of four per cent per month negotiated by PSAL in respect of the subject loan was a commercial rate in the short term market at all material times. Lenders like PSAL were able to demand such high interest rates because of the desperate need of certain borrowers to obtain short term loans, and the risks involved in such lending. The risks can include risks which are inherent in lending to individuals and companies who are unable to obtain finance from other sources, and who seek the approval of loans as a matter or urgency. In such circumstances, a lender such as PSAL has limited time to investigate the worth of security being offered, the creditworthiness of the borrower and its capacity to repay the loan upon its expiry. The risk of the loan going into default and the lender suffering a substantial loss, together with the possibility of making a handsome profit in the event that it is able to recover interest at the higher default rate, are reflected in the high interest rates that PSAL and other lenders in the short term lending market are able to negotiate.

Negotiation of the loan between Ms Kellas-Sharpe and PSAL

[25] The loan was negotiated and agreed in the space of a few days, with Ms Kellas-Sharpe and Goldiway requiring the funds urgently in order to settle Goldiway's contract.

[26] On 8 December 2009 the defendants' broker, Mr Wiley, emailed a loan application on behalf of Ms Kellas-Sharpe and Goldiway and a statement of their assets and liabilities. This was received by Mr Flanders at PSAL. The loan proposed in the application was in the amount of $1,000,000 for a term of two to three months. First mortgage security was to be offered over the property at Cooroibah which the applicant/borrowers estimated to have a value of $2,200,000, notwithstanding its contract price of $1,000,000. The figure of $2,200,000 was supported by a valuation report dated 10 November 2009 that Ms Kellas-Sharpe had obtained. The assets and liabilities of Goldiway and Ms Kellas-Sharpe were reported to include real property at Killarney and Ms Kellas-Sharpe's home property at Leeville in northern New South Wales. Another company, OPM Holdings Qld Pty Ltd as trustee for the Wembley Trust ("OPM"), was said to own real property at Wembley Road, Browns Plains having a value of $4,300,000 which was subject to liabilities totalling almost $2,500,000. In other words, OPM was said to have equity in the Browns Plains property of approximately $1,800,000. The statement of assets and liabilities asserted that the companies, individuals and trusts listed on it had a surplus of assets over liabilities of $6,146,250.

[27] On Thursday, 10 December 2009 Mr Flanders produced a document styled Estimated Loan Summary on the basis of a principal advance of $1,055,223 which included interest for two months at four per cent per month. Once fees and legal costs were taken into account such a loan would make $919,670 available at settlement. On Friday, 11 December 2009 a new estimated loan summary was produced that enabled $1,000,000 to be available at settlement. This document adopted $2,200,000 as the unencumbered value of the security. The total loan of $1,147,266 (which included interest for two months at four per cent totalling $91,781, together with fees) produced a loan to value ratio (LVR) of 52.15 per cent.

[28] At a meeting on the morning of Friday, 11 December 2009 PSAL's loan approval committee approved a facility of $1,139,368. Its minutes record the term of the loan as being for two months with a monthly interest rate of four per cent. Shortly afterwards a meeting of the directors of the company approved the loan.

[29] Later on 11 December 2009 Ms Kellas-Sharpe signed a further finance application form.

[30] On Sunday, 13 December 2009 PSAL sent to Ms Kellas-Sharpe a formal letter of offer for a loan amount of $1,139,368. The formal letter of offer contained PSAL's standard terms, save for the amount of the loan and the interest rate. It advised that the "lower interest rate" would be calculated at four per cent per calendar month, payable in advance for the term of the loan and that the "higher interest rate" would be calculated at 7.5 per cent per calendar month. Ms Kellas-Sharpe amended the letter of offer in certain respects (but not in respect of the interest rate) and signed the letter of offer on her own behalf and on behalf of Goldiway as borrowers, and on behalf of OPM as guarantor. Her proposed amendments related to matters such as a provision included by PSAL that made the borrowers liable for valuation fees and

legal fees even if the transaction did not settle. On 14 December 2009 Mr Flanders advised Ms Kellas-Sharpe that her proposed amendments would need to go back to the Board to see if they wished to proceed. However, the Board was not prepared to accept the proposed amendments. In these proceedings PSAL explained the provision which made applicants liable for certain fees on the basis that it, unlike many other lenders in the same market, did not charge an application fee, and that the provision in relation to legal and valuation costs was necessary to protect it in respect of substantial costs if the transaction did not proceed.

[31] On 15 December 2009 a further formal letter of offer was produced and signed by Ms Kellas-Sharpe on her own behalf, on behalf of Goldiway and on behalf of OPM. It was accompanied by two solicitor's certificates of independent advice. The solicitor had acted for Ms Kellas-Sharpe and her companies previously. One certificate stated, amongst other things, that if the borrowers did not make all payments on the due date, or if there was any other default, the lender could demand repayment of the debt and sell up any security provided by the borrower or any guarantor. It also certified that the borrowers had been informed that if they were in any doubt about the viability of the transaction or of their ability to make the required payments to the lender they should obtain independent financial advice before signing the documents. The certificate in relation to advice given to the borrowers stated that following the explanations that had been given the borrowers stated to the solicitor that they understood his advice as to the obligations and risks involved in signing the documents, and that they were signing them "freely, voluntarily and without pressure from any other person". A similar certificate in respect of the guarantor recorded that it had understood the advice and was signing the documents "freely, voluntarily and without pressure from any other person".

[32] The settlement date for the purchase had been extended for a few days from the original settlement date of 14 December 2009.

[33] A Loan Agreement was executed on 17 December 2009. On the same day OPM executed a guarantee and indemnity. The transaction settled that day, and so the date for repayment was 16 February 2010.

The Loan Agreement

[34] The terms of the Loan Agreement include the following:

> "4. **Interest**
>
> 4.1 **Interest before the 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 of the outstanding 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."

[35] The Loan Agreement defines 'Interest Rate' as being:

"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 3.5% per month higher than interest rate which would otherwise prevail."

[36] Clause 9 of the Loan Agreement specifies a number of matters that constitute an "Event of Default". The first is:

"**(non-payment)** if the Borrower fails to pay or repay on time the Debt which is due and payable to the Lender under this Agreement, a Security or the Transaction Documents."

[37] The agreement defines "debt" to include "further monies" which in turn is defined to include monies involved with the enforcement or attempted exercise of the enforcement of rights of the lender or in consequence of default in payment of the borrower in breach of any covenant.

[38] The effect of the provisions of the Loan Agreement was to make a failure to pay the debt which was due and payable two months after the advance date an event of default. After a default PSAL was entitled to recover all the monies paid or payable by it on account of the costs, charges, expenses and outlays, all on a solicitor and client basis, that were involved with the exercise or enforcement or attempted exercise or enforcement of its rights or in consequence of default in payment of the debt or the breach of any covenant.

Security

[39] The letter of offer provided for a first registered mortgage over the Cooroibah property and a first registered mortgage over a property owned by Goldiway at Killarney (to which the statement of assets and liabilities attributed a value of $250,000). Goldiway gave a first registered charge and OPM was to give a charge in the event of default. The letter of offer also provided for security to be given in respect of OPM's shopping centre property at Browns Plains in the event of default. Two motor vehicles were also to be provided as security. The Loan Agreement also provided for securities to be given over those assets.

Subsequent events

[40] Despite being reminded by letter that the loan was repayable, the borrowers failed to repay it, or any part of it, upon the expiry of the two month loan period.

[41] There followed a lengthy period during which Ms Kellas-Sharpe and her companies sought to refinance. There were regular and frequent communications between her and Mr Flanders, and also between solicitors. Ms Kellas-Sharpe attempted without success to source funds that would enable her to "take out" PSAL's facility. At various times PSAL produced a Loan Settlement Statement. For example on 11 June 2010 its solicitors wrote to the defendants' then solicitors and attached a Loan Settlement Statement calculated to 12 July 2010. By that time PSAL had received payments of $130,000, but the loan balance was $1,500,084.27. A total sum of $1,630,084.27 was calculated before deduction of the payments received of $130,000. This consisted of the original loan advance of $1,139,368. The balance of $490,716.27 was stated to consist of, amongst other things:

- "Normal interest" of $245,102.12;
- "Default interest" of $214,464.35;
- various amounts by way of enforcement costs and default management fees.

In short, over a period of approximately five months since the default in payment, and notwithstanding payments of $60,000, $30,000 and $40,000 in April, May and June respectively, interest totalling approximately $460,000 had been charged.

[42] By October 2010 the balance of the loan had increased to $1,802,145.90 according to a Loan Settlement Statement which calculated the loan payout figure in that amount as at 14 October 2010, excluding settlement costs. By October 2010 a further $80,000 had been repaid by various payments made between July and September 2010. The Loan Settlement Statement as at 14 October 2010 calculated interest of $825,394.50 consisting of "Normal Interest" of $440,210.40 and "Default Interest" of $385,184.10.

[43] Although, according to its records, PSAL was owed slightly more than $1,800,000 as at 14 October 2010, it was prepared to negotiate the payment of a lesser amount in order to resolve the matter.

[44] The defence and counterclaim pleads that in or about October 2010 Mr Flanders advised Ms Kellas-Sharpe that PSAL would accept the sum of $1,100,000, that she advised that she would be able to repay that sum within a period of two weeks, and that Mr Flanders, on behalf of PSAL, agreed to accept this offer. Having had the advantage of hearing both witnesses, and having regard to the extensive email

correspondence that constitutes Exhibit 1, I am not satisfied that any such binding agreement was made. Instead, on 20 October 2010 the defendants' solicitors communicated a proposal, and this proposal was rejected by PSAL's solicitors upon its instructions on 21 October 2010.

[45] Negotiations continued between the parties in late 2010, including email correspondence when Mr Flanders was abroad on holidays. The defendants plead that there was a concluded agreement reached between Ms Kellas-Sharpe and Mr Flanders for the payment of $1,300,000. However, I do not accept that a binding agreement was reached. If it had been it probably would have been confirmed and documented in correspondence between the parties' then solicitors, and had PSAL not honoured the alleged oral agreement, then there would have been further reference to it by the defendants' solicitors at the time.

[46] Ms Kellas-Sharpe and Mr Flanders discussed various proposals in late 2010, but I am not persuaded that Mr Flanders committed PSAL to the agreements alleged in the pleadings.

[47] PSAL continued to press for payments. On 14 December 2010 Mr Dormer advised by email that the amount outstanding to PSAL was $2,040,420.67. Mr Dormer noted that the debt was "growing rapidly" by a daily amount of approximately $4,500. PSAL indicated that it was prepared to accept a payment of $1,600,000 by 24 December 2010 in full and final settlement. However, no compromise agreement was reached.

[48] On 24 December 2010 the defendants paid to PSAL $689,368.

[49] PSAL commenced these proceedings on 4 May 2011. In addition to claiming recovery of possession of the land at Cooroibah owned by Goldiway and the land upon which OPM's shopping centre is situated at Browns Plains, PSAL sought $1,745,166.25 as the balance of the loan account as at 20 April 2011 and interest pursuant to the Loan Agreement "at the Standard Rate of 7.50% per month". Its Reply and Answer filed 4 October 2011 particularised in a table how the figure of $1,745,166.25 was calculated. The table's calculations referred to "Normal Interest" calculated at 48 per cent per annum (or four per cent per month) and "Default Interest" calculated at 42 per cent per annum (or 3.5 per cent per month). The table indicates that interest was capitalised each month.

PSAL's Cost of Funds

[50] Mr Dormer testified that PSAL borrowed almost all of the funds required to make the necessary advance of $1,139,368 to the first and second defendants. His evidence was that $877,000 was advanced by Balani Pty Ltd, $70,000 was advanced by DW & MA O'Brien as trustee for the D & M O'Brien Superannuation Fund and a further $69,000 was advanced by Horizon Investments Australasia Pty Ltd as trustee for The O'Brien Family No 2 Trust. Mr Dormer's evidence was that each of these lenders advanced the sum in question at an interest rate of 30 per cent per annum. This meant that PSAL received $1,016,000 from these sources and was required itself to advance the remaining $123,368. Approximately $120,000 was disbursed at settlement on 17 December 2009 on account of interest ($91,149) and various fees.

[51] Although Mr Dormer adhered to his evidence that each of the three lenders charged interest at the rate of 30 per cent, there was no independent documentary evidence that DW & MA O'Brien as trustee for the D & M O'Brien Superannuation Fund charged interest of 30 per cent per annum. On the contrary, a Loan Agreement made 21 December 2009 recorded an interest rate of nine per cent per annum in its case. There were, however, documents supporting his evidence that the other two lenders charged interest at 30 per cent per annum. When asked to explain how it was that the D & M O'Brien Superannuation Fund charged PSAL interest at the rate of 30 per cent, Mr Dormer referred to an arrangement, said to be documented in an email from Mr O'Brien and recorded in PSAL's accounts, by which the remaining 21 per cent of interest was paid to Horizon Pty Ltd. However, neither the email nor any other documents were produced and tendered by PSAL, despite an opportunity to do so on the second day of the trial, to prove that PSAL in fact paid interest at 30 per cent on the $70,000 that was lent to it.

[52] I found Mr Dormer's evidence about the circumstances under which the remaining 21 per cent of interest was paid to Mr O'Brien or entities associated with him unsatisfactory. I found his other evidence generally reliable. It is possible that PSAL entered into a side agreement with the trustees of the D & M O'Brien Superannuation Fund to supplement the written loan agreement that provided for an interest rate of nine per cent per annum, so that its total interest liability was 30 per cent. PSAL's failure to produce documents supporting such a side agreement is unexplained. If there was such a side agreement it may have been entered into in order to assist the D & M O'Brien Superannuation Fund or another entity to conceal a source of income. The matter may warrant investigation by the Australian Taxation Office in respect of such income or by a regulator in relation to PSAL's documentation of the transaction. Because PSAL was reluctant to produce documents that might prove an agreement with the D & M O'Brien Superannuation Fund to pay interest totalling 30 per cent per annum, I decline to find that it incurred an interest liability to the D & M O'Brien Superannuation Fund to such an extent. I find that the D & M O'Brien Superannuation Fund advanced $70,000 at an interest rate of nine per cent per annum, that Balani Pty Ltd advanced $877,000 at 30 per cent per annum and the remaining $69,000 was advanced by Horizon Investments Pty Ltd at an interest rate of 30 per cent per annum. The effective annual interest rate was therefore less than the 30 per cent claimed in Mr Dormer's evidence. I conclude that the cost of external funding to it was 28.5 per cent**.**

[53] The loans negotiated by PSAL were for a period of two months. These loans were unable to be repaid according to their terms. Mr Dormer's evidence was that PSAL was required to "buy out" these loans and replace them with additional debt funders and its own funds in some cases.

Interest for the initial period of two months and thereafter

[54] The interest that Ms Kellas-Sharpe and Goldiway were offered, and agreed to pay, for the two months duration of the loan was described at the trial as "prepaid interest". In a sense it was, in that the letter of offer and the Loan Agreement provided for interest calculated at a rate of four per cent per month to be pre-paid on the Advance Date. It was included in the "Principal Sum" of $1,139,368 to be advanced by way of loan, and formed part of the loan balance that was to be paid on the expiry of the two month term of the loan. Like legal fees, broker's fees and other items, the two months interest was paid for by the borrowers at the time the

loan was made, but not from funds independently available to them at that time. Expressed differently, PSAL advanced to the borrowers funds to enable them to pay two months interest in advance, the interest was paid to PSAL at the start of the loan and PSAL was never at risk of the borrowers' defaulting in paying those two months interest. In terms of the Interest Rate provisions of the Loan Agreement, PSAL agreed to "accept interest at a concessional rate of 4.00% per month". PSAL was not at risk of not being paid the two months interest of $91,149. Its risk was in not being paid the sum of $1,139,368 (or some part thereof including the interest component). In that event, the Loan Agreement entitled PSAL to charge interest at 7.5 per cent on the outstanding balance of the debt.

The Penalty Issue – submissions

[55] The defendants contend that the interest rate provisions of the Loan Agreement are void as a penalty. They rely on the principle that the Court's equitable jurisdiction to relieve against penalties depends on matters of substance, rather than form.[1] They submit that the first sentence of the Interest Rate provision of the Loan Agreement could have stipulated:

> "Interest is payable at 4% per month, but if the Borrower is in default, interest is payable at 7.5%."

The substance would be the same. The defendants submit that the interest rate should not be construed as providing for an indulgence or an incentive for punctual payment. In substance, it provides that if the borrower is in breach of the contract, the interest rate will be 7.5 per cent per month, being 3.5 per cent per month higher than if the borrower is not in default.

[56] The defendants appreciate that their submissions confront a longstanding rule that effectively avoids the jurisdiction to relieve against a penalty if, instead of providing for a higher rate of interest in default of punctual payment, the mortgagee stipulates that the higher rate is payable under the mortgage and provides for its reduction in case of punctual payment. In a thorough analysis of old authority, the defendants submit that the rule is not soundly based and should not be followed.

[57] If the rule does not apply, then the defendants submit that the 7.5 per cent per month interest rate should be judged a penalty because it is "extravagant and unconscionable in amount"[2], and could not be explained by the risk to PSAL of recovering a loan in default, or the cost of administering a loan in default. The increase of 3.5 per cent was submitted to be "wildly in excess of any loss conceivable at the time of the contract", and the ability to compound or capitalise interest also is said to result in a "recovery" that was extravagant in comparison to any such loss. The provision for interest was also submitted to be extravagant when regard was had to the security available to PSAL in the event of default.

[58] PSAL relies on the well-established rule that permits a higher rate of interest to be specified, with punctual payment at a lower rate being a sufficient discharge of the

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1 *Bridge v Campbell Discount Co Ltd* [1962] AC 600 at 624 per Lord Radcliffe; *O'Dea v Allstates Leasing System* (WA) Pty Ltd (1983) 152 CLR 359 at 368 per Gibbs J; *Acron Pacific Ltd v Offshore Oil NL* (1985) 157 CLR 514 at 520 per Deane J.

2 *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 at 669 [32].

obligation to pay interest. The rule has been recognised for more than 300 years, and has been restated in recent times by this and other Australian courts.[3]

[59] PSAL submits that this is not a case in which, upon breach, it became entitled to charge a rate over and above the standard interest rate. In substance and in commercial reality, the interest rate of 7.5 per cent was set on the basis that the loan would not have been repaid at the due date. The "standard interest rate" was determined by commercial considerations, including the extent of security on offer, was a commercial rate and was not a penalty.

The Penalty Issue – discussion

[60] I respectfully adopt the summary of principle of White J in *Bay Bon Investments Pty Ltd v Selvarajah*.[4] In that case the contracts expressly provided for the payment of damages if the loans were not repaid at the end of their term. There were two components of the damages. One was for the payment of a higher rate of interest from the expiry date until repayment. In addition, for each month or part of a month that the loan was overdue a further "one month's interest" was payable. White J stated:

> [47] The agreement to pay interest as damages for late repayment attracts the doctrine of penalties if, as a matter of substance, the sum payable is not a genuine pre-estimate of the loss the plaintiff may suffer by being kept out of its money, but is in the nature of a punishment (*Acron Pacific Ltd v Offshore Oil NL* (1985) 157 CLR 514 per Deane J at 520). The moneys are payable as a consequence of a breach of contract rather than as the withdrawal of an incentive. This distinguishes this case from those where a mortgage stipulates a higher rate of interest reduceable to a lower rate if instalments are paid on time.
>
> [48] It is no longer the law that damages cannot be recovered for late payment of a debt (*Hungerfords v Walker* (1989) 171 CLR 125). In any event, a provision for the payment of interest at a higher rate after default which does not operate retrospectively is not a penalty provided it can be seen as a genuine pre-estimate of compensation for loss the lender would suffer by being kept out of its money (*David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 23 FCR 1 at 30 and 31).
>
> [49] In *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71; (2005) 224 CLR 656, the High Court referred with approval to a statement by Mason and Wilson JJ in *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 at 190 that an agreement to pay a sum as damages should only be struck down as a penalty if "it is out of all proportion to damage likely to be

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3 *Beil v Mansell (No 2)* [2006] 2 Qd R 499 at 504-505 [23] – [24]; *O'Dea v Allstates Leasing System (WA) Pty Ltd* (supra) at 366-367 per Gibbs J; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 23 FCR 1 at 29 per Lockhart, Beaumont and Gummow JJ; *Summer Hill Business Estate v Equity Trust Ltd* [2011] NSWCA 149 at [45] – [49] per Young JA.

4 [2008] NSWSC 1251 at [47] – 48].

suffered as a result of breach" (at 667 [27]). In *Ringrow Pty Ltd v BP Australia Pty Ltd* the High Court said (at 669 [32]):

> 'Exceptions from that freedom of contract require good reason to attract judicial intervention to set aside the bargains upon which parties of full capacity have agreed. That is why the law on penalties is, and is expressed to be, an exception from the general rule. It is why it is expressed in exceptional language. It explains why the propounded penalty must be judged 'extravagant and unconscionable in amount'. It is not enough that it should be lacking in proportion. It must be 'out of all proportion'."

[61] In *Beil v Mansell (No 2)*[5] Chesterman J (as his Honour then was) was concerned with a "typical penalty case". The relevant agreement provided for interest to accrue at the rate of 16 per cent until repayment, with interest calculated on a monthly basis. Clause 5 of the relevant agreement provided that in the event of any failure to repay the loan on the due date, the interest charged on the loan would increase to 25 per cent per annum. Chesterman J reviewed relevant authority, including the rule that if a mortgagee wishes to stipulate for a higher rate of interest in default of punctual payment, it must reserve the higher rate as the interest payable under the mortgage and provide for its reduction in case of punctual payment. The rule was criticised by Lord Eldon in 1802 as preferring form over substance.[6] The learned authors of *Fisher & Lightwood's Law of Mortgages*[7] describe it as a "well settled, if not an intelligible, rule", and as being "too well entrenched to be altered". Amongst modern Australian confirmations of the rule are the observations of Gibbs CJ in *O'Dea v Allstates Leasing System (WA) Pty Ltd*.[8] His Honour addressed a submission that the first respondent was suing for the consideration payable under the contract, and was not seeking to recover a sum payable in the event of a breach by the appellants of their contractual obligations, so that the question whether the amount payable was a genuine pre-estimation of damage did not arise. In this matter a similar argument is open to PSAL, namely that it is seeking to recover a sum payable under the contract, namely interest at the "standard rate" of 7.5 per cent per month, and not an amount that is payable in the event of breach. Having regard to the substance of the matter, whereby the obligation to pay interest at the "standard rate" arose upon default in repayment, the obligation to pay interest at the rate of 7.5 per cent was brought about by a breach of contract.

[62] The question of whether the contract imposes a penalty must be judged as at the time of the making of the contract, and it is a question of substance, not of form.[9] However, the principle that a penalty is determined as a matter of substance rather than of mere form is qualified by the much-criticised rule that permits a mortgagee to effectively avoid the jurisdiction to relieve against penalties by reserving the higher rate as the interest payable under the mortgage and providing for its reduction in the event of punctual payment. The Full Court of the Federal Court in

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5 Supra.

6 *Seton v Slade* (1802) 7 Ves Jun 265; 32 ER 108 at 111.

7 Second Australian edition 2005 at 3.18.

8 Supra at 366-367; c.f. Murphy J at 375 who stated that to describe a contractual right to pay the lower sum as an indulgence was a misdescription, and elevated form over substance.

9 *Bridge v Campbell Discount Co Ltd* (supra); *O'Dea v Allstates Leasing System (WA) Pty Ltd* at 368, 375, 400; *Acron Pacific Ltd v Offshore Oil NL* (supra) at 520 per Deane J.

David Securities Pty Ltd v Commonwealth Bank of Australia[10] referred to the "well-known, if not much praised, 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). The Court described the distinction as anomalous but well-established.

[63] Windeyer J observed in *Accom Finance Pty Ltd v Mars Pty Ltd*[11] that while it may be time for substance to prevail over form, a trial judge can do nothing but follow the established law. In *Kowalczuk v Accom Finance Pty Ltd*[12] Campbell JA (with whom Hodgson and McColl JJA agreed) referred to the conventional view that a properly drafted mortgage containing higher and lower rates does not attract the law of penalties at all.[13] The Court of Appeal was not concerned in that case to consider whether that conventional view of the application of the law of penalties to mortgages containing a higher rate and a lower rate of interest is correct.

[64] In circumstances where intermediate appellate courts in this country have confirmed the existence of the rule, and the rule has been recognised by judges of the High Court, I do not consider that it is open to me to not follow it.

[65] In deference to the research and analysis undertaken by counsel for the defendants about the origin of the rule and his submissions that the rule should not be followed I will briefly summarise them. The frequently cited cases of *Lady Holles v Wyse*[14] and *Strode v Parker*[15] are submitted to have been decided *per incuriam* because of a misunderstanding of what was decided in *Lord Halifax's Case*.[16] The rule has been frequently cited in obiter, and was stated in the frequently cited judgment of Lord Hatherley in *Wallingford v Mutual Society*.[17] The rule has been consistently criticised as an impermissible triumph of form over substance.

[66] The defendants also submit that the impulse for the rule probably arose from the practice of English courts in the seventeenth and eighteenth centuries of viewing any increase in interest on default as a penalty, including increases as small as one half a per cent. An increase in the rate of interest upon default, however modest, was treated as a penalty. In modern times modest increases have been upheld. The defendants submit that because the rationale for the rule has now gone, the rule itself should not be followed.

[67] The rule may have unsatisfactory origins. The time may have arrived for it to be replaced. However, the rule is so well-established in Australian law that I do not consider that it is open to me as a judge at first instance to alter it, particularly when the rule has been confirmed in recent times by intermediate appellate courts.

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10 Supra.
11 (2007) 13 BPR 24,729; [2007] NSWSC 726 at [55].
12 (2008) 77 NSWLR 205.
13 At 241 [162].
14 (1693) 2 VERN 290; 23 ER 787.
15 (1694) 2 VERN 316; 23 ER 805.
16 *Marquis of Halifax v Higgens* (1690) 2 VERN 134; 23 ER 694.
17 (1880) 5 App Cas 685 at 702.

The Penalty Issue – conclusion

[68] I decline to find that the provision as to the interest rate is a penalty. It does not provide for a higher rate of interest after default. It provides for a standard interest rate and also provides that while the borrower is not in default under the facility the lender will accept interest at a concessional rate. It is a well-established rule that a provision governing the rate of interest in such a form does not attract the doctrine concerning penalties.

Penalties – other issues

[69] The defendants acknowledged that if I followed the established rule, then it was not open to me to find that the interest rate provision was void as a penalty. This makes it strictly unnecessary to address other issues that arise in this context. However, in case it becomes necessary I should indicate the findings that I would have reached had I not followed the rule and, instead, had regard to the substance of the interest rate provision in its commercial context.

[70] Viewed in isolation, it is possible to regard the interest rate provision as allowing for a four per cent per month interest rate in the absence of default under the facility, which increases to 7.5 per cent if the borrower is in default. However, the loan contract provided for, in effect, the payment of interest in advance, so that the borrowers would never be in default in the payment of interest during the two month term of the loan. They made arrangements for its payment in advance and the amount paid formed part of the loan balance. Because in this sense PSAL was assured of the payment of interest for the two month duration of the loan and there was no other obligation to pay money during that two month period, the four per cent "concessional rate" did not take account of the risk of not being paid interest during the term of the loan. The 7.5 per cent interest was payable if the borrower was in default, and applied to the non-payment of any part of the sum of $1,139,368 which was due for payment on 16 February 2010 which was two months after the Advance Date. The Loan Agreement made no provision for the payment of monthly interest amounts after 16 February 2010 at the "concessional" or lower rate of four per cent. That rate would never apply after 16 February 2010. Accordingly, this is unlike the case of a long term loan contract which provides for monthly interest payments (or monthly payments of interest together with an amount by way of reduction of principal) and which also provides that the interest rate will increase to a higher or default rate if the monthly payment is not made on time. In this case the standard rate of 7.5 per cent was intended to provide for the consequences of a breach of contract if the borrower failed to pay all or part of the amount of $1,139,368 which fell due for payment at the expiry of the two month period.

[71] If the interest rate provision attracted the doctrine of penalties, then it would be a penalty if it was not a genuine pre-estimate of the loss PSAL might suffer by being kept out of its money, but was, instead, in the nature of a punishment. Whether a provision is to be treated as a penalty is to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach. That the contractual function is deterrent rather than compensatory can be deduced by comparing the amount that would be payable on breach with the loss

that might be sustained if breach occurred.[18] The High Court in *Ringrow Pty Ltd v BP Australia Pty Ltd*[19] stated that the principles relating to penalties applied if the money stipulated to be paid on breach will produce for the payee advantages significantly greater than the advantages which would flow from a genuine pre-estimate of damage. The Court stated that before a payment would be regarded as a penalty:

> "... the propounded penalty must be 'extravagant and unconscionable in amount'. It is not enough that it should be lacking in proportion. It must be 'out of all proportion'."[20]

This question is to be determined by reference to matters at the time the contract was entered into. One category of loss that would arise as a consequence of the borrowers' failing to repay the loan monies was PSAL's loss of the opportunity to lend the funds to other borrowers. Although PSAL did not have a fixed rate of interest, its typical short term loans provided for a higher or standard rate of 8.5 or 9 per cent per month and a lower or concessional rate of five per cent per month. Another category of loss that could be anticipated would be the direct costs of taking steps to enforce the loan and recover securities. The Loan Agreement made additional, specific provision for these. In the absence of such a specific provision for their recovery these costs would be a consequence of breach. In addition, there might be substantial internal costs in administering the loan in default which might not be recoverable under such a specific provision. Another significant consequence of default would be the risk that PSAL would be unable to recover the amount that it had loaned, or a substantial part of it, notwithstanding the availability of security. The provision of security, and the promise to provide additional security in the event of default, is one thing. The realisation of the proceeds of sale is another, and there was no guarantee in December 2009 that PSAL would be able to realise the security being offered to it within a short period, or that the amounts that would be realised from any sale would be for the values that the borrowers estimated those properties to have in December 2009. The estimated values contained in the borrowers' statement of assets and liabilities were not verified, and the value of the Cooroibah property was more likely to be closer to the purchase price of $1,000,000 than the $2,200,000 attributed to it in the valuation report obtained by Ms Kellas-Sharpe.

[72] The fact of a default in repayment of the loan monies in February 2010 would signal the borrowers' inability to obtain further finance, either in the short term or for a longer period. The default itself might impair their ability to obtain further finance from other sources. The default might be for a short period because of an inability to settle a contract or obtain further finance for a few days. However, it might signal a lengthy period of default and the loss of any realistic chance to recover the loan or a substantial part of it.

[73] The onus is on the defendants to show that the provision is a penalty. However, as White J observed in *Bay Bon Investments Pty Ltd v Selvarajah*[21], once some evidence is adduced which may be sufficient to satisfy that onus, there is an evidentiary onus on the plaintiff to explain the nature of its business, the rates at

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18 *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752 at 762-763; followed in *Beil v Mansell (No 2)* (supra) at 507 [34].

19 Supra at 667 [27].

20 Ibid at 669 [32].

21 Supra at [51].

which it is able to lend and how, when the contracts were entered into, it would have been anticipated that the monies would be redeployed on repayment of the loans. I consider that PSAL has discharged any such evidentiary onus. The evidence that it adduced indicated that short term loans during this period carried a wide range of interest rates. The market in which it operated had short term interest rates of between 1.5 per cent and 12 per cent per month. PSAL's loans typically had higher rates of 8.5 or 9 per cent per month and lower or concessional rates of five per cent per month. I am not persuaded that the higher or default rate of interest of 7.5 per cent per month for this transaction was not a genuine pre-estimate of the loss PSAL might suffer as a consequence of a default in repayment, including the cost of being kept out of its money. I am not satisfied that the agreed rate of 7.5 per cent per month is out of all proportion to the damage likely to be suffered as a result of a breach, or that the propounded penalty is "extravagant and unconscionable in amount".

[74] The 7.5 per cent per month figure might be a genuine pre-estimate of compensation for loss, having regard to the security being offered by the borrowers. PSAL's evidence tends to indicate that the interest rates that it was prepared to offer would have been higher had such security not been on offer. Any pre-estimate of the loss PSAL might suffer as a result of breach must take account of the context of a default in the repayment of loan monies at the expiry of a short term loan. The breach was not simply a late payment of a monthly interest instalment. The breach reflected the borrowers' inability to secure further funding and potentially might signal a complete inability to refinance the loan. It might suggest some unexpected development, or a flaw in the borrowers' assessment of its ability to refinance, including possibly an over-estimation of the value of security on offer. 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.

[75] This conclusion is not to deny that over a substantial period the agreed interest rate of 7.5 per cent per month had the potential to be "crushing to a borrower".[22] However, the payment of compensatory damages often will be crushing to a party who is unable to pay them. The present issue is not whether the application of such a high monthly interest rate has the potential to be crushing, especially when the lender elects to capitalise the interest that accrues. The issue is whether the provision is a penalty, and I am not persuaded that it is. In circumstances in which PSAL might have lent the money that was owed to it in February 2010 in a short term market in which rates varied between 1.5 per cent and 12 per cent month, the interest rate of 7.5 per cent per month has not been proven to be "significantly greater than the advantages which would flow from a genuine pre-estimate of

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22 *Kawalczuk v Accom Finance Pty Ltd* (supra) at 245 [175].

damage".[23] The propounded penalty should not be judged "extravagant and unconscionable in amount". As the High Court observed in *Ringrow Pty Ltd v BP Australia Pty Ltd*,[24] exceptions from freedom of contract require good reason to attract judicial intervention to set aside the bargains upon which parties of full capacity have agreed. The propounded penalty must be judged "extravagant and unconscionable in amount". It must be out of all proportion. The defendants have not discharged the onus of proving this.

[76] If I had found the provision of the Loan Agreement that stipulated an interest rate of 7.5 per cent was void as a penalty, then there would have been no scope for the contractual provision as to severance to save the "concessional rate" of four per cent. The agreement would not have contained an interest rate. In that event, PSAL would have been confined to a claim for interest pursuant to statute. The defendants submitted in such an event for the rate provided for in Practice Directions for interest on default judgments. Although those rates are often relied upon as a guide to the exercise of discretion in awarding interest on damages or in money claims at commercial rates, I do not consider that they would be an appropriate rate by which to assess the value of PSAL's loss of the use of its money. Its actual loss of use would be at least the value of the cost of funds to it being, as I have found, more than 25 per cent per annum at least during the first months of the loan. A rate of 25 per cent per annum compounding annually would seem to be an appropriate rate to have adopted had the occasion arisen to declare the interest rate provision void and award, instead, interest pursuant to statute.

Unconscionability

[77] The defendants invoke the provisions of s 12CC of the *ASIC Act* and s 51AC of the *TPA*. PSAL took no point that these provisions might apply to the subject transaction. No point was taken that the supply of financial services was to "a person whose acquisition or possible acquisition of the financial services is or would be for the purpose of trade or commerce"[25], or that the supply of services was to "a person whose acquisition or possible acquisition of the goods or services is or would be for the purpose of trade or commerce" within the meaning of s 51AC(7) of the *TPA*.[26]

Relevant statutory provisions

[78] Section 12CC of the *ASIC Act* provided at the relevant times:

> "**12CC Unconscionable conduct in business transactions**
>
> (1) A person must not, in trade or commerce, in connection with:

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23 *Ringrow Pty Ltd v BP Australia Pty Ltd* (supra) at 667 [27].

24 Ibid at 669 [32].

25 *ASIC Act* s 12CC(6) in the form in which the provision appeared at the relevant time.

26 c.f. *Kawalczuk v Accom Finance Pty Ltd* (supra) at 246-248 [182] – [189] in which it was unnecessary, on the facts of that case, to decide whether an investment made by a private individual, or a private individual's company, as part of a business in investing would have the necessary character of being entered "for the purpose of trade or commerce" within the meaning of s 51AC.

(a) the supply or possible supply of financial services (see subsection (6)) to another person (other than a listed public company); or

(b) the acquisition or possible acquisition of financial services (see subsection (7)) from another person (other than a listed public company);

engage in conduct that is, in all the circumstances, unconscionable.

(2) Without in any way limiting the matters to which the court may have regard for the purpose of determining whether a person (the ***supplier***) has contravened subsection (1) in connection with the supply or possible supply of financial services to another person (the ***service recipient***), the court may have regard to:

(a) the relative strengths of the bargaining positions of the supplier and the service recipient; and

(b) whether, as a result of conduct engaged in by the supplier, the service recipient was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the supplier; and

(c) whether the service recipient was able to understand any documents relating to the supply or possible supply of the financial services; and

(d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the service recipient or a person acting on behalf of the service recipient by the supplier or a person acting on behalf of the supplier in relation to the supply or possible supply of the financial services; and

(e) the amount for which, and the circumstances under which, the service recipient could have acquired identical or equivalent financial services from a person other than the supplier; and

(f) the extent to which the supplier's conduct towards the service recipient was consistent with the supplier's conduct in similar transactions between the supplier and other like service recipients; and

(g) if the person is a corporation—the requirements of any applicable industry code (see subsection (11)); and

(h) the requirements of any other industry code (see subsection (11)), if the service recipient acted on the

reasonable belief that the supplier would comply with that code; and

(i) the extent to which the supplier unreasonably failed to disclose to the service recipient:

(i) any intended conduct of the supplier that might affect the interests of the service recipient; and

(ii) any risks to the service recipient arising from the supplier's intended conduct (being risks that the supplier should have foreseen would not be apparent to the service recipient); and

(j) if there is a contract between the supplier and the service recipient for the supply of the financial services:

(i) the extent to which the supplier was willing to negotiate the terms and conditions of the contract with the service recipient; and

(ii) the terms and conditions of the contract; and

(iii) the conduct of the supplier and the service recipient in complying with the terms and conditions of the contract; and

(iv) any conduct that the supplier or the service recipient engaged in, in connection with their commercial relationship, after they entered into the contract; and

(ja) without limiting paragraph (j), whether the supplier has a contractual right to vary unilaterally a term or condition of a contract between the supplier and the service recipient for the supply of the financial services; and

(k) the extent to which the supplier and the service recipient acted in good faith.

...

(5) For the purpose of determining whether a person has contravened subsection (1) in connection with the supply, possible supply, acquisition, or possible acquisition of financial products or financial services:

(a) the court must not have regard to any circumstances that were not reasonably foreseeable at the time of the alleged contravention; ..."

[79] If a contravention of s 12CC is proven, then the *ASIC Act* confers broad discretionary powers to make appropriate orders which will compensate the affected person for loss or damage or which will prevent loss or damage. Section 12GM of

the *ASIC Act* confers a discretionary power to make such orders as the Court thinks appropriate against the person who engaged in the contravening conduct if the Court considers that the orders will compensate in whole or in part for the loss or damage that the party has suffered, or will prevent or reduce the loss or damage. The orders may include an order declaring the whole or part of a contract to be void, and orders varying the contract.

[80] Section 51AC of the since repealed *TPA* relevantly provided:

"**51AC Unconscionable conduct in business transactions**

(1) A corporation must not, in trade or commerce, in connection with:

(a) the supply or possible supply of goods or services to a person (other than a listed public company); or

(b) the acquisition or possible acquisition of goods or services from a person (other than a listed public company);

engage in conduct that is, in all the circumstances, unconscionable.

(2) A person must not, in trade or commerce, in connection with:

(a) the supply or possible supply of goods or services to a corporation (other than a listed public company); or

(b) the acquisition or possible acquisition of goods or services from a corporation (other than a listed public company);

engage in conduct that is, in all the circumstances, unconscionable.

(3) Without in any way limiting the matters to which the court may have regard for the purpose of determining whether a corporation or a person (the ***supplier***) has contravened subsection (1) or (2) in connection with the supply or possible supply of goods or services to a person or a corporation (the ***business consumer***), the court may have regard to:

(a) the relative strengths of the bargaining positions of the supplier and the business consumer; and

(b) whether, as a result of conduct engaged in by the supplier, the business consumer was required to comply with conditions that were not reasonably necessary for the protection of the legitimate interests of the supplier; and

(c) whether the business consumer was able to understand any documents relating to the supply or possible supply of the goods or services; and

(d) whether any undue influence or pressure was exerted on, or any unfair tactics were used against, the business consumer or a person acting on behalf of the business consumer by the supplier or a person acting on behalf of the supplier in relation to the supply or possible supply of the goods or services; and

(e) the amount for which, and the circumstances under which, the business consumer could have acquired identical or equivalent goods or services from a person other than the supplier; and

(f) the extent to which the supplier's conduct towards the business consumer was consistent with the supplier's conduct in similar transactions between the supplier and other like business consumers; and

(g) the requirements of any applicable industry code; and

(h) the requirements of any other industry code, if the business consumer acted on the reasonable belief that the supplier would comply with that code; and

(i) the extent to which the supplier unreasonably failed to disclose to the business consumer:

(i) any intended conduct of the supplier that might affect the interests of the business consumer; and

(ii) any risks to the business consumer arising from the supplier's intended conduct (being risks that the supplier should have foreseen would not be apparent to the business consumer); and

(j) the extent to which the supplier was willing to negotiate the terms and conditions of any contract for supply of the goods or services with the business consumer; and

(ja) whether the supplier has a contractual right to vary unilaterally a term or condition of a contract between the supplier and the business consumer for the supply of the goods or services; and

(k) the extent to which the supplier and the business consumer acted in good faith.

...

(6) For the purpose of determining whether a corporation has contravened subsection (1) or whether a person has contravened subsection (2):

(a) the court must not have regard to any circumstances that were not reasonably foreseeable at the time of the alleged contravention; ..."

[81] Section 87 of the now repealed *TPA* conferred extensive discretionary powers to make appropriate orders to compensate a party in whole or in part for the loss or damage suffered by it, or which will prevent or reduce loss or damage.

Relief sought by the defendants

[82] By their counterclaim the defendants sought relief that included the following:

1. An order that the Loan Agreement and any collateral bills of mortgage be read and construed as if any reference to payment of interest on unpaid interest or capitalisation of interest were deleted from each of those documents.

2. An order that the Loan Agreement and any collateral bills of mortgage made between the plaintiff and the defendants be read and construed as if "Interest Rate" in the Schedule to the Loan Agreement entitled "Commercial Details" were deleted and the following substituted:

   "Interest Rate: Two per cent (2%) per calendar month."

3. The defendants pay to the plaintiff such sum as may be outstanding to the plaintiff taking into account the interest rate as set out in Order (2) above and any payments made by the defendants to date.

4. Upon payment by the defendants to the plaintiff the sum identified pursuant to Order (3) above, the plaintiff release any mortgages or other securities held by it over the defendants' property.

[83] PSAL denied that its conduct was unconscionable. It submitted that the 7.5 per cent interest rate was not unconscionable. It sought judgment in the sum of $2,210,617.46 being the balance of the loan calculated to 23 January 2012 at the rate of 7.5 per cent per month. This calculation did not include the capitalisation of interest in the exercise of PSAL's entitlement to capitalise interest in accordance with cl 4.3 of the Loan Agreement.

Interpretation of the statutory provisions

[84] The parties' submissions in relation to unconscionability proceeded on the basis that the same considerations applied in respect of the defendants' case in respect of s 12CC of the *ASIC Act* and their case in respect of s 51AC of the *TPA*. The defendants would either succeed or fail on both provisions. I accept this approach.

[85] The two statutory provisions that are invoked by the defendants in relation to unconscionable conduct are not constrained by the general law in relation to unconscionability. The provisions are not to be read down by limiting their operation only to circumstances where the general law would grant relief in respect of unconscionable conduct.[27] These provisions were intended to build on and not

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[27] *Australian Securities and Investments Commission v National Exchange Pty Ltd* (2005) 148 FCR 132 at 140 [30]; 56 ACSR 131 at 138 [30].

be constrained by cases decided under the general law.[28] The provisions exist to protect persons engaged in small business.

[86] "Unconscionable conduct", on its ordinary and natural interpretation, means doing what should not be done in good conscience.[29] Section 51AC of the *TPA* has been said to apply to conduct that is regarded as unconscionable, serious misconduct or something clearly unfair or unreasonable.[30] The Full Federal Court in *Hurley* cited the meaning given by the Shorter Oxford English Dictionary to unconscionable, namely, actions showing no regard for conscience or that are irreconcilable with what is right or reasonable. Their Honours observed that the various synonyms used in relation to the term "unconscionable" import a pejorative moral judgment.

[87] Different tests have commended themselves to courts. It has been said that the conduct must demonstrate "a high level of moral obloquy" on the part of the person said to have acted unconscionably.[31] The phrase "high level of moral obloquy" has been adopted in later authorities. Basten JA observed in *Canon Australia*[32] that the use of "such concepts as high moral obloquy is to risk substituting for the statutory term language of no greater precision ...". In 2011 the New South Wales Court of Appeal again discussed the term "unconscionable" in the context of s 12CB and s 12CC of the *ASIC Act*. After quoting some of the formulations that I have noted ("high level of moral obloquy" and conduct "irreconcilable with what is right or reasonable") and also observing that the statutory provisions focus on the conduct of the person said to have acted unconscionably, the Court observed:

> "It is neither possible nor desirable to provide a comprehensive definition. The range of conduct is wide and can include bullying and thuggish behaviour, undue pressure and unfair tactics, taking advantage of vulnerability or lack of understanding, trickery or misleading conduct. A finding requires an examination of all of the circumstances."[33]

[88] Unconscionable conduct may arise where the borrower is at a disadvantage, either constitutional or situational.[34] However, as Gleeson CJ observed in *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd*:[35]

> "A person is not in a position of relevant disadvantage, constitutional, situational, or otherwise, simply because of inequality of bargaining power. Many, perhaps even most, contracts are made between parties of unequal bargaining power, and good conscience does not require parties to contractual negotiations to forfeit their advantages, or neglect their own interests".

The fact that a finding of unconscionable conduct requires an examination of all of the circumstances, and is not established simply because a party is in a situation of

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28 Ibid.

29 Ibid at [33].

30 *Hurley v McDonald's Australia Ltd* (2000) 22 ATPR 41-741 at 40,585 [22] cited with approval in *Canon Australia Pty Ltd v Patton* (2007) 244 ALR 759 at 768 [40]; (2007) 29 ATPR 42-183 at 47,980 [40].

31 *Attorney-General (NSW) v World Best Holdings Ltd* (2005) 63 NSWLR 557 at 583 [121] per Spigelman CJ in discussing a different statutory regime under the *Retail Leases Act* 1994 (NSW).

32 Supra at 47,974 [4].

33 *Tonto Home Loans Australia Pty Ltd v Tavares* [2011] NSWCA 389 at [291].

34 *Perpetual Trustees Australia Ltd v Schmidt* [2010] VSC 67 at [194].

35 (2003) 214 CLR 51 at 64 [11].

disadvantage in negotiations, is illustrated by the fact that "pure asset lending" is not necessarily unjust or unconscionable.[36] "Pure asset lending" is "to lend money without regard to the ability of the borrower to repay by instalments under the contract, in the knowledge that adequate security is available in the event of default".[37] The mere fact that a loan is asset based is not, of itself, sufficient to make it unconscionable. There must be some other factor that makes the conduct of the lender morally repugnant.[38]

[89] Although the statutory provisions that are invoked are not constrained by principles derived from the unwritten law, the approach of the general law to the protection of the vulnerable may inform assessments of whether conduct is "unconscionable" within the meaning of the statute. In *Kakavas v Crown Melbourne Ltd*,[39] Harper J stated:

> "One of equity's enduring concerns has been the protection of the vulnerable. But that protection must be both principled and consistent. Neither principle nor consistency are served without a clear conception of both; and that in turn requires a careful identification of what is encompassed by the vulnerability which equity is prepared to protect. It requires, as well, an equally careful assessment of the proper measures of protection which in any given set of circumstances is appropriate. So, for example, while equity will sometimes intervene in circumstances where there has been an inequality of bargaining power, sometimes it will not. Again, it may on occasion be proper for equity to protect people from themselves. Ordinarily, however, each must accept responsibility for his or her action or inaction."

[90] Section 12CC of the *ASIC Act* and s 51AC of the *TPA* each contain matters to which the Court may have regard in determining whether a contravention of the section has occurred. Factors that are relevant to an assessment of whether a contract is "unjust" within the meaning of the *Contracts Review Act* 1980 (NSW) may arise for consideration in the context of s 12CC of the *ASIC Act* and s 51AC of the *TPA*. However, some care is required not to equate the provisions of the *Contracts Review Act* and case law about what may be "unjust" within the meaning of its provisions with the concept of "unconscionable conduct" for the purpose of the provisions that are invoked in these proceedings. For example, a provision for a higher rate of interest can be "unjust" within the meaning of the *Contracts Review Act* without itself being unconscionable.[40] Not all of the specific factors that are relevant to the consideration of the Court under s 9 of the *Contracts Review Act* may be relevant in a case under s 51AC of the *TPA* or s 12CC of the *ASIC Act*. Section 9 of the New South Wales Act requires the Court to have regard "to the public interest". In short, a conclusion that a provision of a contract is "unjust" within the meaning of the New South Wales Act cannot be equated to a finding that the same provision and its enforcement is "unconscionable" within the meaning of the Commonwealth statutes that I am required to apply.

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36 *Kowalczuk v Accom Finance Pty Ltd* (supra) at 227 [96].

37 *Perpetual Trustee Company Limited v Albert and Rose Khoshaba* [2006] NSWCA 41 at [128].

38 *Perpetual Trustees Australia Ltd v Schmidt* (supra) at [200].

39 [2009] VSC 559 at [426].

40 *Kowalczuk v Accom Finance Pty Ltd* (supra) at 244 [171].

[91] Not all of the matters to which regard may be had under the two Commonwealth statutes arise for consideration in the present case. I shall focus upon the matters relied upon by the defendants.

The defendants' case on unconscionability

[92] I have quoted the defendants' pleading in relation to unconscionability at the start of this judgment. Certain further matters falling within their particularised case were advanced in the course of submissions. The defendants' case, as pleaded and as argued, concentrates upon:

- the relative strengths of the parties' bargaining positions and the fact that PSAL was unwilling to change the terms upon which it was prepared to enter the Loan Agreement;

- PSAL's legitimate interests and the fact that, on the defendants' case, the Loan Agreement contained provisions that went far beyond what was reasonable to protect PSAL's legitimate interests;

- PSAL's alleged conduct in relation to negotiation about the amount that would be required to settle the loan, and a contention that it failed to tell the defendants that "the sole purpose of the interest rate scheme was to set up an opportunity to drive the debt to the value of the security";

- the fact that the Loan Agreement contained specific contractual entitlements to recover loss and expenses suffered in consequence of a default;

- the potential of the high interest rate to compound, with "the potential to be utterly crushing to a borrower".[41]

In general, the defendants submit that the various provisions of the Loan Agreement in respect of interest were themselves sufficient to render PSAL's conduct unconscionable.

[93] I have previously found that PSAL did not engage in certain conduct alleged against it, namely reach agreements in late 2010 in relation to payout figures and then resile from those agreements. More generally, I do not accept that PSAL was intent on ensuring that the loan went into default and remained in default for a lengthy period whereby the debt would rise close to the value of the security that was available to it, allowing it to earn a handsome profit. I accept the evidence of Mr Dormer that PSAL's approach is to avoid a loan going into default and that its preference is for the loan to be paid out at the end of its term so that PSAL can carry on its business and the borrower can carry on its business. I also find that PSAL attempted to negotiate in good faith during 2010 for the borrowers to refinance. I decline to find that its purpose was to "drive the debt to the value of the security".

[94] In permitting the borrowers additional time in 2010 to refinance and to pay out the loan, PSAL took the risk that eventuated, namely that the borrowers would be unable to find sufficient finance to pay the amount PSAL required to compromise the matter, let alone the then loan balance. Whilst PSAL took that risk, the passage

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41 *Kowalczuk v Accom Finance Pty Ltd* (supra) at 245 [175].

of time exposed the borrowers and the guarantor to great financial loss as the short term loan became a long term loan. The high rate of monthly interest, and PSAL's election pursuant to cl 4.3 of the Loan Agreement to capitalise it, ensured that the loan balance grew substantially. This was the consequence of provisions as to interest being applied to a loan that had long ceased to be the short term loan contemplated by both parties at the time it was agreed. PSAL may not have intended such a development, but the provisions of the Loan Agreement, and PSAL's exercise of its right to capitalise interest, permitted it to increase the loan balance at a rate that exceeded the increase in PSAL's cost of funds and prejudiced the borrowers' ability to refinance such a rapidly growing amount. A critical issue is whether the exercise by PSAL of its entitlement to capitalise interest over a lengthy period at such a high rate was reasonably necessary to protect its legitimate interests and was unconscionable in all of the circumstances.

Relative strength of bargaining positions

[95] I do not regard this to be a significant factor. Ms Kellas-Sharpe was under pressure to settle the purchase of the property at Cooroibah, and PSAL knew of this. The pressure to secure finance was largely of Ms Kellas-Sharpe's own making. She entered into a contract for Goldiway to purchase the property, hoping to catch a bargain. She did not negotiate a provision that made the contract subject to finance. She may have hoped to obtain finance from a family company, but took the risk of not being able to do so. Her company, Goldiway, contracted with the seller of that property for the $100,000 to be forfeited if Goldiway did not settle.

[96] Ms Kellas-Sharpe was experienced in business. She understood the commercial terms of the loan negotiated with PSAL and, as her solicitor's certificates indicated, she and her companies entered into the Loan Agreement and the guarantee and indemnity freely and voluntarily.

[97] PSAL did not exploit her vulnerability in negotiating the loan. It operated in a sector of the financial market that Ms Kellas-Sharpe and her companies chose to access, rather than forfeit the deposit under the sale contract. This was not a case of pure asset lending where PSAL appreciated that its only prospect of obtaining repayment of the loan was by selling assets that were provided as security. Ms Kellas-Sharpe was confident of her ability to obtain finance after the Christmas holidays, and persuaded PSAL that she would probably do so. On paper at least, she and her companies appeared to have substantial assets, well in excess of their liabilities.

[98] PSAL's unwillingness to renegotiate the terms of its letter of offer was reasonable. Without the provision upon which it insisted it was exposed to substantial costs in circumstances in which it, unlike other lenders in that market, did not charge a substantial application fee.

[99] PSAL may prefer to describe itself as a short term lender, and it would be wrong to describe its business as being "a lender of last resort". However, in the circumstances in which Ms Kellas-Sharpe found herself in December 2009, with settlement of the contract a few days away, PSAL became her lender of last resort. The observations of Marshall J in *Chilcott v Homesec Finance Express Pty Ltd*[42] are apposite:

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[42] [2011] FCA 729 at 40.

> "It did no more than carry on its usual business as a lender of last resort at transparently high interest rates to people who had a choice not to go ahead with the transaction at the risk of losing their deposit ... The [borrowers] were not placed at a serious disadvantage simply because of the high rates charged ... There was no unconscientious exploitation by [the lender] of [the borrowers'] inability to conserve their own interests. The [borrowers] had a choice. They were able to walk away from the ... transaction and not enter a short term loan."

PSAL's legitimate interests – security

[100] The defendants' pleading and their submissions contend that the provisions of the Loan Agreement went beyond what was reasonably necessary to protect PSAL's legitimate interests because, amongst other things, PSAL was to obtain substantial security over the Cooroibah property and over a property at Killarney. The pleaded value of the property at Cooroibah of $2,200,000 is unproven. Its value is likely to have been closer to the $1,000,000 that Goldiway promised to pay for it. As Mr Orange observed, as a general proposition, the market pays what the market wants to pay and, as a matter of credit analysis, it would have been reasonable to assess the market value of the property as $1,000,000. Even if PSAL was prepared to assess the value of the Cooroibah property at more than $1,000,000, its value was uncertain. The assets and liabilities estimated by the borrowers were unverified. The fact that security was being offered, including a first registered mortgage over the Cooroibah property, was relevant to the protection of PSAL's interests. However, without such security a higher interest rate could have been reasonably demanded.

[101] The defendants have not proven their plea that PSAL ordinarily accepted an interest rate of two per cent per month when offered security by way of first registered mortgage. The evidence was that loans with an interest rate of four per cent and a concessional rate of two per cent per month were rare and required "very low LVRs or very good cash flow or both".

PSAL's legitimate interests – interest rates

[102] The defendants complain that they were charged exorbitant interest rates, and in particular exorbitant capitalised interest rates. The interest rate of four per cent per month was reasonable to cover PSAL's costs of funds and its overheads. It was a reasonable interest rate in the event that the borrower complied with its obligations, allowing PSAL to use the repaid funds for new loans. If PSAL's costs of funds were in fact about 28.5 per cent per annum, not 30 per cent per annum, for the initial period of the loan then the concessional rate of interest may have allowed it some profit.

[103] I am not persuaded that the 7.5 per cent standard rate that applied when the loan went into default was an exorbitant rate, having regard to PSAL's potential for loss on a defaulting loan (together with its potential to profit if the loan was repaid in full, together with interest at 7.5 per cent). An interest rate of this order accords with the evidence concerning commercial rates at the time and has not been shown to be an unreasonable rate to cover the costs and losses that result from default. However, PSAL negotiated specific contractual entitlements to recover certain costs incurred by it in consequence of a default. In a different statutory context, namely

the *Contracts Review Act* 1980 (NSW), Campbell JA (with whom Hodgson and McColl JJA agreed) observed:

> "Where a lender has specific contractual entitlements to recover all loss and expenses it suffers in consequence of a default, a provision for a higher rate of interest to become payable in circumstances where there has been a default (even if such a provision is cast in a form that takes it outside the law concerning penalties) is not in my view reasonably necessary for protection of any legitimate interest of any party to the contract."[43]

The specific contractual provision in this matter that entitles PSAL to recover certain costs and expenses involved in enforcement of its rights does not extend to all of the loss and expense it suffers in consequence of a default. However, I consider that where a lender like it has a specific contractual entitlement to recover certain costs and expenses, it becomes harder for it to justify a provision for a higher rate of interest to become payable upon default by reference to the cost of administering the loan in default and other costs associated with its enforcement. Still, even with such a specific contractual entitlement to recover certain enforcement costs, a lender will incur certain internal costs in administering a loan in default which may fall outside of the specific contractual provision, and not be recoverable pursuant to it.

[104] The defendants' submissions relied upon what was said to be a concession by Mr Flanders under cross-examination that the only purpose of the provision for interest at the rate of 7.5 per cent was to make large windfall profits. However Mr Flanders did not concede this. In one part of his testimony, he accepted the proposition that the increase to 7.5 per cent was not connected to "any cost, any disability that you could be put under by the default". However this concession must be seen in the context of his evidence as a whole. He went on to explain that the four per cent was sufficient to cover the cost of funds and overheads and make a profit "provided the loans are repaid". His evidence, like that of Mr Dormer, explained the difference of 3.5 per cent between the concessional and standard rates (or the normal and default rates) as relating to losses that had to be covered on underperforming or non-performing loans. As Mr Flanders explained "the extra interest" makes up for the losses. According to Mr Flanders, those losses arose upon default when PSAL ended up "with either a reduced amount or zero, which has been the case quite often".

[105] I do not consider that the four per cent "concessional rate" in this case should be treated as reflecting the risk that the loan might go into default, thereby requiring the lender to justify the higher rate of interest by reference to additional risks and additional costs. The four per cent interest rate assumed that the loan was not in default and would be repaid upon its expiry, allowing the lender to use its money and make some profit. This is not a case in which the lending business was structured in a way that it was only by having contracts go into default that the lender could make a satisfactory profit that recognised the risk of its business. It is therefore not necessary to address the issue of whether it is not in the public interest or unconscionable "that a money lending business should be structured in a way that

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43 *Kowalczuk v Accom Finance Pty Ltd* (supra) at 242 [166].

it is only by its contracts going into default that it can make a satisfactory profit that recognises the risk of its business".[44]

[106] In *Kowalczuk v Accom Finance Pty Ltd*[45], Campbell JA observed:

> "It does not follow from the view I am expressing that in no circumstance is any difference between a higher and lower rate in a mortgage justified, when the higher rate becomes payable upon a default. I have some doubt about whether such a provision could coexist with provisions like those in the present Memorandum, that made every cent of the extra expense incurred as a consequence of a default specifically recoverable. If there were no provisions that made extra expense incurred in consequence of a default recoverable, or provisions that made only certain specific expenses incurred as a consequence of a default recoverable without covering the entire field of loss suffered in consequence of a default, there would often, it seems to me, be room consistently with the *Contracts Review Act* for a provision that allowed a higher rate of interest to be paid upon default, to the extent that it protected a legitimate interest of the lender."

In the present factual circumstances, and different statutory context, I conclude that a higher and a lower rate of interest can be justified when the higher rate becomes payable upon a default. The higher rate can be justified (even with a specific provision in relation to the recovery of costs and expenses incurred as a consequence of default) by reference to losses associated with the default. These include opportunity costs reflected in the loss of the opportunity to use the money which would have been repaid in the absence of default. The consequences of default include the increased risk of not recovering principal and interest for the term of the loan, notwithstanding the provision of security.

[107] I am not satisfied that the Loan Agreement's provision in relation to a higher interest rate, standing alone, made PSAL's conduct in entering into the Loan Agreement unconscionable. The fact that the interest rates reflected commercial rates does not necessarily mean that they were not unconscionable. However, it is a factor in concluding that the defendants have failed to prove that the interest rates specified in the Loan Agreement were exorbitant.

Capitalisation of interest over a lengthy period

[108] In *Chen v Song*[46] James J found there was nothing about the contract to borrow money that was harsh or unjust, either in its terms or its operation, in the context of a short term loan. However, the position was different after the loan had ceased to be a short term loan:

> "I find that the rate of interest was not unjust for a short term bridging loan, where the loan was required urgently, and would not be unjust for the original term of the loan and perhaps somewhat longer. However, in the present state of the evidence I would be

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44 *Kowalczuk v Accom Finance Pty Ltd* (supra) at 244 [168]. In that case the lender had 75 per cent of its loans in default.

45 Supra at 244 [174].

46 [2005] NSWSC 19.

> disposed to find that the rate of interest of 8.5% or 7.5% per month, especially if compounded, would be unjust, as a rate of interest continuing year after year, after the loan had ceased to be a short term bridging loan."[47]

Those observations were made in the context of proceedings in relation to the *Contracts Review Act* 1980 (NSW), however, the same point may be made in the present statutory context.

[109] The facts of one case do not determine the outcome of another, and a loan may cease to be a short term loan for many different reasons. One is where the borrower is content for the loan to continue for months, if not years. Another is where the lender is content for the loan to continue, and takes inadequate steps to resolve the situation with the borrower.

[110] In this matter PSAL permitted the loan to continue, and delayed taking steps to recover all of the security given to it. It allowed the borrowers time to seek alternative finance. However, it did not indicate that it was content to allow the loan to continue for as long as the borrowers might continue to seek alternative finance.

[111] Importantly, PSAL exercised its entitlement to capitalise the substantial interest that accrued each month. The consequences of its decision to capitalise interest are significant. The provision for capitalisation of interest, when exercised every month at the higher interest rate, increased the loan balance markedly.

[112] In *Asia Pacific International Pty Ltd v Dalrymple*[48] the defendants obtained a loan for business purposes from the plaintiff for a period of one month. As here, the borrowers were in urgent need of a loan for a short period. They were prepared to pay $9,000 interest in return for a loan of $60,000, or 15 per cent per month. However, the loan agreement provided for an interest rate of 20 per cent per month, with a reduction to 15 per cent per month if the interest was paid on time. It also included a provision that entitled the mortgagee to capitalise unpaid interest. Shepherdson J concluded that the insertion of provision for a default rate of interest at 20 per cent per month and for unpaid interest to be capitalised was unconscionable. He concluded that the plaintiff acted unconscionably by inserting into the Deed of Loan provisions enabling unpaid interest to be capitalised and then bear further interest at the rate of 20 per cent per month. His Honour ordered that the Deed of Loan be varied to provide for an interest rate of 15 per cent per month and all references to capitalisation of interest were deleted.

[113] The arithmetic and practical effect of a high monthly interest rate being capitalised monthly and applied over a period of many months need not be set out in a table in this judgment.[49] In *Asia Pacific International Pty Ltd v Dalrymple*, the effect was to increase the loan debt "astronomically". It might be said that the defendants in these proceedings must be taken to have understood the consequences of default in their obligations under the Loan Agreement and under the Guarantee, and that if they allowed the loan to continue unpaid for months the debt would increase at the

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47 Ibid at [197].

48 [2000] 2 Qd R 229 at 240-241 [57] – [59].

49 c.f. the illustration of the operation of a default rate of compound interest in *Kowalczuk v Accom Finance Pty Ltd* (supra) at 236-238 [143] – [146].

agreed rate of 7.5 per cent per month, with PSAL being entitled to capitalise unpaid interest. It might also be argued that it is not unconscionable for the defendants to be required to accept these financial consequences where, following default, they sought the understanding of PSAL and a continuation of the loan, rather than taking immediate steps to sell the security and avoid the further escalation of the loan debt. PSAL's conduct in permitting the borrowers time to refinance the debt can hardly be described as unconscionable conduct. It was what the defendants wanted PSAL to do in the circumstances. PSAL did not cynically permit a short term loan to become a long term one. Instead, it allowed the borrowers additional time to refinance the debt, rather than take its chances of recovering the loan that was in default by taking prompt action under the securities that were given to it and other steps by way of enforcement.

[114] In a case such as this, where the borrower is allowed a reasonable time to refinance, there must be a point when, with capitalisation of interest, it simply becomes impossible for the borrower to refinance the substantially increased mortgage debt on the basis of the security that it was able to offer for a short term loan or at all. To permit a short term loan to become a long term loan may not involve conduct that has a "high level of moral obloquy". However, the exercise of the entitlement to capitalise interest at the higher or default rate of 7.5 per cent per month has the potential to be crushing to a borrower. Such a consequence will be difficult to justify in circumstances in which the higher or default rate of interest cannot be explained by reference to the need to recover certain costs and expenses that are incurred as a consequence of the default. The Loan Agreement included specific contractual provision to recover certain costs and expenses that arose as a consequence of a default and the provision for default interest was not reasonably necessary for the protection of any legitimate interest of PSAL in respect of such costs and expenses.

[115] I do not find that the rate of interest of 7.5 per cent per month was unconscionable for the original term of the loan, and it would not have been unjust for that higher or default rate to be charged for a period of a few months during which time the borrowers were given a reasonable opportunity to refinance. However, continuing to charge that rate of interest, capitalised monthly, for the long period during which interest was charged at the default rate was unconscionable in circumstances in which costs associated with the default were added to the loan balance and attracted interest at that rate. By mid-2010 the loan had ceased to be a short term loan and the capitalisation of interest at such a high rate imperilled any prospect that the borrowers had of being able to pay out the loan balance. To continue to capitalise interest at such a rate for a period of months and years is irreconcilable with what is right and reasonable. It is true that, in permitting the loan to continue and to capitalise interest, PSAL put at risk its ability to recover the growing loan balance from the proceeds of sale of the security which it had obtained. Although PSAL ran this risk, it did so knowingly in circumstances in which it also must have known that the capitalisation of interest at interest rates that were negotiated in the context of a short term loan placed the borrowers and the guarantor in a position of great disadvantage. At a certain point the borrowers lost any realistic prospect of being able to refinance the mortgage debt. They had difficulty in obtaining finance in late 2009 for a loan of $1,000,000. They faced even greater difficulty in being able to secure funds to pay out the loan balance which by October 2010 exceeded $1,800,000. In addition, they faced the loss of the proceeds of sale of properties offered as security and the prospect of recovering far less from the proceeds of sale

than if PSAL had taken action to recover its debt much sooner, and not capitalised interest.

[116] Whilst the loan balance was increasing markedly during 2010, the cost of funds to PSAL apparently did not alter.

[117] PSAL permitted a short term loan to become a long term loan at the request of the borrowers. The borrowers and the guarantor did not invite PSAL at any stage to step in and exercise its power of sale without further delay as a means of repaying the debt, or at least reducing it. Still, PSAL was content for the borrowers to find a new source of funds to resolve the matter, rather than itself take action by exercising its rights to recover the loan and sell the properties over which it had security. During this lengthy period the prospects of the borrowers being able to refinance and thereby "exit" from the PSAL loan was reduced by PSAL's decision to capitalise interest.

[118] The provisions of the Loan Agreement permitted PSAL to charge the default rate of interest of 7.5 per cent, and to capitalise such interest, for periods of months and years following the default. Provision for it to capitalise interest at such a rate at its election was not reasonably necessary for the protection of its legitimate interests. The capitalisation of interest over a lengthy period in 2010 and 2011 was a significant factor in the escalation of the mortgage debt and the defendants' inability to refinance it. At the same time that it charged the borrowers interest at the default rate of 7.5 per cent per month, and capitalised interest, PSAL also increased the debt by claiming costs and expenses associated with the default and the administration of the loan in default. Although it was contractually entitled to claim such amounts as part of the debt owed to it, interest accrued on these amounts at the default rate.

[119] I conclude that PSAL's conduct in enforcing the interest rate provisions of the Loan Agreement throughout 2010 and 2011 whilst relying upon specific contractual provisions that entitled it to add certain costs to the loan balance was not reasonably necessary to protect its legitimate interests. Exercising its entitlement to capitalise interest at such a high rate over such an extended period was irreconcilable with what was right and reasonable in all the circumstances.

[120] I find that it contravened s 12CC of the *ASIC Act* and s 51AC of the *TPA*.

Remedies

[121] PSAL in effect conceded that it should not recover a debt calculated on the basis of the capitalisation of interest. Exhibit 13 calculated the loan payout figure as at 23 January 2012 on the basis of an interest rate of 7.5 per cent ($2,201,617.46) and at four per cent ($1,276,013.62) without the capitalisation of interest.

[122] The *ASIC Act* and the *TPA* provide for the Court to make orders to remedy the loss and damage suffered by the defendants or which they are likely to suffer. I am satisfied that the capitalisation of interest at the default rate of 7.5 per cent per month was a cause of the defendants losing any real prospect that they had of being able to refinance the mortgage debt.

[123] I consider that the appropriate orders in the circumstances are orders that will vary the loan agreement to delete the provision in the schedule to the agreement so that a

standard interest rate of five per cent is substituted in lieu of 7.5 per cent. The provision for capitalisation of unpaid interest should be deleted.

[124] Subject to hearing submissions as to the appropriate form of orders, I propose to order as follows:

1. Declare the provisions of the Loan Agreement dated 17 December 2009 made between the plaintiff and the first and second defendants ("the Loan Agreement") insofar as its provisions require payment by the defendants of interest at a rate of 7.5 per cent per month and permit capitalisation of unpaid interest and payment of interest on unpaid interest to be unconscionable.

2. That the Loan Agreement and any collateral bills of mortgage be read and construed as if any reference to payment of interest on unpaid interest or capitalisation of interest were deleted from each of those documents.

3. That the Loan Agreement and any collateral bills of mortgage made between the plaintiff and the defendants be read and construed as if "Interest Rate" in the Schedule to the Loan Agreement entitled "Commercial Details" were deleted and the following substituted: "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."

4. Direct the plaintiff and the defendants calculate the debt outstanding to the plaintiff taking into account the interest rate provided for in the previous order, and any payments made by the defendants, as at 1 March 2012.

5. Upon payment by the defendants to the plaintiff of the sum so calculated, together with interest calculated thereon at the rate of five per cent per month to the date of payment, the plaintiff release any mortgages and other securities held by it over the defendants' property.

6. Failing such payment within 28 days of the date of these orders, the plaintiff recover possession of the land described in paragraphs 1, 2 and 3 of the Claim.

7. Failing such payment within 28 days of the date of these orders, judgment be entered for the plaintiff against each defendant for the balance of the loan account calculated in accordance with paragraph 3 above.

[125] I will hear the parties in relation to the form of order and any issue of costs.