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Avoiding the penalty rule? Take a potentially penal secondary obligation in one agreement and make it a primary obligation in a new and separate agreement between the same parties: Moran v Argonaut Equity Partners Pty Ltd

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The Court of Appeal of Western Australia held that an obligation to pay default interest of 5% per month was not penal because it was a primary obligation, not a secondary one.[1] The decision indicates that it may sometimes be possible to avoid the operation of the penalty rule by taking a potentially penal secondary obligation in one agreement and making it a primary obligation in a new and separate agreement between the same parties.

Mr Moran was a director and shareholder in Atrum Coal NL (Atrum) which listed on the Australian Securities Exchange (ASX) in 2012. He entered into a loan agreement as borrower with various lenders in June 2014. The loan did not accrue interest. However, if the loan was not repaid when due, interest was payable at the "default rate" of 5% per month. The repayment date was 31 July 2014 with an option to extend. He exercised that option, extending the repayment date to 11 December 2014.

In December 2014, he and the lenders entered into the Amended and Restated Loan Agreement. The repayment date was extended to 11 June 2015. This time, interest was payable on the loan at approximately 25% per annum. Interest was also payable on demand at the "default rate" of 5% per month for any amounts not repaid when due under the Amended and Restated Loan Agreement.

Under the Amended and Restated Loan Agreement, it was an event of default if Atrum shares ceased to be traded. This occurred in June 2015 and led Mr Moran to seek a further extension.

A letter, known as the first extension letter, was issued to Mr Moran offering more time to repay the loan. It referred to amounts owing under the Amended and Restated Loan Agreement, approximately $8 million, as the payment obligation. The payment obligation was due on 18 June 2015 (extended from 11 June 2015) with interest payable at the "default rate" of 5% per month.

After alternative funding fell through, Mr Moran sought a further extension. Another letter, the second extension letter, was then issued offering him more time to repay the loan. The payment obligation now became due on 17 July 2015 (extended from 18 June 2015) and interest was payable at the "default rate" of 5% per month. The letter waived, until 17 July 2015, the event of default that would arise if Atrum remained suspended from trading.

Payment was not forthcoming. Following unsuccessful negotiations, in December 2016, parties associated with the lenders, Argonaut Equity Partners Pty Ltd (Argonaut), enforced their security interest by selling Atrum shares on the ASX.

Trial

Based on *Andrews v Australia and New Zealand Banking Group Ltd*[2] (*Andrews*), the trial judge said a penalty is essentially a secondary obligation imposed on a contracting party that breaches a primary obligation.

He concluded that each extension letter was a new and separate agreement, and that the payment of interest at 5% per month was a primary obligation in each agreement, payable independently of any other contractual obligation. On this basis, he held the interest payment at 5% per month was not penal.

Appeal

Mr Moran submitted the finding that each extension letter was a new and separate agreement adopted "an artificial and excessively narrow view" of the substance of those letters.[3] He submitted that the extension letters

continued the secondary obligation to pay default interest on the breach of the primary obligation to repay the payment obligation when due, while extending the date to repay the payment obligation. He said the agreement to extend was an agreement not to enforce the original breach, and that the secondary obligation to pay default interest, which had come into effect upon the original breach, effectively remained in effect.

He said the extension letters, in substance, implemented the provision of the Amended and Restated Loan Agreement that required the payment of default interest at 5% per month upon the failure to repay overdue amounts under that agreement.

He argued that the primary judge should have found the default interest provisions of the extension letters were secondary obligations and therefore engaged the penalty doctrine.[4]

Argonaut submitted that the default interest provisions of the extension letters were primary obligations because those provisions:

- were consideration for the extension of the loan Agreement and
- had the effect that interest was not payable upon the default of the payment obligation or any other loan agreement obligation

The Court of Appeal noted that, to succeed, Mr Moran had to establish that, in substance, the extension letters gave effect to the prima facie penal obligation under the provision of the Amended and Restated Loan Agreement that required the payment of a "default rate" of 5% per month upon the failure to repay amounts when due under that agreement.

Referring to *Andrews*, the Court of Appeal stated that in the circumstances of this case, the essence of a penalty is that it is a secondary obligation, the purpose of which is to punish the borrower for breach, and thus compel performance.[5] It concluded that the default interest provisions of the extension letters were not penal. Some of the court's reasons are briefly discussed below.

The obligation to pay default interest under the first extension letter did not arise on the default of the obligation to pay the payment obligation and was not an "additional detriment" imposed on Mr Moran upon his failure to pay the payment obligation by 18 June 2015.

The first extension letter gave Mr Moran an extension of time to repay the loan on the terms in that letter. It did so even though he was not contractually entitled to an extension. The Court of Appeal said the first extension letter was a further agreement between the parties, imposing additional and different rights and obligations from those in the Amended and Restated Loan Agreement.

The court stated the second extension letter was also a further contract, imposing different and additional obligations and rights from those imposed by the earlier contractual iterations. The second extension letter also gave Mr Moran an extension of time to repay the loan even though he had no contractual entitlement to one.

The court emphasised the extension letters provided an extension of time for Mr Moran's payment obligations, which Argonaut was not obliged to grant. It noted that the price for Argonaut to grant those extensions was Mr Moran's agreement to pay interest at 5% per month from 11 June 2015.[6] The court stated that the price may be regarded as high, and that it was "a matter for Mr Moran's commercial judgment as to whether the price for obtaining the extensions was too high".[7]

In conclusion, the Court of Appeal stated:

> . . . as a matter of substance, Mr Moran's obligation to pay 5% interest per month was *the contractual price for obtaining new rights* conferred by the First and Second Extension Letters, rather than a consequence of any breach of the terms on which those rights were conferred [emphasis added].[8]

Payment for an additional accommodation or a penalty in disguise?

The decision of the Western Australia Court of Appeal raises the issue of whether a provision is in substance the price for an additional accommodation or is instead a penalty. As the following cases indicate, the distinction may not always be straightforward.

The High Court has recognised the difference between a penalty and an amount paid for an additional accommodation. In *Andrews*, the High Court referred with approval to the following statement by Lord St Leonards in *French v Macale*:

> If a man let meadow land for two guineas an acre, and the contract is, that if the tenant choose to employ it in tillage, he may do so, paying an additional rent of two guineas an acre, no doubt this is a perfectly good and unobjectionable contract; the breaking up the land is not inconsistent with the contract, which provides, that in case the act is done [that is, the tenant chooses to till the land that is leased] the landlord is to receive an increased rent.[9]

In *Metro-Goldwyn-Mayer Pty Ltd v Greenham*[10] (*Metro-Goldwyn-Mayer*), cl 9 of a contract for the hiring of films to exhibitors for screening to public audiences gave the right to screen a film at prices set out in the contract. Clause 56(a) of the contract also provided that if the film exhibitor screened a film more often, and did so without the written consent of the distributor, the exhibitor was obliged to pay, for each additional screening, a sum equivalent to four times the original fee paid to screen the film.

A majority of the Court of Appeal of New South Wales (Jacobs and Holmes JJA) held that cl 56(a) was

not penal on the basis that the clause provided for a payment for an additional contractual entitlement.[11] Jacobs JA stated:

> . . . it seems to me that cl. 56 is properly regarded as one *providing for an additional hiring fee in the event of an additional showing of a film*. It may well be intended by the agreement that such an additional showing should be strongly discouraged. For this reason a very large hiring fee compared with the original hiring fee is provided. ... First it would be necessary to determine that cl. 56(a) truly dealt with damages and not with hire of the film for a further occasion or occasions. In the light of the interpretation which I have given to the agreement I do not see how, despite the language of cl. 9, the clause in question can be regarded as a clause dealing with damages. *There is no right in the exhibitor to use the film otherwise than on an authorized occasion. If he does so then he must be taken to have exercised an option so to do under the agreement, if the agreement so provides. The agreement provides that he may exercise such an option in one event only, namely, that he pay a hiring fee of four times the usual hiring fee.* In my view this is not a clause dealing with damages but is dealing with the price of such an option . . . [emphasis added][12]

The Full Federal Court in *Paciocco v Australia and New Zealand Banking Group Ltd*[13] (*Paciocco*) confirmed the primary judge's view that an overdraw fee was not penal because the fee was properly characterised as a fee for an accommodation given by the bank. The Full Federal Court stated:

> The primary judge's analysis was correct. The clause as a whole provides for the discretion of ANZ to permit an overdrawing, for a fee. The clause make[s] plain that overdrawing is not to take place without prior arrangements, but then provides for a mechanism, at the discretion of ANZ, of permitting an overdrawing that contains a fee. In its own terms . . . the fee is payable for the accommodation provided.[14]

The court in *Paciocco* also touched on the difficulty of distinguishing a provision that "on its face provides for a fee for an additional contractual benefit", from a provision that "is in substance a disguise for a fee for a breach that is extravagant and unconscionable".[15]

A large fee for the provision of the additional contractual accommodation is relevant, but not determinative, to assessing whether the fee is a penalty — as the Full Federal Court stated, a "high fee for the contractual benefit may, however, be just that — a high fee for the additional contractual benefit".[16]

Practice tips

- A contractual obligation to pay interest is unlikely to be regarded as penal if the obligation does not arise upon the breach of another contractual obligation.
- It may be possible to avoid the operation of the penalty rule by taking a potentially penal secondary obligation in one agreement, and making it a primary obligation in a new and separate agreement between the same parties.

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Footnotes

1. *Moran v Argonaut Equity Partners Pty Ltd* [2021] WASCA 45; BC202101850.
2. *Andrews v Australia and New Zealand Banking Group Lt* (2012) 247 CLR 205; 290 ALR 595; [2012] HCA 30; BC201206622 at [10].
3. Above n 1, at [68].
4. Engaged the penalty doctrine in the sense that the court was required to determine whether or not the interest payment of 5% per month was penal.
5. Above n 1, at [79].
6. Above n 1, at [89].
7. Above.
8. Above.
9. Above n 2, at [80] citing *French v Macale* (1842) 2 Drury and Warren 269 at 275–76.
10. *Metro-Goldwyn-Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717.
11. Above, at 723–24.
12. Above.
13. *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199; 321 ALR 584; [2015] FCAFC 50; BC201503488.
14. Above, at [215].
15. Above n 13, at [222].
16. Above.