# Default Interest Rates and *ParkingEye* – a Commonwealth Perspective

## Robin Kingham

The recent decision of the Supreme Court in *ParkingEye Ltd v Beavis*; *Cavendish Square Holding BV v El Makdessi* [2015] UKSC 67 is a landmark in the development of the common law doctrine of penalties. In four lengthy judgments delivered by seven Justices, the court took the opportunity to revisit and reshape a broad area of law with far-reaching consequences for both commercial and consumer contracts.

But how does this decision affect lenders? While potentially penal clauses will arise in many contexts, lenders are particularly likely to encounter difficulty in specifying an increased rate of interest on default (or 'default rate'). Whether a default rate constitutes a penalty is likely to have significant financial implications for the lender. Unfortunately, the law on the subject has not always been clear and litigation is common.

Following the decision in *ParkingEye*, a default rate is generally acceptable so long as it is not 'unconscionable' or 'extravagant'. But what constitutes an 'unconscionable' or 'extravagant' rate of interest? Can such a rate be identified with any precision? Is there still a distinction between default rates and concessionary rates? And how does the situation differ in commercial and consumer contexts?

This article will attempt to answer these questions. In particular, the Commonwealth lending cases cited by Lord Mance in *ParkingEye* will be considered, as they provide a helpful insight into acceptable default rates. First, however, a summary of the decision in *ParkingEye* may be helpful.

### The decision in *ParkingEye*

The Supreme Court took the opportunity in *ParkingEye* to revisit the law of penalties in detail for the first time in almost 100 years. Previously, the general principle was that a clause was a penalty if its primary purpose was to punish breach (i.e. that it was *in terrorem*) rather than to compensate the other party for its losses. Consequently, an alleged penalty clause could be defended on the basis that it constituted a 'genuine pre-estimate of loss' or 'liquidated damages'.

The Supreme Court dismissed this reasoning as unpersuasive. There were several potential justifications for an otherwise penal term (e.g. a legitimate commercial interest). The correct approach was to consider whether the clause was 'extravagant' or 'unconscionable' – the two usually being the same. In determining this point, the courts are entitled to consider the factual background of the contract.

## The decision in *Lordsvale*

Although the court in *ParkingEye* was concerned with the general doctrine of penalties, specific attention was paid to rates of interest charged by lenders on default. In particular, the celebrated judgment of Colman J in *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752 was approved and applied. Since it is now the leading English authority on default interest rates, and since it has been referred to in all of the subsequent Commonwealth decisions, Colman J's judgment warrants consideration.

*Lordsvale* concerned a syndicated commercial loan agreement in which provision was made for interest to be paid at 1.5% above LIBOR. On default, however, the rate was increased by a further 1%. The borrower argued that the extra 1% constituted a common law penalty.

Colman J disagreed. Although the increase did not purport to be a pre-estimate of loss, there were other compelling reasons for permitting the increased rate. Specifically, once a borrower defaulted on a loan, he represented a new and increased credit risk to the lender. Essentially, by defaulting, the debtor had changed the nature of the agreement and could no longer expect to be charged the same amount for the facility as he had done previously. The 1% increase was therefore justifiable.

## Default interest rates and the Commonwealth authorities

*Lordsvale* has had a tremendous impact on the development of the law relating to default rates of interest. As Lord Mance put it: 'in a whole series of cases across the world, courts have taken their cue from *Lordsvale* and held that provisions in loan agreements for uplifting the interest rate for the future after a default should not be regarded as penalties, save where the uplift is evidently extravagant'.[1]

But how much is a lender permitted to charge? What constitutes an 'evidently extravagant uplift'? Whilst Colman J did not attempt to specify the upper limits of acceptable rates in

[1] *ParkingEye* at [147]

*Lordsvale*, the series of cases mentioned by Lord Mance provide useful examples. They are considered below in chronological order.

*Hong Leuong Finance Ltd v Tan Gin Huay*

In *Hong Leuong Finance Ltd v Tan Gin Huay* [1999] 2 SLR 153, the loan agreement related to a mortgage of a food market stall in Singapore. Interest was agreed at 5.5% per annum for the first two years of the loan and 6.75% per annum thereafter. However, in the event of default, the agreement provided for 'late payment interest' to be charged at 1.5% per month or 18% per annum. In holding the rate to be penal, the Court of Appeal of Singapore placed particular emphasis on the decision in *Lordsvale* in concluding that an uplift of **11.25%** per annum on default was 'eminently an extravagant increase'.[2] Furthermore, the fact that the default rate was commonplace in the particular market and was charged by other finance houses was 'really besides the point'.[3]

*Place Concorde East Ltd Partnership v Shelter Corp of Canada*

The deal in *Place Concorde East Ltd Partnership v Shelter Corp of Canada* (2003) 43 BLR (3d) 54 lay at the other end of the commercial spectrum. In that case, the mortgage related to the purchase of a $26 million residential and commercial complex in Calgary. Interest was charged at 1.75% above a defined 'Prime Rate' per annum.[4] On default, this rose to 6% above the Prime Rate – an increase of **4.25%** per annum.

The lender submitted that this 'reflected a commercially reasonable, modest increase' in accordance with the decision in *Lordsvale*.[5] The expert instructed by the lender distinguished between commercial and non-commercial lenders, stating that commercial banks tended to establish interest rates at 2%-3% above the Prime Rate while non-commercial lenders could expect 3%-4%. He concluded that 6% was reasonable for a non-commercial lender, whilst admitting it was on the high side.

The Ontario Superior Court of Justice determined that the increase of 4.25% on default was penal. Although Pepall J stated that he did 'not quarrel with the proposition that an increase on default should not per se be treated as a penalty', he stated that the increase was 'extravagant and unconscionable' and that he was 'not persuaded that it was commercially reasonable in the circumstances'.[6]

[2] At [27]
[3] Ibid.
[4] I.e. 1.75% above the prime commercial lending rate of a specified Canadian bank.
[5] At [281]
[6] At [292]

*Re Mandarin Container*

*Re Mandarin Container & ors* [2004] 3 HKLRD 554 concerned a commercial shipping dispute. The loan agreement, which was secured on a number of ships, set interest at 1.4% above LIBOR.[7] On default, a further **2%** was added for a total of 3.4% above LIBOR. In his tightly reasoned judgment in the Court of First Instance of Hong Kong, Waung J permitted the default rate and concluded that 'the 2% uplift is clearly in my view not extravagant or exorbitant or excessive'.[8]

In reaching this conclusion, it was relevant that loan was large and covered a range of ships over a long period of time. Consequently, 'the range of possible losses consequent upon non-payment by the defendant of its contractual obligations would be broad, extensive and difficult to visualise, identify or enumerate. It is therefore sensible for the parties to agree beforehand on an agreed formula for interest rate regime covering the time when there was default in payment'.[9] The 2% uplift was clearly agreed 'for the commercial reason of providing a different interest rate regime in respect of a borrower which had deteriorated into an inferior credit risk situation. The rate increase of 2% although higher than the 1% increase in *[Lordsvale]* is really quite modest compared to the 11.25% increase condemned in *[Hong Leuong Finance Ltd]*'.[10]

Notably, Waung J refused to accept that the existence of security should affect the default rate:

> 'In reaching my conclusion in favour of the validity of [the default interest rate], I have not overlooked the many points made by Mr Kat for the defendants. His point for example about this loan being secured as compared to the *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752 loan not being secured does not assist him. Floating security is often difficult to enforce and the loss of credit-worthiness upon non-payment is one of the many imponderables which the lenders have to take into account in assessing what should be the appropriate default rate uplift… Further the fact that the bank has security in the form of the mortgage of the vessels does not in any way detract from the necessity of a higher rate uplift upon default. Banks very often do have both security as well as a reasonable spread over LIBOR as well as uplift interest rate upon default. Security and default uplift are not mutually exclusive and their coexistence do not therefore suggest that default uplift is exorbitant or extravagant. Both are needed for the proper protection of the banks.'[11]

[7] At the time, LIBOR was roughly 0.49%.
[8] At [21]
[9] At [19]
[10] At [22]
[11] At [23]

*Beil v Mansell (No 2)*

Bearing in mind the burgeoning Commonwealth consensus on default rates evident in the above decisions, it is hardly surprising that the Supreme Court of Brisbane considered an uplift of **9%** per annum to constitute a penalty in *Beil v Mansell (No 2)* (2006) 2 Qd R 499. Like the *Place Concord* case, *Beil* concerned a commercial property deal. Interest was initially charged at 10% per annum, but the agreement was subsequently altered to provide for interest at 16% and rising to 25% on default. Chesterman J noted that the default rate was 'on its face, exorbitant'.[12]

*Elberg v Fraval*

In *Elberg v Fraval* [2012] VSC 342, the Supreme Court of Victoria was presented with an extreme example of default uplifting. In a short term commercial securities lending context, interest was set at $3,500 per day on an advance of $500,000 – i.e. 0.7% per day. On default, this was increased to $5,000 or **1% per day** – a 70% increase in the interest payable. Predictably, this was viewed by the court as 'exceptionally large'.[13] Furthermore, no evidence was given by the lender as to how this figure had been determined and no adequate explanation was otherwise put forward. Habersberger J therefore concluded that 'even accepting that Mr Fraval represented an increased credit risk when he did not repay the loan plus interest on the due date, the increased interest was out of all proportion to the increased risk'.[14]

*PSAL Limited v Kellas-Sharpe*

In *PSAL Limited v Kellas-Sharpe and ors* [2012] QSC 31 the Supreme Court of Queensland indicated that it was prepared to accept an uplift of **3.5% per month**. That case concerned a commercial loan for $1,139,368 in a very 'short term, high risk' market. Although the court ultimately upheld the rate for other reasons (considered below), Applegarth J's judgment remains relevant to default rates. He accepted expert evidence that relevant interest rates in the market ranged from 1.5%-12% and that 7.5% was 'roughly middle of the road'.[15] The standard rate was therefore 'a commercial rate in the relevant market'. Furthermore, the context of the loan – being outside the scope of traditional lending – was particularly relevant. As Applegarth J noted:

> '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*, 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 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

[12] At [27]
[13] At [107]
[14] At [120]
[15] At [13]

> discharged any evidentiary onus… 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 the breach, or that the propounded penalty is "extravagant and unconscionable in amount".'[16]

Analysis

Broadly speaking then, the Commonwealth authorities seem to suggest that an uplift of 1%-3.5% is an acceptable reflection of the increased credit risk presented by a borrower on default. Of course, much depends on the term and context of the loan, as well as the quality of expert evidence concerning applicable market conditions. As the court noted in *PSAL*, lenders will bear an evidential burden in proving the reasonableness of their default rates. Presumably, the higher the default rate, the greater the burden will be in proving the uplift to be reasonable.

But what if the structure of the charge is turned on its head? The courts have long upheld a distinction between default rates and concessionary rates. As will be seen, it is a troublesome – albeit, sometimes profitable – distinction.

**Concessionary rates**

Traditionally, a distinction has been drawn at common law between a low rate of interest that is increased on default (a 'default rate') and a higher rate of interest that is lowered if payment is made promptly (a 'concessionary rate').[17] A concessionary rate is generally not considered to be a penalty.[18] The rule has long been criticised, as the end result is essentially the same for the borrower.[19] None the less, it continues in force.

*PSAL Limited v Kellas-Sharpe and ors* [2012] QSC 31 is a recent lending example from Australia. It concerned a commercial loan for $1,139,368 in the 'short term, high risk' market. The agreement provided for a 'standard rate' of 7.5% per month. However, so long as the borrower was not in arrears, the lender agreed to accept a 'concessional rate' of 4% per month. In substance, therefore, the agreement was much the same as a 4% rate with a 3.5% per month uplift on default.

[16] At [74]
[17] See inter alia *Lady Holles v Wyse* (1693) 2 Vern 289, *Jory v Cox* (1701) Prec. Ch. 160, *Brown v Barkham* (1720) 1 P. Wms. 652, *Marquis of Powis (ex. Parte Nicholls) v Maynard* (1747) 3 Atk. 519, and *Bonafous v Rybot* (1763) 3 Burr. 1370
[18] See inter alia *Wallingford v Mutual Society* (1880) 5 App. Cas. 685 and *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752
[19] As early as 1802, Lord Eldon criticised the distinction as 'preferring form over substance'. See *Seton v Slade* (1802) 7 Ves Jun 265.

Whilst acknowledging the difficulties in justifying the distinction between default and concessionary rates, the Supreme Court of Queensland declined to depart from the rule, stating 'the rule has been recognised for more than 300 years, and has been restated in recent times by this and other Australian courts'.[20] The rate was concessionary in nature, rather than penal, and the doctrine of penalties therefore could not apply.

**Default rates in consumer contracts**

It is notable that none of the cases above considered default rates in a consumer lending context. All involved loans between commercial parties, albeit of widely varying sophistication.

It seems highly likely that the acceptable range of default rates will be lower in consumer contexts than in commercial cases. Furthermore, even where the doctrine of penalties does not specifically apply – for example, because the agreement stipulates a concessionary rather than default rate – the courts will still be able to employ the regulatory regime imposed on consumer credit transactions in the UK to mitigate otherwise harsh results (e.g. the wide ranging powers contained in the unfair relationship provisions of s140A of the Consumer Credit Act 1974).

None the less, both the acceptable range of default rates identified above and the rule concerning concessionary rates will still be highly relevant to lenders – provided, of course, that consideration is given to the additional factual and regulatory factors particular to consumer lending.

**Conclusion**

Unfortunately, the Supreme Court in *ParkingEye* did not consider lending cases in great detail. While there was some discussion of default rates, concessionary rates were wholly omitted from their Lordships' consideration. However, the series of international cases cited by Lord Mance in *ParkingEye* aid in identifying the correct approach.

At present, it remains open to lenders to restructure default charges as concessionary rates from the outset and avoid the issue of penalties. However, considering the repeated protests made by first instance courts around the world as to the artificial and legalistic distinction drawn between default and concessionary rates, it may be that the rule will be reconsidered by the appellate courts. If this happens, lenders will find themselves on a stronger footing if they are prepared to face the issue of penalties by reference to the Commonwealth authorities.

[20] At [68] and [58]