ICLR

*752 Lordsvale Finance Plc. v Bank of Zambia

Queen's Bench Division

20 March 1996

[1996] 3 W.L.R. 688

[1996] Q.B. 752

Colman J.

1996 March 14; 20

Contract—Construction—Indemnity clause—Default interest—Facility agreement with bank—Agreement providing for increased rate of interest in event of borrower's default—Increase only payable during period of default—Whether penalty

Practice—Judgment by default—Incomplete action—Action for repayment of advance and for contractual default interest—Summary judgment entered for repayment of advance plus interest to be assessed—Second action commenced to recover default interest—Whether plaintiff estopped from claiming default interest in second action—Whether election to pursue claim for interest in first action

The defendant bank entered into two facility agreements with two syndicates of banks under which the sums of U.S.$100m. and $130m. were made available to the defendant. The agreements provided that in the event of default the defendant was to pay interest during the period of default at the aggregate rate of the cost of obtaining dollar deposits to fund the banks' participation, the margin (which was defined as 1 ½ per cent.) and an additional, but unexplained, 1 per cent. When the facility advances fell due for repayment the defendant defaulted. The plaintiffs, who were assignees of the rights of certain members of the syndicates, claimed payment of the principal sum together with default interest due under the agreements. On the hearing of an application for summary judgment under R.S.C., Ord. 14 , the plaintiffs did not proceed with the claim for summary judgment for interest. It was ordered that the defendant should have leave to defend upon condition that it paid £800,000 into court, but that in default of payment the plaintiffs were to be at liberty to sign judgment for the principal sum claimed "plus interest (if any) to be assessed." The defendant failed to comply with the condition of payment in and judgment was entered against it in the agreed terms. The defendant failed to pay the default interest and the plaintiffs commenced a second action to recover it.

On the plaintiffs' application for summary judgment in both actions: -

Held, granting the application,

(1) that the first action was not an election of one juridical route to compensation to the exclusion of another but an incomplete cause of action for default interest; that the plaintiffs had not omitted to make a claim for default interest in the original proceedings since the cause of action for default interest only arose after commencement of the first action when the demand on the defendant was made; and that when judgment was entered against the defendant in the first action both parties had understood that liability as to interest remained at large (post, pp. 757C-F, 759A-B, 767D-E)

(2) That there was no reason in principle why a contractual provision the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided its dominant purpose was not to deter the other party from breach; that if an increased rate of interest applied only from the date of default or thereafter,

provision for a modest increase in the rate would not be struck down as a penalty; that ***753*** the rate of 1 per cent. could not be said to be in terrorem but was consistent only with an increase in the consideration for the loan by reason of the increased credit risk represented by a borrower in default; and that, accordingly, the default interest provision would be fully enforced (post, pp. 763H-764A, 767B-E). *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd. [1915] A.C. 79* , H.L.(E.) applied.

Quaere. Whether the order in the first action was a regular judgment given that it left open not only the quantification of interest but also the question of liability for any interest at all (post, p. 759C-D).

The following cases are referred to in the judgment:

Burton v. Slattery (1725) 5 Bro.P.C. 233 , H.L.(I.)

Citibank N.A. v. Nyland (CF8) Ltd. (1989) 878 F.2d 620

David Securities Pty. Ltd. v. Commonwealth Bank of Australia (1990) 93 A.L.R. 271

Downey v. Parnell (1882) 2 O.R. 82

Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd. [1915] A.C. 79, H.L.(E.) .

Elphinstone (Lord) v. Monkland Iron and Coal Co. Ltd. (1886) 11 App.Cas. 332, H.L.(Sc.) .

General Credit and Discount Co. v. Glegg (1883) 22 Ch.D. 549

Henderson v. Henderson (1843) 3 Hare 100

Herbert v. Salisbury and Yeovil Railway Co. (1866) L.R. 2 Eq. 221

Holles (Lady) v. Wyse (1693) 2 Vern. 289

Kemble v. Farren (1829) 6 Bing. 141

Ruskin v. Griffiths (1959) 269 F.2d 827

Scarf v. Jardine (1882) 7 App.Cas. 345, H.L.(E.) .

Strode v. Parker (1694) 2 Vern. 316

Talbot v. Berkshire County Council [1994] Q.B. 290; [1993] 3 W.L.R. 708; [1993] 4 All E.R. 9, C.A. .

United Australia Ltd. v. Barclays Bank Ltd. [1941] A.C. 1; [1940] 4 All E.R. 20, H.L.(E.) .

Wallingford v. Mutual Society (1880) 5 App.Cas. 685, H.L.(E.) .

The following additional cases, supplied by courtesy of counsel, were cited in argument:

Alghussein Establishment v. Eton College [1988] 1 W.L.R. 587; [1991] 1 All E.R. 267, H.L.(E.) .

Hallifax (Marquis of) v. Higgens (1689) 2 Vern. 134

Jobson v. Johnson [1989] 1 W.L.R. 1026; [1989] 1 All E.R. 621, C.A. .

Kok Hoong v. Leong Cheong Kweng Mines Ltd. [1964] A.C. 993; [1964] 2 W.L.R. 150; [1964] 1 All E.R. 300, P.C. .

Linden Gardens Trust Ltd. v. Lenesta Sludge Disposals Ltd. [1994] 1 A.C. 85; [1993] 3 W.L.R. 408; [1993] 3 All E.R. 417, H.L.(E.) .

Philips Hong Kong Ltd. v. Attorney-General of Hong Kong (1993) 61 B.L.R. 49

South American and Mexican Co., In re; Ex parte Bank of England [1895] 1 Ch. 37, C.A. .

Tang Man Sit (Personal Representatives of) v. Capacious Investments Ltd. [1996] A.C. 514; [1996] 2 W.L.R. 192; [1996] 1 All E.R. 193, P.C. .

Wright, In re; Blizard v. Lockhart [1954] Ch. 347 ; [1954] 2 W.L.R. 481; [1954] 1 All E.R. 864

Yorke (M.V.) Motors v. Edwards [1982] 1 W.L.R. 444; [1982] 1 All E.R. 1024, H.L.(E.) . ***754**

Summons

By a writ of summons dated 12 April 1995 and endorsed with a statement of claim, the plaintiff bank, Lordsvale Finance Plc., claimed from the defendant bank, the Bank of Zambia, U.S.$5,612,447.30 together with default interest in the sum of $6,840,435.96 payable to them under was not satisfied and by a summons issued on 27 April 1995 the plaintiffs proceeded by way of R.S.C., Ord. 14 . The plaintiff did not proceed with summary judgment in respect of interest. On 10 July 1995 Mance J. ordered that the defendant have leave to defend upon payment into court of $800,000. In default of payment the plaintiffs were to be at liberty to sign judgment for $5,612,447.30 "plus interest (if any) to be assessed and costs." The defendant failed to comply with the condition of payment in and judgment was entered against it. A demand for the default interest was not paid and a second writ was issued. The defendant served a defence contending, inter alia, that the cause of action for default interest had been merged with the first action, further or alternatively that the plaintiffs were estopped from maintaining a claim in the second action, further or alternatively that they had elected to pursue their claim for interest in the first action, and that the rate of default interest provided for in the agreement constituted a penalty and was irrecoverable.

The summons was heard in chambers but judgment was given by Colman J. in open court.

The facts are stated in the judgment.

Barbara Dohmann Q.C. and *Michael Lazarus* for the plaintiffs.

Michael Brindle Q.C. and *Richard Handyside* for the defendant.

Cur. adv. vult.

20 March. COLMAN J.

read the following judgment. This is an application for judgment under R.S.C., Ord. 14 in two actions arising out of the same transaction. One of the points raised by way of defence to part of the plaintiffs' claim is of far-reaching importance in the English law of banking and I am therefore giving judgment in open court.

The claim arises in this way. On 24 April 1984 an international syndicate of banks entered into an oil import facility agreement with the defendant, a bank, under which a facility of U.S.$130m. was made available to the defendant. Amongst the participating banks were Sumitomo and B.C.C.I. On 19 July 1985 another international syndicate of banks, again including Sumitomo and B.C.C.I., entered into a further oil import facility agreement with the defendant in the sum of $100m.

In the course of 1986 the facility advances fell due for repayment, but the defendant defaulted. In the course of 1991 both Sumitomo and B.C.C.I. assigned their respective rights under both agreements to Lazards. On 23 December 1994 Lazards entered into an agreement to assign its rights under both agreements to the plaintiffs in these proceedings to take effect on 10 January 1995. On 7 March 1995 solicitors acting on behalf of the plaintiffs made a demand on the defendant for payment of the amounts due under the two agreements.

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Payment not having been made, the writ in the first action was issued on 12 April 1995. In the points of claim served with the writ the plaintiffs claimed a principal amount due under both agreements of $5,612,447.30. They also claimed default interest in respect of the principal sum due. That default interest exceeded the principal sum and amounted in total to $6,840,435.96. The claim was not satisfied and the plaintiffs proceeded by way of R.S.C., Ord. 14. On 10 July 1995 Mance J. ordered that the defendant should have leave to defend upon condition that it paid $800,000 into court. In default of payment, the plaintiffs were to be at liberty to sign judgment for $5,612,447.30 "plus interest (if any) to be assessed and costs." The reason for the insertion of the words which I have just quoted was that, following the hearing before Mance J., when junior counsel were seeking to agree the terms of the order to be drawn up, there was disagreement as to how the reference to interest should be framed. The plaintiffs had not proceeded with their claim for summary judgment for interest at the hearing before Mance J. and, for that reason, the defendant had not on that occasion argued the various points which it had by way of defence to that claim. Not least amongst those points was the argument that under the terms of the two agreements it was necessary for a separate demand to be made in respect of default interest before that became due and payable. It was therefore recognised between counsel that whatever was written into the order following the hearing had to make provision for the defendant to be able to argue its various points which went to liability in respect of interest. It was therefore agreed that the words "(if any)" should be inserted after the words "interest." I shall have to return to consider the legal consequences of this arrangement later in this judgment.

The defendant failed to comply with the condition of payment in and, in consequence, on 14 August 1995 the plaintiffs entered judgment against it in the first action for the amount claimed namely, $5,612,447.30 "plus interest (if any) to be assessed." On 11 October 1995 demand was made for payment by the defendant of $6,467,134.13 by way of default interest. This not having been paid, on 25 October the writ in the second action was issued. This was confined to a claim for default interest as at 30 September 1995 in the sum of $5,925,360.96 and continuing after that date. By December 1995, by means of various garnishee orders, the whole of the judgment debt in the first action had been discharged.

On 20 December 1995 the defendant served points of defence in the second action; four main points were taken by way of defence. These were as follows. (1) The defendant contended that the cause of action relied upon by the plaintiffs in the second action, whereby they claimed default interest, had been merged in the judgment in the first action. Alternatively, it said that the plaintiffs were estopped

by the judgment in the first action from maintaining their claim for default interest in the second action. Alternatively, the defendant said that the plaintiffs had elected to pursue such claims they might have for interest in the first action. Alternatively, the defendant said that the second action was frivolous and/or vexatious and/or an abuse of process. (2) The defendant contended that on the true construction of article 10.03 of both agreements, default interest fell to be calculated, where there had been an assignment, by reference to the actual ***756*** cost to the assignee of obtaining dollar deposits to fund its participation under the agreements, by which was meant the amount which it had paid for the assignment from the particular assignor in question and not by reference to the original principal amount of that part of the total facility which represented the original assignor's participation. (3) The defendant contended that under article 10.03(A) of both agreements, which specified how default interest was to be calculated, part of the method of calculation was unenforceable because it was in the nature of a penalty. (4) The chain of assignments leading from Sumitomo and B.C.C.I. to the plaintiffs was not shown to have been effected in accordance with the terms of the two agreements and, accordingly, the plaintiffs were unable to establish title to sue.

Mr. Michael Brindle, who has appeared on behalf of the defendant, has, very properly, in my view, not pursued point (4) before me. Accordingly, it is necessary for me only to consider whether the first three points represent arguable defences to the whole or part of the plaintiffs' claim. I refer to these points respectively as the res judicata/election point, the construction point and the penalty point.

The res judicata election point

The defendant's argument is that, by reason of the form of the judgment in the first action, the plaintiffs are estopped from raising a claim for default interest in the second action. It is submitted that the only means which is open to the plaintiffs of obtaining a judgment for default interest is by having it assessed in the first action.

At first sight, this submission might appear to be of a somewhat technical nature. In reality, however, it is of fundamental importance to the recoverability of any default interest. This is because article 10.03(A) expressly provided that such interest "shall be payable on demand made by the agent." The first such demand was that made on 11 October 1995 - some six months after the issue of the writ in the first action. If, therefore, the plaintiffs are precluded from claiming default interest in the second action, and are confined to having their entitlement to recover default interest adjudicated in the first action, they will be met by the defence that at the date of the writ there was no cause of action for default interest.

Mr. Brindle, on behalf of the defendant, submits that by claiming default interest and by entering judgment in the form in which they did, the plaintiffs irrevocably elected to confine their claim for default interest to their claim in the first action and cannot now pursue substantially the same claim in the second action. The defendants rely on the well known dictum of Lord Blackburn in Scarf v. Jardine (1882) 7 App.Cas. 345 , 360: "where a man has an option to choose one or other of two inconsistent things, when once he has made his election it cannot be retracted." They rely also on the decision of the House of Lords in *United Australia Ltd. v. Barclays Bank Ltd. [1941] A.C. 1* and in particular upon the principle of waiver of tort as stated by Viscount Simon L.C., at p. 19:

> "The substance of the matter is that on certain facts he is claiming redress either in the form of compensation, i.e., damages as for a tort, or in the form of restitution of money to which he is entitled, but which the defendant has wrongfully received. The same set of facts ***757*** entitles the plaintiff to claim either form of redress. At some stage of the proceedings the plaintiff must elect which remedy he will have. There is, however, no reason of principle or convenience why that stage should be deemed to be reached until the plaintiff applies for judgment."

Lord Atkin expressed the principle there being applied in these words, at p. 30:

> "I therefore think that on a question of alternative remedies no question of election arises until one or other claim has been brought to judgment. Up to that stage the plaintiff may pursue both remedies together, or pursuing one may amend and pursue the other: but he can take judgment only for the one, and his cause of action on both will then be merged in the one."

In my judgment, this principle of election essentially involves the availability to the plaintiff of two or more distinct juridical routes to compensation for a particular loss attributable to one set of facts. To commence proceedings and pursue them to judgment based on one such juridical route operates as an election to exclude the other available routes. But that is not this case. What happened here was that there was an incomplete cause of action for default interest based on a particular set of facts existing when the first action began and that cause of action remained incomplete just as that set of facts continued to exist at the time when judgment was entered for "interest (if any) to be assessed." Both parties understood that to mean that liability in respect of default interest remained at large to be determined by the court. As a matter of logic, it is therefore entirely unarguable that by reference to what was said in *United Australia Ltd. v. Barclays Bank Ltd.* the conduct of entering that judgment (i) employed one available cause of action where there existed another available cause of action, since there could always only have been one such cause of action available at the time when the first action was started; or (ii) led to a judgment for default interest, because both liability and quantum were left at large by the form of the judgment that was entered.

Mr. Brindle on behalf of the defendant also relies on the principle of cause of action estoppel laid down by Wigram V.-C. in *Henderson v. Henderson (1843) 3 Hare 100* and recently reiterated and explained by the Court of Appeal in *Talbot v. Berkshire County Council [1994] Q.B. 290* . In the latter case the plaintiff was held to be precluded from suing the council in the county court for damages for personal injuries sustained by him in a car accident when in a previous action in which he had been sued by his passenger and had served third party proceedings on the council he had confined his claim against the council to one for a joint tortfeasor's contribution and had omitted his personal injuries claim. Stuart- Smith L.J. said, at p. 296:

> "In *Henderson's case, 3 Hare 100* , Wigram V.-C. stated the law thus, at pp. 114-115: 'In trying this question, I believe I state the rule of the court correctly, when I say, that where a given matter becomes the subject of litigation in, and of adjudication by, a court of ***758*** competent jurisdiction, the court requires the parties to that litigation to bring forward their whole case, and will not (except under special circumstances) permit the same parties to open the same subject of litigation in respect of a matter which might have been brought forward as part of the subject in contest, but which was not brought forward, only because they have, from negligence, inadvertence, or even accident, omitted part of their case. The plea of res judicata applies, except in special cases, not only to points upon which the court was actually required by the parties to form an opinion and pronounce a judgment, but to every point which properly belonged to the subject of litigation, and which the parties, exercising reasonable diligence, might have brought forward at the time.' The rule is thus in two parts. The first relates to those points which were actually decided by the court; this is res judicata in the strict sense. Secondly, those which might have been brought forward at the time, but were not. The second is not a true case of res judicata but rather is founded on the principle of public policy in preventing multiplicity of actions, it being in the public interest that there should be an end to litigation; the court will stay or strike out the subsequent action as an abuse of process: see *per* Lord Wilberforce in *Brisbane City Council v. Attorney-General for Queensland [1979] A.C. 411* , 425G."

Later in his judgment he said, at pp. 297-298:

> "Mr. Miller submitted that the rule should be limited to those cases where points could have been, but were not, taken in relation to a particular cause of action and defence. But in my judgment there is no warrant for so limiting it. In *Yat Tung Investment Co. Ltd. v. Dao Heng Bank Ltd. [1975] A.C. 581* the cause of action in the second action was different from the plaintiff's claim in the first action; but it could have been raised by way of defence and counterclaim to the bank's counterclaim in the first action. It was accordingly not maintainable. Such a limitation would substantially emasculate the rule. Moreover there is a safeguard to prevent injustice in that the court will not apply the rule in its full rigour if there are special circumstances why it should not do so."

Mann L.J. said, at p. 301:

> "Wigram V.-C.'s observations are an expression in our vernacular of the maxim 'interest reipublicae ut sit finis litium.' It is contrary to public policy and abusive of process that matters which could have been litigated in earlier proceedings should thereafter be allowed to proceed. This is the true basis of the doctrine: see *per* Lord Wilberforce in *Brisbane City Council v. Attorney-General for Queensland [1979] A.C. 411* , 425G."

Fundamental to this principle is the availability to the plaintiff of a claim which he omits to make in the original proceedings. The reason why he is subsequently precluded from litigating it is that he should have taken the opportunity to do so in the earlier proceedings and it is contrary to public policy that, having omitted to do so when he first had the ***759*** opportunity, he should subsequently have another opportunity because of the earlier oversight or omission.

Where, however, the claim which is said to have been omitted from the earlier proceedings is one based on a cause of action which had only arisen after commencement of those proceedings, the whole basis of the principle is missing. That which in this case it is said ought to have been claimed could not have been claimed because of the absence of a demand on the defendant by the agent. That the plaintiffs might have procured the making of a demand before the commencement of the first action is nihil ad rem. They might have had perfectly good reasons for not doing so and there is no conceivable reason in policy or principle why they should have to prove that those reasons were justifiable.

It is right to add that the order drawn up between counsel and subsequently signed by Mance J. required that, if the defendant bank failed to satisfy the condition of paying $800,000 into court, the plaintiffs would have liberty to sign judgment for the principal amount claimed and also for liability in respect of interest and the amount of any such interest then to be determined. I doubt whether, if that is what the words were intended to mean, it was a regular judgment because, not only did it leave open the quantification of interest, but it also left open the question of liability for any interest at all. In so far as it related to interest, it was therefore a judgment wholly without substance. All that was needed was an order giving liberty to apply for directions as to the trial of the claim for interest.

It only remains to add that, had the issues as to interest been adjudicated pursuant to such an order and the plaintiffs' claim had failed, as it must have done, for want of a demand, the defendant would have been entitled to a judgment dismissing the plaintiffs' claim. Such a judgment would, however, have left wholly intact the plaintiffs' entitlement subsequently to perfect their cause of action for default interest by getting the agent to make demand. Had they then done so and after that demand commenced fresh proceedings claiming default interest, it would have been quite impossible for the defendant to raise a defence of res judicata for the simple reason that the judgment against the plaintiffs in the first action was based on facts materially different from those on which the subsequent cause of action was based.

Accordingly, I conclude that there is no arguable defence on the basis of election or estoppel.

The construction point

Article 10.03(A) provides:

> " *Default Interest and Indemnity.* (A) In the event of default by the borrower in the payment on the due date therefor of any sum expressed to fall due under this agreement (or on demand in respect of any sum expressed to fall due under this paragraph (A)), the borrower shall pay interest on the participation of each bank in each such unpaid sum from (and including) the date of such default to (but excluding) the date on which such sum is paid in full (as well after as before judgment) at a rate per annum equal to the aggregate of (i) 1 per cent., (ii) the margin and (iii) the cost as determined by ***760*** such bank of obtaining dollar deposits (from whatever source or sources it shall think fit) to fund its participation in the unpaid sum for such period or periods as the agent may from time to time determine. For the purposes of paragraph (B) below and section 13.03(B), each such period shall be deemed to be an interest period. Such interest shall be payable on demand made by the agent."

The issue here is whether under article 10.03(A), in the case of an assignment, default interest is to be calculated by reference to the proportional participation in the original principal sum advanced by a bank participating in the facility agreement as contended by the plaintiffs, or by reference to the amount paid by the assignee as consideration for the assignment, as contended by the defendant.

Article 12.03 of the agreements provides:

> " *'Bank(s)' to include successors and assigns.* The expression 'bank' wherever used in this agreement shall include every assignee of such bank and every successor in title of any such assignee or of such bank, and 'banks' shall be construed accordingly."

There can be no doubt that, in the absence of an assignment by any of the participating banks, the basis of calculation of default interest is the percentage share in the unpaid sum in question. That is because the words "the participation of each bank in each such unpaid sum" can as a matter of ordinary language only mean the share of each bank in the unpaid principal sum. When one bank assigns the whole of its share to an assignee, the latter has exactly the same participation as the assignor had. That the assignee may have purchased the share for a particular sum, whether more or less than an amount equivalent to the assignor's share of the principal sum, does not have the effect of fixing the assignee's participation as a sum equivalent to the consideration for the assignment. The effect of an assignment is to assign the debt, that is the assignor's share of the unpaid principal and interest together with the right to be paid future interest. The obligation of the debtor to the assignee to pay interest (as distinct from default interest) remains precisely the same as his obligation to the assignor: it is calculated by reference to his share of the principal sum.

Accordingly, where there is a default and default interest becomes payable to a participant, it must be calculated by reference to the same share of the principal sum. Why should default interest cease to be calculated by that means following an assignment? Mr. Brindle on behalf of the defendant argues that the calculation of the component of the default interest rate which involves the cost as determined by the bank of obtaining dollar deposits "to fund its participation in the unpaid sum" shows that the participation really means the amount which the bank or assignee is actually out of pocket as regards the loan to the debtor. In the case of an assignee that, argues Mr. Brindle, can only be the consideration paid for the assignment.

In my judgment, this construction cannot be correct. The word "participation" must have the same meaning in both parts of the article. It cannot mean "share" in the first part of the article but either share in or cost of acquisition of the unpaid sum, depending on whether there has ***761*** been an assignment, in the second part of the article. It seems to me that the natural meaning of the words "its participation in the unpaid sum" is "its share of the unpaid sum." It appears highly improbable that as a matter of commercial common sense: (i) default interest would be agreed to be calculated on a different principal sum from ordinary interest; (ii) a borrower would agree to enter into an indefinite exposure of this kind where he could not know in advance what the capital basis of default interest might be; (iii) the original banks would agree to allow the borrower to pay default interest calculated by reference to an unpredictable sum, depending upon the consideration for any future assignment, which might be appreciably lower than *their share* of the original capital sum and, therefore, might enable a debtor, known already to be in default, to pay less default interest to an original participant in respect of the same percentage share.

I do not consider that the words of article 10.03(A) are capable of bearing the meaning for which Mr. Brindle contends, but, if they are equally capable of bearing that meaning and that which I have put forward, the latter is to be preferred because it accords much more closely with the commercial basis and purpose of the agreement.

I therefore reject the defendant's submission on this point.

The penalty point

The defendants contend that, inasmuch as the constituents of the default interest under article 10.03(A) include at (i) 1 per cent., a rate completely unexplained, in addition to the margin (defined in article 1 as 1 ½ per cent.) and the cost of obtaining dollar deposits to fund the bank's participation, the 1 per cent. is a penalty. It is said to be in terrorem the borrower, its sole function being to ensure

compliance with the agreements. This point is of considerable importance for English banking law because it is a well known fact that a default interest rate uplift is very widely used, particularly in syndicated loans, such as this.

The interest regime ordinarily applicable under article 2.05 of the facility agreement was that the borrower was to pay interest on each advance for each interest period at a rate to be determined by the agent "to be the aggregate of (i) the margin and (ii) LIBOR." It will thus be observed that the effect of article 10.03(A) in respect of default interest was to change the constitutents of the rate. The main constituent, LIBOR, the London Inter-Bank Offered Rate, was replaced by the cost of obtaining dollar deposits to fund the bank's participation. This was clearly a constituent whose function was to recompense the lender for being deprived of the unpaid funds in future. The margin, defined as 1 ½ per cent., was clearly intended to have the same function as under article 2.05, namely as additional revenue attributable to the cost of administration, any possible risk premium and pure profit. However, the additional 1 per cent. is an unexplained extra provision. If it is arguably capable of being struck down as a penalty, the defendant is entitled to leave to defend to the extent of that part of the claim attributable to application of the 1 per cent. If it is incapable as a matter of law of amounting to a penalty, the plaintiffs are entitled to judgment. The 1 per cent. is payable only if there has been default and it is payable only for such period as there is default. ***762*** The only circumstance which gives rise to the obligation to pay is therefore a breach of the agreement. It was settled law by the end of the 17th century that in the case of a mortgage debt a covenant to pay an increased rate of interest on default would not be enforced by the Court of Chancery: see Lady Holles v. Wyse (1693) 2 Vern. 289 and Strode v. Parker (1694) 2 Vern. 316 . It was said that such provisions were in the nature of penalties. By 1829 it was settled law that if a contract provided for the payment of a certain sum of money on the happening of a particular event but for the payment of a greater sum in the event of default than that which would otherwise have been due, such provision would be a penalty: see *Kemble v. Farren (1829) 6 Bing. 141* . In *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd. [1915] A.C. 79* , 87 Lord Dunedin, in the course of setting out various tests for determining whether a particular provision was a penalty, observed with reference to the latter case:

> "It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid (*Kemble v. Farren, 6 Bing. 141*). This though one of the most ancient instances is truly a corollary to the last test. Whether it had its historical origin in the doctrine of the common law that when A promised to pay B a sum of money on a certain day and did not do so, B could only recover the sum with, in certain cases, interest, but could never recover further damages for non-timeous payment, or whether it was a survival of the time when equity reformed unconscionable bargains merely because they were unconscionable - a subject which much exercised Jessel M.R. in Wallis v. Smith (1882) 21 Ch.D. 243 - is probably more interesting than material."

Certainly, in Wallingford v. Mutual Society (1880) 5 App.Cas. 685 , 702 Lord Hatherley repeated as settled law the rule that, at least in mortgages, an increase in the rate of interest upon default was treated as a penalty and therefore unenforceable, whereas the practice was to avoid the effect of that rule by provisions for the abatement of the rate of interest upon prompt payment which had long been held to be enforceable. Although the early cases on this point do all appear to be mortgage cases, it has to be said that the refusal of the Court of Chancery to enforce the increased rate was expressed to be because it was of a penal nature and not because it would operate as a clog on the equity of redemption. The rule would therefore appear to be of general application and not confined to mortgage debts.

The speeches in *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd. [1915] A.C. 79* show that whether a provision is to be treated as a penalty is a matter of construction 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. Thus the presumption of ***763*** penalty arises where "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage . . ." which is a citation of the speech of Lord Watson in Lord Elphinstone v. Monkland Iron and Coal Co. Ltd. (1886) 11 App.Cas. 332 , 342.

It is clear that, if a loan agreement were to provide that upon the happening of a default in payment by the borrower the rate of interest were to be increased with retrospective effect, that which would be payable on default would be a sum in addition to the amount of principal and interest outstanding which would be calculated by reference to a period of time during which the borrower was entitled to the use of the principal and which might vary in length depending upon when the default in payment occurred in relation to the period of borrowing. Moreover, the amount of interest which would be payable would be unrelated to the extent of default. If therefore default in payment triggered a retrospective increase in the rate of interest, it would be impossible to say in advance how much extra interest would become payable and what arithmetical relationship it would have to the amount of time during which the principal was outstanding. Moreover, assuming that any increase in the rate of interest was to continue into the future, the period of time during which the default was continuing would be compensated by the continuing increased rate, but also by the accumulated increase in the interest derived from the period before default. Such a provision would therefore have all the indicia of a penalty.

Where, however, the loan agreement provides that the rate of interest will only increase prospectively from the time of default in payment, a rather different picture emerges. The additional amount payable is ex hypothesi directly proportional to the period of time during which the default in payment continues. Moreover, the borrower in default is not the same credit risk as the prospective borrower with whom the loan agreement was first negotiated. Merely for the pre-existing rate of interest to continue to accrue on the outstanding amount of the debt would not reflect the fact that the borrower no longer has a clean record. Given that money is more expensive for a less good credit risk than for a good credit risk, there would in principle seem to be no reason to deduce that a small rateable increase in interest charged prospectively upon default would have the dominant purpose of deterring default. That is not because there is in any real sense a genuine pre-estimate of loss, but because there is a good commercial reason for deducing that deterrence of breach is not the dominant contractual purpose of the term.

It is perfectly true that for upwards of a century the courts have been at pains to define penalties by means of distinguishing them for liquidated damages clauses. The question that has always had to be addressed is therefore whether the alleged penalty clause can pass muster as a genuine pre-estimate of loss. That is because the payment of liquidated damages is the most prevalent purpose for which an additional payment on breach might be required under a contract. However, the jurisdiction in relation to penalty clauses is concerned not primarily with the enforcement of inoffensive liquidated damages clauses but rather with protection against the effect of penalty clauses. There would therefore seem to be no reason ***764*** in principle why a contractual provision the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach.

Within a very few years of the late 17th century cases to which I have referred there came before the House of Lords on appeal from the Lord Chancellor of Ireland Burton v. Slattery (1725) 5 Bro.P.C. 233 . That was the case of a mortgage deed which provided for interest to be paid on the mortgage debt at 5 per cent., but, if any of the repayment instalments should not be paid, interest was to run at 8 per cent. on that instalment from three months after the date for payment. The Lord Chancellor had decreed that interest on unpaid amounts should be computed only at 5 per cent. The creditor appealed, but it appears that the debtor took no part in the appeal. The House of Lords concluded that the 8 per cent. rate in the deed should be paid with effect from the end of three months from the due date. The report does not indicate whether the Lord Chancellor of Ireland justified his decision by reference to the by then well-established principle in Lady Holles v. Wyse, 2 Vern. 289 , but it seems likely that he did.

The point as to a *prospective* interest rate rise does not appear to have been raised in any subsequent case until 1866. In *Herbert v. Salisbury and Yeovil Railway Co. (1866) L.R. 2 Eq. 221* under a contract for the sale of land the purchaser company was allowed into possession before the day fixed for payment of the price on condition that it paid interest on the price at 4 per cent. up to the payment date, but if it failed to pay at that date it was to pay interest from that date at 5 per cent. and, if the price had not been paid within six months after that, it was to pay interest at 8 per cent. from the end of the six-month period. Although the purchaser entered into possession, it failed to complete for seven years. The main issue was whether the court should enforce the rates of 5 per cent. for the first six months and 8 per cent. thereafter or whether a continuous rate of 5 per cent. applied. The

defendant argued that the case was governed by the line of authority commencing with Lady Holles v. Wyse, 2 Vern. 289 . Lord Romilly M.R. held that the term imposing the increased rate of interest was enforceable. He said, *L.R. 2 Eq. 221* , 224-225:

> "I am of the opinion that the contract is a perfectly good contract. The law upon the subject is unquestionably somewhat refined, and leads to very nice distinctions. For instance, it is quite clear that if a mortgagor agrees to pay 5 or 6 per cent. interest, and the mortgagee agrees to take less, say 4 per cent. if it is paid punctually, that is a perfectly good agreement; but if the mortgage interest is at 4 per cent., and there is an agreement that if it is not paid punctually, 5 or 6 per cent. interest shall be paid, that is in the nature of a penalty which this court will relieve against. I am of opinion, however, that the stipulation in this contract for payment of interest at 8 per cent. is not in the nature of a penalty, but is a separate and distinct contract. . . . So also if the contract provides that the purchase money shall be paid in the course of, or at the end of, ten years, and that the interest for the first two years shall be 5 per cent., and the ***765*** interest for the next two years shall be 6 per cent., and the interest for the next two years shall be 7 per cent., and so on, that is a perfectly good contract. That is quite distinct from a stipulation that if the interest is not paid regularly the amount shall be increased. Here the parties thought fit to enter into this contract, that the rate of interest was to be 4 per cent. up to a certain date, 5 per cent. for the next half year, and 8 per cent. for every subsequent year. I know of nothing to prevent persons from entering into a contract of that description."

Seventeen years later a very similar point arose in General Credit and Discount Co. v. Glegg (1883) 22 Ch.D. 549 . Under a mortgage deed the mortgagor covenanted to pay a rate of interest adjustable by reference to bank rate also "a commission of £1 per cent. for every month or part of a month that may elapse between the due date and the date of the payment of such instalment, upon the whole amount of such instalment." The additional 1 per cent. was challenged by the mortgagor as a penalty and the line of authority beginning with Lady Holles v. Wyse, 2 Vern. 289 was relied on. However, relying on Burton v. Slattery, 5 Bro.P.C. 233 and *Herbert v. Salisbury and Yeovil Railway Co., L.R. 2 Eq. 221* , it was argued for the mortgagees that, although they did "not dispute the rule that a retrospective increase of interest in case of default is a penalty," that case did not fall within it because the increase was not retrospective but ran from the date of default. In rejecting the argument that the £1 per cent. was a penalty, Bacon V.-C. held that that was not in substance a payment for additional interest, but his reasoning is less than satisfactory, 22 Ch.D. 549 , 553:

> "In my opinion the contract to pay commission is a thing wholly separate from the contract to pay interest. The payment is called by a separate name. Whether it be an accurate name or not, it is the name which the parties have adopted for themselves. The agreement is, that if the borrower does not pay the interest punctually, he will pay £1 per cent. upon what he ought to have paid until he does pay. The case does not come within the principles of [Lady Holles v. Wyse, 2 Vern. 289 and Strode v. Parker, 2 Vern. 316] , nor within that of Wallis v. Smith, 21 Ch.D. 243 . It is a distinct, separate, substantive contract to pay something in case the borrower makes default. That is not an agreement in the nature of a penalty."

In the meantime, the Canadian courts appear to have enforced provisions for increased rates of interest applicable after the date of default: see for example Downey v. Parnell (1882) 2 O.R. 82 . In the United States the Court of Appeals Second Circuit has held that a higher rate of interest applicable from the date of default is recoverable: see Ruskin v. Griffiths (1959) 269 F.2d 827 . More recently the same court gave judgment in Citibank N.A. v. Nyland (CF8) Ltd. (1989) 878 F.2d 620 . Amongst the issues in that case, which was a foreclosure action, was whether the mortgagor was liable for default interest at an increased rate applicable from the date of default or whether that was unenforceable as a penalty. ***766*** Commenting on the decision in Ruskin v. Griffiths the Court of Appeals Second Circuit said, at p. 625:

> "The court's analysis suggested that variable rates simply reflected the heightened risk of repayment that the creditor bears upon entry of default. Indeed, the court observed

> that debtors might fare worse in the future if creditors were not allowed to impose variable rates, because creditors would then impose higher rates for the full life of the loan in order to reallocate the risk."

The court held the default interest to be recoverable in these words:

> "The Philippines argues that the charging of default interest is a penalty and not a reflection of increased risk, and as such is not enforceable. However, the Philippines does not, and indeed cannot, answer the persuasive argument in Ruskin, 269 F.2d 827 that the increased interest rate reflects the increased risk of non-collection. The fact the collateral in this case is sufficient does not negate Judge Knapp's observation that Nyland's default 'presented an increased risk that the collateral was in less-than-perfect health and that the mortgagee might have to resort to that collateral to obtain payment.' The default rate was simply part of Nyland's bargain."

It is, therefore, settled law in the State of New York that default interest rates charged prospectively will not generally be struck down as penalties.

In David Securities Pty. Ltd. v. Commonwealth Bank of Australia (1990) 93 A.L.R. 271 the Federal Court of Australia reached precisely the same conclusion. Having referred, at p. 299, to "a long line of authority which indicates that the additional interest will not be considered as a penalty, but rather as a liquidated satisfaction fixed and agreed on by the parties as compensation for the lender being kept from his money" the court referred to Burton v. Slattery, 5 Bro.P.C. 233 and the argument of the creditor in General Credit and Discount Co. v. Glegg, 22 Ch.D. 549 , which I have already referred to, as well as to the Canadian authorities including Downey v. Parnell, 2 O.R. 82 , and concluded that if the interest rate increase was not retrospective operating in respect of the period before the default, it would be enforced "as a genuine pre-estimate of compensation to the bank with respect to funds it would otherwise have had available to it to reinvest:" 93 A.L.R. 271 , 300.

While fully accepting that the English authorities can hardly be described with justification as a "long line of authority" (pace the Federal Court of Australia) and that none of those authorities is notable for its clarity of analysis, such authority as there is does suggest that at least on three occasions since 1725 the courts have been prepared to enforce increased rates of interest or analogous payments where the increase applied as from the date of default. On the other hand, the conventional line of authorities characterising default interest as a penalty appears to be based on cases where the default interest provision operated retrospectively as well as prospectively from the date of default.

London is one of the greatest centres of international banking in the world. Here and in New York most of the world's international syndicated ****767*** loans are set up. Such loans almost invariably provide for enhanced rates of default interest to apply. It would be highly regrettable if the English courts were to refuse to give effect to such prevalent provisions while the courts of New York are prepared to enforce them. In the absence of compelling reasons of principle or binding authority to the contrary there can be no doubt that the courts of this country should adopt in international trade law that approach to the problem which is consistent with that which operates in that nation which is the other major participant in the trade in question. For there to be disparity between the law applicable in London and New York on this point would be of great disservice to international banking.

In my judgment, weak as the English authorities are, there is every reason in principle for adopting the course which they suggest and for confining protection of the creditor by means of designation of default interest provisions as penalties to retrospectively-operating provisions. If the increased rate of interest applies only from the date of default or thereafter there is no justification for striking down as a penalty a term providing for a modest increase in the rate. I say nothing about exceptionally large increases. In such cases it may be possible to deduce that the dominant function is in terrorem the borrower. But nobody could seriously suggest that a 1 per cent. rate increase could be such. It is in my judgment consistent only with an increase in the consideration for the loan by reason of the increased credit risk represented by a borrower in default.

For these reasons I conclude that article 10.03(A) contains nothing in the nature of a penalty and that the default interest provision must be fully enforced.

In the event all the defences raised by the defendant fail and there must accordingly be judgment for

the full amount of the plaintiffs' claim for interest.

Representation

Solicitors: Dibb Lupton Broomhead ; Lovell White Durrant .

Judgment accordingly. ([Reported by Simone Greaves, Barrister])