Administration of insolvent partnerships – whether interest increase on default in commercial agreement constitutes a penalty.

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IN THE HIGH COURT OF JUSTICE IN NORTHERN IRELAND

CHANCERY DIVISION (COMPANIES)

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IN THE MATTER OF ROBERT BROWN AND DANIEL MORTON T/AS DEVENISH ENTERTAINMENT AND LEISURE COMPLEX

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IN THE MATTER OF THE INSOLVENT PARTNERSHIPS ORDER (NORTHERN IRELAND) 1995

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GIRVAN J

Introduction

[1] The questions raised in this matter arise in relation to the administration of the insolvent partnership of Robert Brown and Daniel Morton ("the partners") who traded as the Devenish Entertainment and Leisure Complex at Finaghy Road North. The insolvent partnership is currently in administration, the administrators being Sean Fox and Richard Kelly. The dispute relates to the right of Bass Ireland Limited ("Bass") to recover from the insolvent partnership a substantial sum of interest, the issue being whether the relevant provisions of agreements made between Bass and the partners constituted unenforceable penalty clauses.

[2] On 19 June 1998 Bass entered into an agreement with the partners advancing the sum of £450,000 by way of two loans secured by a mortgage and charge over the Devenish Entertainment and Leisure Complex. As a result of the partners falling into arrears regarding repayments due to Bass under the terms of that agreement further agreements were entered into on

10 January 2000 restructuring the partners' indebtedness to Bass. Under the restructuring arrangement Bass advanced the sum of £378,593.82 ("the Advance") under what can be called the Advance Agreement and lent the sum of £250,000 ("the Loan") under what can be called the Loan Agreement.

[3] The advance was to be repaid to Bass by the partners by means of earned discounts over 102 months. Clause 2.2 provided that the Advance should be deemed to reduced by £44,540.45 for every year the partners complied with the terms of the Advance Agreement. By clause 2.3 if the partners were in breach of any other obligations under the agreement the outstanding balance of the Advance was immediately to become due and payable. Under that agreement the partners were obliged to purchase from Bass the agreed range of beer products as defined. The partners agreed to pay the trade account at Bass's applicable wholesale prices payable from time to time and such payments were to be made on receipt of invoice and before any other goods were supplied. If the trade account should not be paid in accordance with the trading terms then it should carry interest of 5% above UK clearing bank base lending rate as fixed from time to time by the Bank of Ireland ("the relevant base rate") calculated as from the due date of payment. Under clause 5 of the Advance Agreement it was provided that if the partners were in default of any the terms of the agreement and/or the security documents interest would be charged immediately upon default at the rate of 5% above the relevant base rate as fixed from time to time on the outstanding balance of all accounts. By clause 6 it was provided that all discounts and allowances granted or promotional incentives offered were conditional on payment of all accounts to be made on their respective due dates and if the partners were in default on any account or in breach of the terms and conditions of the advance agreement and/or the security documents then discounts would be disallowed from that date.

[4] Under the Loan Agreement the repayment period was defined as 102 months. Interest was specified as 3% below the relevant base rate to a minimum of 4%. The Loan Agreement obliged the parties to purchase the agreed range of beer products at the relevant prices during the relevant period. Under Clause 5 it was provided that in default of any of the terms of the agreement and/or the security documents interest would be charged immediately at the rate of 5% above the relevant base rate as fixed from time to time on the outstanding balance of the accounts. Clause 2.2 of the incorporated Bass loan conditions provided that the outstanding balances of the loan and all accrued interests and all other monies due to Bass under the agreement or the security documents should become immediately due and payable and the concessions specified should cease immediately if the partners failed to pay any interest due or any monthly repayments to the loan or trade account in accordance with the terms of the agreement.

[5] It is accepted that the partners defaulted in their obligations to make monthly repayments of the Loan and failed to make payments on the due dates in respect of the trading account in respect of beer purchased from Bass. As a consequence under the agreements the principal sums due under the Advance Agreement and the Loan Agreement became due and payable as from the relevant date of default. It appears that cheques and direct debits for payments due under the Advance Agreement and the Loan Agreement were dishonoured as from 26 January 2000. Subject to the penalty argument that the prescribed interest of 5% over the relevant base rate constituted a penalty, under the terms of the contract interest became payable on the principal sums due at that rate as from the relevant date or dates.

[6] Bass supplied quantities of product to the partners who defaulted in their obligations to pay on the trading account. Under the terms of the Advance Agreement and the Loan Agreement it was provided that if the trading account was not paid in accordance with the trading terms then the trade accounts should carry interest at 5% above the relevant base rate. This constituted a straightforward provision for the payment of interest at an agreed rate on arrears on foot of the trading account. It is clear that parties may expressly contract for the payment of interest in the event of delay in the payment of a debt (see President of India v La Pintada [1984] 2 All ER 773 at 778j). If the rate of interest is extortionate then the agreement may fall foul of the provisions of the Consumer Credit Act 1974 but no case has been made out in this case that the prescribed rate of interest on the overdue trading account was exorbitant or extortionate. It represented a commercial rate that was high but not excessive. In the result it seems to me to be beyond argument that the debt due in respect of the trading account bore interest at the prescribed rate.

[7] Mr Shaw QC on behalf of the administrators argued that the relevant provisions in the Advance Agreement and the Loan Agreement constituted unlawful penalties. He argued that four tests had been identified on the authorities to have to decide whether a contractual term is a penalty clause or not. The tests are set out in Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited [1915] AC 79 at 86-87. He submitted that against those tests the provisions here were penal. The sums payable were extravagant and unconscionable compared with the loss suffered by Bass from the breaches. Inasmuch as the breach amounted to mere payment of money due to Bass the sum stipulated was greater than the sum which ought to have been paid. The sanctions imposed did not distinguish between the supposed breaches and the degree of damage occasioned if any. The assessment of pre-estimated loss is not almost impossible as regards the breach consisting of purchasing goods from third parties. Such a loss if any is readily accessible to calculation. He contended that the effect of holding a contractual term to be a penalty clause is where firstly that the term remained

in the contract and could be sued upon but was not enforceable beyond the actual loss suffered in consequence of the breach.

[8] Mr Orr QC resisted the administrators' argument contending that the agreements were the product of an arms' length arrangement. There was nothing unconscionable in relation to the transactions. The Advance Agreement was an interest free advance but only interest free provided the partners complied with their obligations freely undertaken and the loan agreement provided for a low and very favourable rate of interest, again so long as the parties fulfilled their obligations. There was nothing unfair or unconscionable in the parties agreeing to a significantly higher rate of interest in the event of default. The rate of interest fixed under the Late Payment of Commercial Debts (Interest) Act 1998 in relation to debt claims by small commercial businesses is 8% above base rate. Similarly the Law Society conditions of sale prescribe 6% above base rate as the prevailing rate of interest in the event of delay of completion of a contract for the sale of land. He argued that these examples point to the conclusion that at a rate of 5% over the relevant base rate was entirely within the proper range of a commercial rate. He pointed out that the onus of proof lay on the partners and now the administrators to prove that the rate was extortionate and unfair and that it was an ineffective penalty.

[9] In Lordsdale Finance plc v Bank of Zambia [1996] 3 All ER 156 Colman J had to consider the question whether a contractual term that provided for an increased rate of interest in a banking facility agreement in the event of default by the debtor was in the nature of a penalty. He held that the protection afforded to creditors by designating default interest provisions as penalties was generally confined to retrospectively operative provisions providing for a greater rate of interest retrospective to the default and therefore increasing the contractual sum payable in consequence of the breach. A court in his view would not strike down as a penalty a term in an agreement which provided for a higher prospective increase in the rate of interest in respect of default from the date of default and thereafter when the increase was a modest one and not in terrorem against the borrower. At page 170 he stated:

> "… There is every reason in principle … 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 …"

[10] Colman J in his judgment reviewed the English case law and referred to authorities from Australia, United States and Canada. In the Federal Court of Australia decision in David Securities Property Limited v Commonwealth Bank of Australia (1990) 93 ALR 271 the court concluded that prospective additional interest would 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. If the interest was not retrospective it would be enforced as a genuine pre-estimate of compensation to the bank with respect to funds it would have otherwise have had available for re-investment. A similar approach was adopted in Ruskin v Griffiths (1959) 269F 2d 827 and in Citibank NA v Republic of the Philippines (1989) 878 F 2d 620, decisions of the Court of Appeal (Second Circuit) in the United States. Commenting on the decision in Ruskin v Griffiths the Court of Appeal said that the court's analysis suggested that the variable rates simply reflected the heightened risk of repayment that the creditor bears on commencement of default. The court observed that debtors might fair worse in the future if creditors were not allowed to impose variable rates because creditors would then impose higher rates for the full term of the loan in order to re-allocate the risk. In the Citibank case the court considered that the debtors default presented an increase risk that the collateral was in less than perfect health and the default rate as simply part of the bargain.

[11] Colman J concluded that 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 is no reason in principle why a contractual provision the effect of which is to increase the consideration payable under an executory contract upon the happening of a default should be struck down as penalty if the increase could in the circumstances be explained as commercially justifiable provided always that the dominant purpose is not deter the other party in breach.

[12] In the passage from Colman J's judgment referred to in paragraph 9 above he differentiated between on the one hand a modest increase in the interest rate (which could be justified) and on the other exceptionally large increases (where the court might possibly deduce that the dominant function was in terrorem. In the present case the increase is more than minimal but is less than exceptionally large. The agreements imposed a significant but commercially understandable rate of interest in the event of default in place of no interest payable under the advance agreement and a very low rate of interest under the loan agreement. The increased rate of interest is prospective and not retrospective. The rate of interest has not been demonstrated by the administrators (upon whom the onus of proof lies) to be

otherwise than commercially motivated and justifiable. When negotiated the contract made perfectly good commercial sense. Bass was advancing very significant sums of money on favourable terms to the partners on the basis that they should comply with their obligations which, if complied with, would have given Bass a safe return from the capital advanced. It was justifiable for Bass to make a sensible commercial provision for the event of a default by the partners and to provide for repayment of capital advanced and a liquidated satisfaction fixed and agreed by the parties as compensation for the lender being kept out of their money (in the words adopted in David Security Properties Limited v Commonwealth Bank of Australia (1990) 93 ALR 271).

[13] In the result I hold that the relevant impugned provisions in the agreement do not constitute a penalty or penalties and Bass is entitled to charge interest at the specified higher rate. In presenting their respective cases the parties asked the court to rule on the legal question whether the impugned provisions constituted a penalty or penalties and did not ask the court to rule on the correctness or otherwise of the figures put forward by Bass on the basis of its calculations. In the event of any dispute in relation to the figures the matter would clearly have to come back before the court.

[14] I shall hear counsel on the question of costs.