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When is interest and default interest under a loan a penalty?

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Case update: *Ethoz Capital Ltd v Im8ex Pte Ltd and others* [2023] SGCA 3

A "make whole" clause, the sole discretion to vary interest rates, and an "extravagant" default interest rate. These were some features that led the Singapore Court of Appeal to find various default-related clauses unenforceable in the *Ethoz Capital Ltd v Im8ex Pte Ltd and others* [2023] SGCA 3 (**Ethoz**).

Where do banks and lenders go from here?

Brief context and issues before the Court

The salient terms of various facilities (**Facilities**) granted by the lender (Ethoz Capital Ltd) to the borrower (Im8ex Pte Ltd) were briefly as follows.

Principal amount	A total of **$6.3m** (the **Advance**.)	**Term / Instalment Schedule**	Instalment payments to be made every month over 15 years. The instalments were set out in a schedule (the **Instalment Schedule**).
Interest	3.75% per annum. The Instalment Schedule included an amount termed "**Total Interest**". This was equal to the aggregate of all the interest payments; or when a flat rate of 3.75% per annum applied to the Advance.		
Default	(a) "**Default Interest rate**": 0.0650% per day, "calculated daily with monthly rests". Any unpaid Default Interest "shall be added to the relevant outstanding amount on a monthly basis and shall itself bear interest" at the Default Interest rate. (b) "Make whole" clause: An event of default will occur if the borrower does not pay any of the "sum[s] payable under [the Facilities] when due", and that this will entitle the lender to declare that "all amounts due and owing under [the Facilities], including the Advance and the Total Interest and any default interests … be immediately due and payable."		

The borrower defaulted on payment within the first year of all the Facilities. The lender sought orders that the borrower and guarantors jointly and severally pay the lender the Advance, Total Interest, and Default Interest due under the Facilities.

The Court of Appeal found both (a) the Total Interest and (b) the Default Interest amounted to penalties and thus unenforceable. ***See the end of the article for a quick summary on this area of law.**

The “make whole” clause was a penalty

The Court rejected the argument that the Total Interest is merely an acceleration of payment / present debts to be paid in the future and hence falls outside the scope of the penalty doctrine (at [38] to [46]).

The Court found that the acceleration of the Total Interest (i.e., such that the payment of the remainder of the Total Interest was due immediately upon default) was a secondary obligation only trigged upon the borrower’s default.

(a) The Facilities provided that, “[i]n consideration” for the Facilities, the borrower “covenants that it will repay to [the lender] the Advance and interest thereon” in 180 equal instalments. Interpreting this clause, the Court found that “what [the borrower] had “promised to do” was to pay the Total Interest in 180 equal instalments as set out in [the Instalment Schedule]” (at [55]).

(b) Importantly, the interest rate could be varied at the “sole and absolute discretion” of the lender, which would in turn vary the amount of Total Interest payable. The Court found that this suggested the full and immediate payment of the Total Interest could not constitute the borrower’s primary obligation under the Facilities (at [56]).

(c) The Court also noted that there was “nothing in the Facilities that suggests that [the borrower] had promised to make full and immediate payment of the Total Interest absent default” (at [57]).

The Court also found that the immediate and full payment of the Total Interest operated *in terrorem* of the borrower, noting that it satisfied 2 of the tests.

(a) Single lump sum test: any one of the 25 events of default (some of which were as “trifling” as the delivery of accounts “qualified in a manner or to an extent unacceptable to [the borrower]”) could trigger the acceleration of full Total Interest falling due, which was “a single and very substantial lump sum” (at [80]).

(b) Greater sum test: if the borrower were to default on its tenth payment (failing to pay between **$8,680.56 and $18,663.19**), the Total Interest due (between **$507,805 and $1,091,778**) would “dwarf the defaulted payments” (at [81]).

The default interest rate was a penalty

The Court found the clause providing that the borrower would have to “pay interest at an increased rate upon [its] failure to pay any instalment [by] the stipulated time” was a penalty clause.

(a) This was “a provision to pay a larger sum of money upon the failure to pay the stipulated sum within a stipulated time” – the “clearest and the classic example of a penalty”.[1]

(b) The increase between the Default Interest rate and the regular interest rate was “clearly an extravagant increase” (from an effective interest rate of **6.444% per annum** to an effective interest rate of **26.08% per annum**, i.e., an increase of about 20% or of more than 300% the base rate in relative terms) (at [97]).

(c) Although the lender asserted that the default interest rate was a genuine estimate of loss “taking into account [its] business considerations (including the loss of the use of the funds)”, no evidence was adduced in support of this (at [98] and [99]).

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[1] Citing *Hong Leong Finance Ltd v Tan Gin Huay and another* [1999] 1 SLR(R) 755 at [19] to [20]

Lessons from Ethoz – a checklist for acceleration of payment clauses, default interest clauses, and other similar clauses

Although the law surrounding penalty clauses is well-established, *Ethoz* is a timely reminder to ensure that relevant clauses such as acceleration of payment clauses and default interest clauses clearly reflect agreements on primary obligations. We should highlight the following related considerations:

Check	Item for consideration
	Does the agreement clearly reflect that the obligation has been agreed as / as part of a primary obligation? [See illustrations 1 and 2 below.] Consider both the specific clause and the context of the whole agreement.
	What is the difference between the amount the borrower has defaulted on paying and the amount the lender would stand to lose following the breach?
	What is the difference between the amount the borrower has defaulted on paying and the amount the borrower will be obliged to pay following the breach (or, the difference in the interest rate before and after the breach)?
	If there is an additional amount that the borrower will be obliged to pay in the event of default, is it a single lump sum payment?
	Overall, will the effect be to hold the borrower "in torrem" to keeping to their obligations, as opposed to having to pay a genuine pre-estimate of the loss?
	Has sufficient contemporaneous documentation been retained on the estimation of the any loss consequential to default of payment? E.g., any assessment of the borrower's risk profile, any calculations on the loss of use of funds / opportunity costs, etc.

Illustrations

Examples of enforceable clauses seen in *Ethoz*:

Illustration 1: The Court declined to interfere with parties' agreement that interest payments would be "front-loaded", and commented that the "mere fact that the interest component was "front-loaded" does not make it any less a primary obligation" (at [128]). The specific interest amounts which were payable on each month were expressly set out in the Instalment Schedule. It appears it was sufficiently clear that this was something that the parties had agreed would be a primary obligation.

Illustration 2: The Court did not express any clear disapproval when considering another case[2] in which a premium was to be paid immediately but it could be paid in instalments if such instalments were paid punctually. The Court noted "the primary obligation was for the premium to be paid immediately, with an additional stipulation that its payment could be deferred if the [obligor] made punctual instalment payments" (at [48]).

[2] See the UK House of Lords decision in *John Wallingford v The Directors of the Mutual Society* (1880) 5 App Cas 685 at 696 and 702

Illustration 3: The Court distinguished a case[3] in which a default interest rate was upheld, observing that it appeared to be an important part of the judge's reasoning that there was "no significant difference" between the default interest rate (**6% per month**) and the regular contractual interest rate (**5% per month**) (at [96]).

Conclusion

Ethoz may on first glance appear to be a case (or yet another one) frowning on contractual effects of payment default clauses. However, not clearly so because the Court of Appeal had expressly affirmed, "it is unobjectionable for parties to draft appropriate clauses to reflect their agreement to take on primary obligations, however onerous it might be perceived with hindsight" (at [128]).

*** See the following page for a quick-reference guide to penalty clauses.**

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[3] See *Alternative Advisors Investments Pte Ltd and another v Asidokona Mining Resources Pte Ltd and another* [2022] SGHC 41 at [134] and [135]

Quick-reference roadmap to penalty clauses

per *Ethoz Capital Ltd v Im8ex Pte Ltd and others* [2023] SGCA 3

A contractual provision is an unenforceable penalty where: (i) it creates a secondary obligation triggered by a breach of contract that (ii) requires the defaulting party to pay an amount of money that seeks to hold the defaulting party *in terrorem* to their primary obligations (at [33]). These are distinct inquiries.

Question 1: Primary or secondary obligation? (at [51] to [53])

Primary obligation: "the "essential purpose" of the contract. …Primary obligations are the legal obligations imposed upon each party to the contract to procure whatever he has promised to do."[4]

Secondary obligation: "incidental to the primary obligation… the specific category of secondary obligation that the [the penalty doctrine] is concerned with is an obligation to pay money upon a breach of contract".

Characterising the obligation is "a question of construction to be decided upon the terms and inherent circumstances of each particular contract".[5] The Court will analyse the whole contract, and will take a contextual approach to interpretation. In scrutinising any attempts at "clever drafting" to mask a secondary obligation as a primary obligation, the Court can consider factors such as:

(a) "the overall context in which the bargain in the clause was struck";
(b) "any particular reasons for the inclusion of the clause"; and
(c) "whether the clause was contemplated to form part of the parties' primary obligations to secure some independent commercial purpose, or was only to secure the affected party's compliance with his primary obligations".

Question 2: Holding a party in terrorem (which roughly translates to 'in order to frighten') or a genuine pre-estimate of loss?

The "essence of a penalty is a payment of money stipulated as in terrorem of the offending party" while "the essence of liquidated damages is a genuine covenanted pre-estimate of damage" – the objection to the penalty is that it 'forces' compliance with the primary obligations of a contract, interfering with parties' freedom to break contractual undertakings at a price (at [65] and [66]). Tests that the Court may consider include these (though note that these are not determinative) (at [67]):[6]

Test	**The sum payable may constitute a penalty if it …**
Greatest Loss Test	Is "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach"
Greater Sum Test	Is "greater than the sum which ought to have been paid", where "the breach consists only in not paying a sum of money"
Single Lump Sum Test	Constitutes "a single lump sum…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"

Specifically in the context of default interest rates: "where there is an "extravagant increase" between the regular interest rate in a loan and the default interest rate, such increase not being referable to the greatest loss suffered by the lender, the default interest will be held to be a penalty" (at [94]).

For more information or advice specific to your case, please reach out to us at Dentons Rodyk & Davidson LLP.
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[4] Citing Bryan Garner *et al*, *Black's Law Dictionary* (Thomson Reuters, 9th Ed, 2009) at 1180 and *iTronic Holdings Pte Ltd v Tan Swee Leon and another suit* [2016] 3 SLR 663
[5] Citing *Dunlop Pneumatic Tyre Co, Ltd v New Garage and Motor Co, Ltd* [1915] AC 79 (***Dunlop***)
[6] Citing *Dunlop* at 87