Deeds of settlement - avoiding the risk of a default clause being classified as a penalty

Pieter Oomens and Alysha Tuziak | April 2014 | Commercial Disputes and Transactions

TurkAlert

Summary

The decision of *Lachlan v HP Mercantile Pty Limited* [2014] NSWSC 356 is a warning to debtors of the importance of complying with time limits to avoid the impact of 'balloon' payments; an agreement which compromises the sum payable by the debtor but requires the debtor to pay a higher sum if the debtor defaults is enforceable. To achieve this result, the debtor must acknowledge (even if implicitly) the present entitlement of the creditor to the underlying debt for the higher amount.

Who does this impact?

The case impacts all those parties to settlement agreements that compromise debts.

.

Facts

HPM was the assignee of four loans made by the assignor to Dr Lachlan. The total outstanding under the four loans was approximately $1.325m. Dr Lachlan commenced proceedings against HPM seeking a declaration that the loans were not enforceable by HPM. HPM cross-claimed to recover the loan debts.

The parties settled the proceedings. A deed of settlement was executed and the Court made orders by consent dismissing Dr Lachlan's application (but not HPM's Cross-Claim) and specifically incorporating clauses in the Deed to the following effect:

- Dr Lachlan would pay the compromised sum of $300,000 by instalments
- If Dr Lachlan were to default in paying the instalments HPM had leave to immediately enter judgment on its Cross-Claim for $1.5M less any payments made under the Deed.

The instalments consisted of an initial payment of $50,000 and 25 monthly payments each of $10,000, the last of which was due on 15 July 2013.

When Dr Lachlan sent a cheque for $10,000 to HPM in June 2013 he stated in his covering letter that the cheque was for the June 2013 payment which was the final payment. Dr Lachlan was under the erroneous assumption that the June 2013 payment was the final payment.

Under the Deed HPM had to give Dr Lachlan seven days' notice to rectify any default and if he failed to so rectify the default the underlying debt (less payments but plus interest and costs) became immediately payable.

On 6 January 2014, HPM notified Dr Lachlan that he had failed to make the final $10,000 payment and requested rectification of that default.

According to the Deed, Dr Lachlan was deemed to have received the notice on 9 January 2014. He had until 16 January 2014 to rectify the default.

On 13 January 2014, Dr Lachlan sent a letter to HPM requesting a loan history so he could reconcile the payments he had made. HPM did not reply.

On 13 January 2014, Dr Lachlan also instructed his accountant to review the payments he had made. On 14 January 2014, the accountant replied attaching a spreadsheet showing that Dr Lachlan had made 24 and not 25 payments. It was therefore readily apparent that Dr Lachlan had not made the final $10,000 payment due on 15 July 2013. Despite this information, Dr Lachlan took no action.

On 20 January 2014, Dr Lachlan reviewed his own bank statements and concluded that he had missed the final $10,000 payment. On 21 January 2014, he sent a cheque for $10,000 to HPM for the outstanding payment. HPM received the cheque on 24 January 2014, but by this time HPM had already filed its Notice of Motion for judgment.

Key issues

Dr Lachlan sought from the Court an extension of time to make the final $10,000 payment. In the alternative, Dr Lachlan sought a stay to prevent HPM from proceeding to enter judgment. Dr Lachlan submitted that in seeking judgment for the balance of the underlying debt ($1.5M less payments made) HPM was breaching an implied duty of good faith. In the alternative, Dr Lachlan argued that the sum sought by HPM was unenforceable as a penalty.

Judgment

Dr Lachlan failed and the Court made an order in favour of HPM for the underlying debt.

Extension of time refused

The extension of time was sought under rules 1.12 or 36.6 of the *Uniform Civil Procedure Rules* (NSW), which were enlivened due to the Deed being incorporated into the order of the Court. Granting an extension under these rules is discretionary.

In refusing to exercise its discretion to grant an extension of time the Court noted:

- The orders were by consent.
- There was no suggestion that the Deed was unenforceable, void or voidable.
- HPM was under no obligation to remind Dr Lachlan of his obligations or take steps to protect his interests.
- Dr Lachlan received a notice which clearly stated he had 7 days to remedy the default.
- HPM's failure to respond to Dr Lachlan's request for a loan history made no practical difference as by 15 January 2014, Dr Lachlan had received a reconciliation from his accountant and confirmation that the final $10,000 payment was indeed owing.

The judge said that –

> Viewed overall, it seems to me that the failure to comply with the notice, and the consequences which flow from that, must be treated as Dr Lachlan's own fault…. Some sympathy may be held for Dr Lachlan … but… such sympathy is not sufficient reason to deprive HPM of its contractual rights.

Stay refused

The application for a stay was sought pursuant to section 61 of the *Supreme Court Act* 1970 (NSW) which provides that courts have discretion to decline to enforce their orders where it would be inequitable to do so. Dr Lachlan contended that that the circumstances of his case were caused by a mistake and equity relieves against fraud, accident and mistake.

In refusing the request for a stay the Court noted that at least by 15 January 2014, Dr Lachlan had been given advice that confirmed the accuracy of HPM's claim and his mistake should have been clear to him by them. There was still time for him to comply to avoid the detrimental consequences yet he failed to do so.

No duty of good faith

The Court did not agree that a duty of good faith should be implied into the Deed as it failed the test of necessity. Even if there was an implied duty of good faith, HPM had not breached such duty. HPM had given Dr Lachlan the requisite notice and the notice included a telephone number for Dr Lachlan to contact in the event he had queries. HPM's failure to respond to Dr Lachlan's letter requesting a loan history (but not requesting an extension of time) did not rise to the level of conduct required to constitute a failure to act in good faith.

Not an unenforceable penalty

The question to ask in determining whether or not the obligation to pay the balance of the underlying debt as a result of the default constituted a penalty was whether the agreement reached between Dr Lachlan and HPM as reflected in the Deed and consent orders contained an acknowledgement (albeit implicit) by Dr Lachlan that he was orginally indebted to HPM for the amount of the underlying debt.

The Court noted that the Deed provided that Dr Lachlan unconditionally confirmed the debt obligations and that his debt obligations were "current and continuing obligations". Accordingly, the Court held:

> …HPM was pursuing Dr Lachlan for the amount outstanding on the loans, which was an amount at least as great as the Judgment Debt [the underlying debt]. As part of the compromise, Dr Lachlan confirmed the existence of that indebtedness and at the same time secured the opportunity to obtain a discharge by paying a lesser sum (the Net Settlement Amount). If, however, the Net Settlement Amount was not made in accordance with the Deed, Dr Lachlan, who accepted that he was indebted to HPM under the loans, would submit to judgment being entered against him for the Judgment Debt less the amount of any payments under the Deed. In my opinion, implicit in this agreement is an acknowledgment on Dr Lachlan's part that he is indebted to HPM for the full amount of the Judgment Debt.

Take away lesson

Assume that a creditor is willing to compromise its right to a sum and receive a reduced amount. Assume also that the creditor wants to reserve the right to claim the higher sum in the case of default by the debtor. The creditor should aim to have an acknowledgement by the debtor that the higher sum is owed even if the debtor will avoid having to pay that amount if he pays the compromise sum. The safest course for the creditor is to have the agreement include an acknowledgement that the higher amount is payable but state that this right will not be enforced if certain conditions are met, namely that the reduced sum is paid by a particular date or dates.

TurkAlert

For more information, please contact:

Pieter Oomens
Partner
T: 02 8257 5709
M: 0417 268 334
pieter.oomens@turkslegal.com.au

Alysha Tuziak
Senior Associate
T: 03 8600 5035
M: 0402 887 044
alysha.tuziak@turkslegal.com.au