Instalment Payments and the Penalty Doctrine: *Ethoz Capital Ltd v Im8ex Pte Ltd and others* [2023] SGCA 3

I. Executive Summary

Under contract law in Singapore, parties are generally free to contract as they wish. However, while parties are free to enter contracts and undertake what are known as "primary" obligations, they are also free to change their mind and break their contractual obligations if they so wish, albeit at a price. Hence, any clause that essentially *forces* compliance with the primary obligations of a contract – thus interfering with the parties' freedom to break their contractual obligations – will be considered an unenforceable penalty. This is known as the "penalty doctrine".

The prior case of *Denka Advantech Private Limited v Seraya Energy Pte Ltd* [2021] 1 SLR 631 ("***Denka***") established that in Singapore, the penalty doctrine applies only to secondary obligations, i.e. the contractual obligations that require the payment of damages upon the breach of a primary obligation by the defaulting party. In contrast, primary obligations between the contracting parties are not subject to the penalty doctrine. Therefore, a key consideration in determining the applicability of the penalty doctrine is whether the clause in question constitutes a secondary obligation to pay damages upon a breach of the contract.

In *Ethoz Capital Ltd v Im8ex Pte Ltd and others* [2023] SGCA 3, the Court of Appeal ("**CA**") further developed the concept of the penalty doctrine in Singapore. Specifically, the CA held that there was a difference between paying a debt owed in instalments over a period of time, and the immediate and full payment of said debt owed upon default.

The CA further held that here, the immediate and full payment of the debt incurred under the relevant agreements was a secondary obligation that was only triggered upon breach of the underlying agreements. As such, the requirement for immediate and full payment of the debt violated the penalty doctrine and was unenforceable. Further, the CA recognised that while the burden of proving that a clause is a penalty generally rests with the party making the claim, when there is indeed evidence to show that a clause is a penalty, the evidential burden would then shift to the other party to prove otherwise.

II. Material Facts

Ethoz Capital Ltd ("**Ethoz**") lent a total of $6.3 million to Im8ex Pte Ltd ("**Im8ex**") under three loan facilities (the "**Prior Facilities**") for a term of 12 months and an interest rate of between 6.25% to 6.5% per annum. The Prior Facilities, which were guaranteed by Mr Chua Soo Liang ("**Mr Chua**"), the sole director and shareholder of Im8ex, as well as Mr Tan Meng Kim ("**Mr Tan**"), the uncle of Mr Chua, were secured by mortgages over four different properties (the "**Properties**"),

Thereafter, Ethoz and Im8ex began discussing the renewal of the Prior Facilities, and subsequently signed a new set of four loan facilities (the "**Facilities**"), under which the principal borrowed also amounted to $6.3 million (the "**Advance**"). Similar to the Prior Facilities, they were secured by mortgages over the Properties and guaranteed by Mr Chua and Mr Tan. The Facilities contained the following provisions:

- Clauses 5(A) and 7(A) stipulated that the Facilities carried an interest rate of 3.75% per annum, with 180 equal monthly instalment payments to be made over 15 years.
- Clause 6(B) specified that Im8ex could make a prepayment by paying "the Advance and interest computed thereon in full", subject to certain conditions.
- Clause 7(B) provided that the Total Interest "shall be deemed earned and accrued in full upon the drawdown of the Advance".

    - Schedule 3 defined the term "Total Interest" as the aggregate of all the interest payments. Schedule 3 also outlined the instalment payments, which comprise both the Advance and interest payments.
- Clause 14 specified that the Total Interest would be "immediately due and payable" upon an event of default, including the failure to pay a sum under the Facilities when it is due.
- Clause 15 stipulated that Im8ex would have to pay default interest ("**Default Interest**") at a rate of 0.065% per day (the "**Default Interest Rate**") upon any event of default.

Im8ex defaulted on payment of both the Advance and Interest within the first year of entering into the Facilities. Ethoz subsequently filed an originating summons to demand immediate and full payment of the Advance, Total Interest and Default Interest due under the Facilities as well as deliver vacant possession of the Properties. The Assistant Registrar rejected Im8ex's objections to the originating summons and found in favour of Ethoz.[1]

Im8ex then filed an appeal to the General Division of High Court ("**HC**"). The HC found in Im8ex's favour, on the following grounds:

- the payment of the Total Interest upon default was a secondary obligation as well as an unenforceable penalty;
- the payment of the Default Interest was an unenforceable penalty as the Default Interest Rate was an "extravagant increase" from the regular contractual interest rate; and
- Ethoz had misrepresented to Im8ex that the terms of the Facilities were better than the Prior Facilities, thereby inducing Im8ex to enter the Facilities with Ethoz.

Having made the above findings, the HC allowed Im8ex to redeem the Facilities by making a prepayment of the Advance and loan interest. Ethoz appealed against the HC's decision.

III. Issues on Appeal

The CA considered the following three issues on appeal:

A. Whether the HC erred in finding that Ethoz had made misrepresentations to Im8ex that induced Im8ex into entering the Facilities (the "**Misrepresentation Issue**");

B. Whether the HC erred in finding that the payment of the Total Interest upon default and the Default Interest were unenforceable penalties (the "**Penalty Issue**"); and

C. Whether the HC was correct to allow Im8ex to prepay the outstanding Facilities with interest pursuant to Clause 6(B) of the Facilities (the **"Redemption Issue**").

A. The Misrepresentation Issue

Ethoz's pointed out that since the issue of misrepresentation had not been raised by either party during the proceedings, there was no reason for the HC to find misrepresentation. Ethoz further asserted that the finding of misrepresentation was one made "factually without basis".

The CA agreed with Ethoz that the HC had no grounds to find misrepresentation. This was especially given the fact-sensitive nature of an allegation of misrepresentation, as well as the fact that no evidence concerning the elements of misrepresentation was presented.

B. The Penalty Issue

The Penalty Issue was the central focus of Ethoz's appeal. Specifically, Ethoz argued that the HC had erred in finding that the payments of both the Total Interest upon default and Default Interest under Clause 15 were unenforceable penalties. The CA rejected Ethoz's arguments.

[1] This decision was based on a prior decision in *Ethoz Capital Ltd v T-Pacific Pte Ltd and others* HC/RA 350/2019, a case between Ethoz and another borrower which involved a loan on similar terms.

As established under *Denka*, whether a clause violates the penalty doctrine consists of two inquiries. First, it must be determined whether the provision relates to a primary or secondary obligation; if the latter, then whether the operation of the clause has been triggered by the specified breach in the provision. Next, it must be determined whether the provision is invalid for being a penalty.
While Ethoz did not contest the HC's finding that the payment of Default Interest was a secondary obligation, it asserted that the HC erred in finding that the payment of Total Interest upon default was a secondary obligation that arose upon the breach of Facilities. Specifically, Ethoz argued that Clause 7(B)[2] established the Total Interest as a present debt to be paid at a future time. Since the Total Interest was a debt and thus a primary obligation, the requirement of paying Total Interest upon default transformed into an "accelerated primary obligation", which did not qualify as a penalty.

The CA acknowledged that Clause 7(B) indeed gave rise to a debt and constituted a primary obligation. However, the CA disagreed with Ethoz's argument that the acceleration of a primary obligation would always exempt it from being scrutinised under the penalty doctrine. Instead, the CA emphasised the need to evaluate the "nature and extent of the acceleration" to ascertain whether the "accelerated" obligation retained its status as a primary obligation. Further, while Clause 7(B) did establish that the Total Interest is "deemed earned and accrued" as a debt, making its payment a primary obligation, the clause failed to state the timing or method of this payment. This distinction was critical given the difference between paying a debt *immediately* and *in full*, and paying a debt in *instalments* over a period of time.

The CA held that the key inquiry, instead, was which of the two scenarios – the immediate and full payment versus the payment in instalments – constituted the primary obligation, and which one functioned as a secondary obligation triggered upon a breach of contract. The court would then examine whether the secondary obligation was an unenforceable penalty.

(i) Primary vs secondary obligations

The CA first explained the distinction between primary and secondary obligations. A primary obligation was considered the "essential core" of the contract, whereas a secondary obligation was "incidental" to the primary obligation, i.e. an obligation to pay money on a breach of contract.

However, this distinction was not always clear. Indeed, parties may circumvent the "threshold issue" of only secondary obligations triggering the penalty doctrine by drafting contracts in a way that masked a secondary obligation as a primary obligation. The CA noted that such attempts could be revealed by exploring several factors as examined previously in *Denka*: "the overall context in which the bargain in the clause was struck"; "any particular reasons for the inclusion of the clause"; and "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". These factors were not exhaustive, and a "substance over form" approach should be adopted. The CA stressed that the court should thus analyse the whole contract, not just the clauses that were being impugned.

(ii) Immediate and full payment of the Total Interest as a secondary obligation

The CA then held that the primary obligation here was the payment of the Total Interest *in instalments*, while the secondary obligation was the immediate and full payment of the Total Interest upon breach of the contract. This was based on Clause 5(A)(1), which indicated payment of the Advance and "interest thereon" in "180 equal instalments".[3] In contrast, there was nothing in the Facilities to show

[2] Clause 7(B) provided that the Total Interest "shall be deemed earned and accrued in full upon the drawdown of the Advance".
[3] Specifically, the CA noted that while there was no explicit reference to the Total Interest, "interest thereon" referred to the Total Interest because Clause 5(A)(1) also stated that the "respective amounts of principal and interest payable on

that Im8ex had promised to make immediate and full payment of the Total Interest without a breach occurring. Instead, on the plain text of the Facilities, such payment would only occur in the event of default per Clause 14(B)(2) of the Facilities, making it a secondary obligation that only arose upon breach of the contract.

(iii) Immediate and full payment of the Total Interest and Default Interest as unenforceable penalties

Next, the CA considered whether the full and immediate payment of Total Interest upon default and the payment of Default Interest (which was undisputedly a secondary obligation triggered upon breach) were unenforceable penalties.

The CA first addressed Ethoz's argument that Im8ex did not discharge its burden in proving that the Total Interest and the Default Interest rates were penal in nature. Specifically, Ethoz contended that the party claiming a clause as a penalty must bear the burden of proving this assertion. Furthermore, Ethoz argued that without evidence indicating that the Total Interest and Default Interest rates were indeed penal, Im8ex lacked a factual basis to raise any claim.

While the CA agreed with Ethoz in so far that the legal burden fell on Im8ex to prove that the Total Interest and the Default Interest rates were not penal, the CA pointed out that the evidential burden could shift once a party has adduced sufficient evidence to support their claim. In the same vein, the CA rejected Ethoz's argument that Im8ex must provide evidence under all circumstances and if not, their claim must fail. The CA was of the view that if there is already clear and sufficient evidence that the provisions in question are penalties, Im8ex would not need to present further evidence.

Therefore, the crucial question instead was whether there was sufficient evidence before the court to show that the immediate payment of the Total Interest and the Default Interest rates were unenforceable penalties. Where there is insufficient evidence, Im8ex would then have to adduce evidence to support their claim. However, the CA was of the view that there was no need for Im8ex to do so here, as it was evident from the content of the Facilities that the immediate and full payment of the Total Interest and the Default Interest are unenforceable penalties.

The CA then addressed whether the immediate and full payment of the Total Interest and the Default Interest were unenforceable penalties. The CA first noted the tests developed in the seminal case of *Dunlop Pneumatic Tyre Co Ltd v Selfridge & Co Ltd* [1915] UKHL 1 to ascertain whether a clause was a penalty:

- The "Single Lump Sum Test" – where a provision is presumed to be a penalty 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."
- The "Greater Sum Test" – where a provision is 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."
- The "Greatest Loss Test" – where a provision is a penalty "if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach."

The CA concluded that the obligation of full and immediate payment of Total Interest was a penalty, pursuant to the Single Lump Sum Test and the Greater Sum Test. The CA stressed that the key question was whether the provision in question required a payment *in terrorem*[4] of a defaulting party.

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each Instalment Date is set out in Schedule 3" and the aggregate of the monthly instalment payments in Schedule 3 included the Total Interest. Thus, what Im8ex had "promised to do" was to pay the Total Interest in 180 equal instalments as set out in Schedule 3.

[4] This pertains to whether the provision forces compliance with the primary obligations of a contract.

And on the face of it, the requirement of the immediate and full payment of the Total Interest was clearly a payment of money operating *in terrorem* of Im8ex, forcing it to comply with its primary obligation under the Facilities.

The Total Interest constituted a *single lump sum* made payable upon the occurrence of one or more events outlined in Clause 14(A). A total of 25 different "events of default" were outlined under this clause. For example, non-payment as provided for in Clause 14(A)(1) – which stated that failure to pay "any sum payable under [the Facilities] when due" will amount to an event of default – would mean that the failure to pay even one instalment payment would entitle Ethoz to demand payment of not only the Advance, but also the remainder of the Total Interest, in a single and very substantial lump sum. The full and immediate payment of Total Interest also satisfied the Greater Sum Test. Upon default, the sums that Im8ex would have to pay Ethoz would dwarf the actual defaulted payments. These reasons were sufficient for the CA to conclude that the immediate and full payment of the Total Interest was an unenforceable penalty. In addition, the CA noted that by requiring the full and immediate payment of the Total Interest, Clauses 5(A) and 14(B)(2) were essentially forcing Im8ex to comply with its primary obligation under the Facilities (the full payment of Total Interest in instalments) – rendering requirement for the full and immediate payment of the Total Interest as a penalty.

The CA also upheld the HC's finding that the Default Interest rate was an unenforceable penalty. The HC calculated that there was an increase of almost 20% between the regular contractual interest rate and the Default Interest rate, which amounted to a three-fold increase of the effective rate of 6.444% per annum; as such it concluded that the Default Interest rate was a unenforceable penalty.

The CA agreed with the HC. Clause 15 provided that Im8ex would have to "pay interest at an increased rate upon [its] failure to pay any instalment [by] the stipulated time", making it "a provision to pay a larger sum of money upon the failure to pay the stipulated sum within a stipulated time". Further, as the HC calculated, once both rates were compared on an effective basis, the increase was about 20% or of more than 300% the base rate in relative terms. The CA noted that 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.

C. The Redemption Issue

The HC permitted redemption of the Facilities through a prepayment under Clause 6(B), notwithstanding any default, on the grounds that the court in *Hong Leong Finance ltd v Tan Gin Huay and another* [1998] SGHC 318 recognised that even after a default, the mortgagor can still pay off the mortgagee. Therefore, Ethoz challenged this basis which allowed for Im8ex to redeem the Facilities as well as the interest rate imposed on Im8ex.

First, the CA found that the HC had erred in allowing Im8ex to make a prepayment of the Facilities, under Clause 6(B). Clause 6(B)(1) specifically provides that Im8ex is required to give Ethoz not less than three months prior written notice of the date of the proposed prepayment (failing which to pay the equivalent fee) in order to invoke the clause and make prepayment accordingly. The CA found that the HC erred in finding that the requisite three months' notice had been given; in fact, no written notice was ever provided by Ethoz within the meaning of Clause 6(B). In any event, the CA held there could not be any prepayment made after an event of default had occurred.

The CA also held that it was inappropriate for the HC to have allowed for the redemption of the Facilities, because the doctrine of relief against forfeiture did not apply in the mortgagor-mortgagee context. This stemmed from the fact that the mortgagor would maintain a beneficial interest in the

property through the equity of redemption, granting the mortgagor the right to regain property ownership upon full repayment.

As such, the CA decided that the appropriate basis of redemption was to permit Im8ex to exercise its equity of redemption. It granted Im8ex, as defaulting mortgagor, three months from the delivery of this judgment to redeem the Facilities by paying the balance of Advance and loan interest on the remaining sum, excluding the unenforceable penalties of accelerated Total Interest and Default Interest. If Im8ex failed to redeem the mortgages within such period, then Ethoz (as mortgagee) was entitled to pursue the available remedies, including (but not limited to) exercising the power of foreclosure and sale of the property under s 76 of the Land Titles Act 1993 (2020 Rev Ed).

Regarding the precise amount required from Im8ex, the CA held that the payment should follow the terms of Clause 5A(1) read with Schedule 3. This was based on the fact that the primary obligation under the Facilities involved making instalment payments of the Total Interest in accordance with Schedule 3. Referring to Schedule 3, Im8ex would have to pay $4,520,210.88 to redeem the Facilities.

IV. Lessons Learnt

This case was a reaffirmation of Singapore's stance on the penalty doctrine, emphasising the adoption of a substance over form perspective when examining a specific clause. The court's evaluation will encompass three key (but non-exhaustive) aspects:

(a) The overall context in which the bargain in the clause was struck;
(b) The reasons for including 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 primary obligations.

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