
LITIGATION

DECISION UPHELD IN CONSUMER CREDIT TEST CASE APPEAL

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The High Court has just released a decision confirming the ability of lenders to set prepayment fees based on their business model and lending practices, rather than the “safe harbour” formula advocated by the Commerce Commission.

The High Court upheld the District Court’s decision in *Commerce Commission v Avanti Finance* in which the District Court dismissed charges against Avanti under the Credit Contracts and Consumer Finance Act 2003 (CCCFA). Click [here](#) to view our earlier commentary on the District Court’s decision.

The District Court case

The Commission had alleged that the prepayment fees charged by Avanti were unreasonable under the CCCFA because the formula Avanti used did not involve a reasonable estimate of Avanti’s loss on prepayment. Drawing on the “safe harbour” formula provided for in the CCCFA, the Commission alleged that Avanti’s alternative formula did not relate to the time taken to re-lend funds, had no regard to changes in interest rates, and did not take into account mitigation of loss by re-lending. However, the Court found that the safe harbour formula did not reflect Avanti’s loss, was not suited to Avanti’s business structure, and that Avanti’s formula was reasonable.

The High Court appeal

The Commission appealed the District Court decision to the High Court. The focus of the appeal was whether Avanti was required to calculate its loss on the assumption that it would immediately re-lend the prepaid funds despite the fact that it had excess funds available and prepayment did not affect its ability to issue new loans.

The Commission contended that the reasonableness of any alternative formula used to calculate a prepayment fee must be considered against the principles inherent in the safe harbour formula. This would require allowances for changes in prevailing interest rates, mitigation of loss through re-lending, the reduction of the outstanding balance due over time, and the time value of money. In the Commission’s view, although the CCCFA allows creditors to use their own formula, it was wrong for Avanti to depart from the safe harbour formula for reasons linked to its business structure rather than reasons to do with the characteristics of loans themselves.

Justice Asher in the High Court held that a prepayment fee calculation is not unreasonable if it involves an objective estimate at the time of entering into the contract of compensation to the creditor for

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its anticipated actual losses on prepayment. It was further held that it is reasonable for a creditor to take into account the fact that a new loan will not replace the old one and that profit on the loan is lost through prepayment.

His Honour held that the CCCFA explicitly provides two alternatives – the safe harbour formula, or an appropriate alternative formula – and that the reasonableness of an alternative formula does not depend on its similarity to the safe harbour formula. His Honour said that it makes no logical sense for the legislature to have provided for alternative formulae if they were to be driven by the terms of the safe harbour formula, and that the only benchmark is reasonableness.

Finally, His Honour refused to accept the Commission's contention that it is inappropriate to consider the creditor's business structure in setting prepayment fees, saying that an assessment of reasonableness requires consideration of the loss of the actual creditor, and more than "a barren focus on a contractual term against a market backdrop".

The High Court decision affirms the District Court's decision in this important test case and gives lenders welcome guidance on the factors they need to take into account in setting prepayment fees.

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