Penalty Clauses Down Under

Written by Victoria Tyson[1]

Whilst it is widely understood that the law on liquidated damages differs considerably between common law and civil law jurisdictions, there are also differences within common law jurisdictions which are sometimes overlooked. This article summarises the recent developments to the law on penalties in England and Wales, as reported by Steve Mangan in May 2016[2], and compares them with the developments to the law on penalties in Australia.

The position in England

A penalty clause will not be enforced by the courts of England and Wales. The burden of proving that a clause is a penalty clause rests with the party who is sued upon it. Until recently, the case of *Dunlop Pneumatic Tyre Co v New Garage & Motor Co [1915] AC 79* was the leading authority for establishing whether or not a contractual clause amounted to a penalty; the words penalty or liquidated damages not being conclusive in themselves. Lord Dunedin stated, "*The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine pre-estimate of damage … judged of as at the making of the contract, not at the time of breach,*" and set out a four-fold test to assist in construction:

a) "*It will be held to be 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. (Illustration given by Lord Halsbury in Clydebank Case).*"

b) *It will be held to be 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 (Kemble v Farren). This though one of the most ancient instances is truly a corollary to the last test. […]*

c) *There is a presumption (but no more) that it is penalty when "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" (Lord Watson in Lord Elphinstone v Monkland Iron and Coal Co[5]).*

On the other hand:

d) *It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties (Clydebank Case, Lord Halsbury; Webster v Bosanquet, Lord Mersey)".*

After *Dunlop*, anything that was not a genuine pre-estimate of loss at the time the contract was entered into was at risk of being found penal. However, the penalty rule has long been viewed as an interference with freedom of contract.

As Steve Mangan reported in May 2016, in a landmark judgment on two unrelated appeals which were heard together: (1) *Cavendish Square Holding BV – v – Talal El Makdessi* ("*Cavendish*"); and (2) *Parking Eye Ltd – v – Beavis* ("*Beavis*") *[2015] UKSC 67*, the UK Supreme Court determined that after *Dunlop* there had been an over-literal reading of the four-fold test and

[1] Victoria Tyson is a director of Corbett & Co. International Construction Lawyers Ltd. She can be contacted at victoria.tyson@corbett.co.uk.
[2] http://corbett.co.uk/the-highest-uk-court-reviews-the-law-on-penalties/

Tel: + 44 (0)20 8614 6200
Fax: + 44 (0)20 8614 6222
Email: info@corbett.co.uk
www.corbett.co.uk

therefore re-formulated the test. Under this more flexible test, a penalty is now to be regarded as:

"a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."

When considering a clause seeking to apply delay damages for breach of an obligation to complete within the time for completion for the works the key questions to ask are:

- Does the obligation imposed amount to a *"secondary obligation"*? A secondary obligation being an obligation that is dependent upon another obligation which is the primary obligation. For example, the Contractor's primary obligation may be to complete the works on time, and the Contractor's secondary obligation to pay delay damages in the event that he has failed to complete on time. Note: it does not need to be an obligation to pay money, but it will be the most common scenario.
- Does the innocent party have a "*legitimate*" interest in the enforcement of the "*primary obligation*"? For example, does the Employer have good reason to require that the works are completed on time or a good reason to properly manage escalating project costs?

This change of approach means that much less emphasis is now put on whether or not the clause is a deterrent (in Latin, *in terrorem*) or whether the amount of delay damages is a genuine pre-estimate of loss. More weight is given to the freedom of the parties to contract.

For those drafting contracts this will mean that the protection previously afforded to the Employer in making a genuine pre-estimate of loss at the time of contract will no longer apply. Now, if the obligation to pay delay damages is out of proportion to the obligation to complete within the time for completion for the works, the obligation to pay delay damages may be penal even if, at the time of contract, the delay damages arrived upon were a genuine pre-estimate of loss.

The position in Australia

There have been significant developments to the law on penalties in Australia too. Australia has traditionally followed the *Dunlop* test but this has been reconsidered as can be seen in *Andrews v Australia and New Zealand Banking Group Ltd*. which became *Paciocco v Australia and New Zealand Banking Group Ltd*. The case was brought as a representative action by approximately 38,000 customers of the Bank, alleging that certain credit card fees charged by the Bank were penalties, and were therefore void or unenforceable. The proceedings were initially led by Mr Andrews (later by Mr Paciocco), and was instituted in the Federal Court of Australia. The case was the subject of five separate court hearings:

1. The Federal Court (2011)[3]

It was initially heard in the Federal Court. Mr Andrews contended that the fees were void or unenforceable as a penalty because they, (i) were not a genuine pre-estimate of loss, (ii) substantially exceeded that which would be recoverable as general damages for breach of contract, and (ii) were extravagant or unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach. The Bank admitted that the fees were not a genuine pre-estimate of loss but disputed the other allegations.

The judge (Gordon J) held that the late payment fees[4] were capable of being characterised as a penalty because they were imposed as a direct result of Mr Andrew's breach, namely his failure to pay the minimum monthly payment within 28 days

[3] [2011] 211 FCA 1376

[4] In essence, a customer was charged a late penalty fee on his or her credit card account if he or she had not paid the minimum monthly payment within 28 days of the statement date.

Tel: + 44 (0)20 8614 6200
Fax: + 44 (0)20 8614 6222
Email: info@corbett.co.uk
www.corbett.co.uk

of the statement date[5]. However, other fees (such as honour, dishonour, non-payment and overlimit fees) which were not incurred as a result of a breach of contract by the customer (because, for example, they needed authorisation by the Bank) were not found to be penalties.

2. The High Court (2012)[6]

The decision regarding the honour, dishonour, non-payment and overlimit fees was appealed to the High Court who found that such fees were capable of being characterised as penalties in the absence of a breach of contract, but declined to decide whether the fees were, in fact, penalties.

The High Court held that, "*In general terms, a stipulation prima facie imposes a penalty on a party ("the first party") if, as a matter of substance, it is collateral (or accessory) to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party. In that sense, the collateral or accessory stipulation is described as being in the nature of a security for and in terrorem of the satisfaction of the primary stipulation. If compensation can be made to the second party for the prejudice suffered by failure of the primary stipulation, the collateral stipulation and the penalty are enforced only to the extent of that compensation. The first party is relieved to that degree from liability to satisfy the collateral stipulation.*"

The High Court continued, *"It should be noted that the primary stipulation may be the occurrence or non-occurrence of an event which need not be the payment of money. Further, the penalty imposed upon the first party upon failure of the primary stipulation need not be a requirement to pay to the second party a sum of money."*

Importantly, the High Court concluded that there subsisted, independently of the common law rule, an equitable jurisdiction to relieve against any sufficiently onerous clause which was conditional upon a failure to observe some other clause, whether or not that failure was a breach of contract. This equitable doctrine against penalties had not "*withered on the vine*".

The decision was perceived to be a radical expansion of the rules on penalties set out in *Dunlop*, and was widely criticised for its a lack of adequate reasoning for the departure from *Dunlop* and the failure to consider the effect the decision might have on future commercial contracts. It was expressly criticised by the Supreme Court in *Cavendish*.

3. The Federal Court (2014)[7]

The case was remitted back to the Federal Court with a different representative applicant - Mr Paciocco and one of his companies Speedy Development Group Pty Ltd. The pleadings were constructed slightly differently to those in the initial proceedings. Mr Paciocco alleged that the late payment fees and other fees constituted penalties at common law and in equity.

The judge (Gordon J again) found that the late payment fees constituted a penalty at common law and a penalty in equity, i.e. "*That collateral stipulation, upon failure of the primary stipulation, imposed upon the customer and additional detriment in the nature of a security for, and in terrorem of, the satisfaction of the primary stipulation which was extravagant, exorbitant and unconscionable.*" Gordon J's reasoning as to the penal nature of the late payment fees included the following:

- The fees were extravagant and unconscionable within rule 4(a) of *Dunlop*. Based on the expert evidence, Gordon J decided that the loss to the bank was no

[5] She rejected the Bank's arguments that late payment fees were charged by the Bank as part of the operation of the account for the credit extended to the customer for a period beyond that previously agreed and for the increased risk of default in repayment of the amounts borrowed.
[6] [2012] HCA 30
[7] [2014] FCA 35

Tel: + 44 (0)20 8614 6200
Fax: + 44 (0)20 8614 6222
Email: info@corbett.co.uk

more than $3 and in some instances as low as $0.50. Given the late payment fees were either $20 or $35 it followed that the fee was vastly greater than the loss.

- The first part of the rule 4(b) in *Dunlop* applied because the breach consisted only of not paying a sum of money.
- The second part of the 4(b) rule in *Dunlop* applied because the sum stipulated was greater than that which ought to have been paid, i.e. the fees were extravagant and unconscionable pursuant to rule 4(a) in *Dunlop*.
- There was a rebuttable presumption that the obligation to pay late payment fees was penal where there is "*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*" - rule 4(c) in *Dunlop*.
- The Bank admitted that the late payment fee was not calculated by reference to a sum that would have been recoverable as general damages, i.e. it was not a genuine pre-estimate of loss.
- The Bank was entitled to (and did) charge interest on the outstanding amount, which supported the conclusion that the obligation to pay late payment fees was penal.

The honour, dishonour, non-payment or overlimit fees charged by the Bank were held to be of a different nature and did not constitute a penalty at common law or a penalty in equity. The liability to pay each of those fees was not contingent upon a breach of contract nor collateral (or accessory) to a primary stipulation in favour of the Bank.

4. The Full Federal Court (2015)[8]

The Bank appealed the decision that the late payment fees were penalties and Mr Paciocco and his company appealed the decision that the honour, dishonour, non-payment and overlimit fees were not penalties. The Bank's appeal was successful and the Full Federal Court held that the late payment fees did not amount to a penalty. Mr Paciocco's appeal was unsuccessful, and the Full Federal Court upheld Gordon J's findings with respect to the other fees.

The Full Federal Court emphasised that the dichotomy between [97] "*a penalty*" and "*a genuine pre-estimate of loss*" (as set out in *Dunlop*) is still "*central to the operation of the penalty doctrine*". It stated [25], "*…if extravagance and unconscionability, on the one hand, and a genuine pre-estimate, on the other, are to operate as the relevant universe of discourse, the latter must be a descriptive phrase used to explain a sum paid upon breach of a term or pursuant to a collateral stipulation upon the failure of the primary stipulation that is not extravagant and not out of all proportion to the compensation for the breach or failure of the stipulation. The penal character of the provision is derived from the extravagance of the relationship between the payment and the loss capable of compensation*".

Chief Justice Alsop (with whom the other judges agreed) said it was necessary to decide whether a fee was extravagant and unconscionable (rule 4(a) in *Dunlop*) before deciding whether the fee, in fact, exceeded the loss. The analysis should be forward-looking, and should assess whether the party imposing the fee had a legitimate interest in the performance. Mr Reagan (Mr Paciocco's expert) had been instructed to consider what damage Mr Paciocco's breach had actually caused, which was irrelevant as to a prospective enquiry as to whether the fee was extravagant and unconscionable.

Mr Inglis (the Bank's expert) had been instructed to consider what could possibly be the greatest loss or damage that could arise by some breach of the term in question, as a means of assessing the proper protection for the Bank's interest in the due performance of the obligation, which was in accordance with a prospective enquiry as to extravagance and unconscionability.

[8] [2015] FCAFC 50

Gordon J had had erred in preferring the analysis of actual loss caused by the breaches when the correct approach "*Was founded upon the need to show, by an ex ante analysis at the time of entry into the contract, that the stipulation was extravagant and unconscionable in comparison with the greatest loss that could conceivably be proved to follow from such breach*". The Full Federal Court preferred the forward-looking analysis of Mr Inglis which did not demonstrate the fees to be extravagant, unconscionable or exorbitant.

The Court found that the fact that a clause fell within rule 4(b) of *Dunlop* was not decisive, and did not alter the onus of proof. In any event, the late payment fee did not fall within rule 4(b) of *Dunlop* because the late payment fees were not necessarily a demand for payment of a larger sum upon failure to pay a smaller sum. Whilst the late payment fee might have fallen within rule 4(c) of *Dunlop*, it was incorrect to consider the actual damage flowing from the breach.

5. The High Court (2016)[9]

Special leave to appeal the decision on the late payment fees in the High Court was granted. A High Court majority (4 to 1) upheld the Full Federal Court decision and found that Mr Paciocco had not proved that late payment fees amounted to a penalty. The late payment fees did not amount to a penalty, notwithstanding that it did not represent a genuine pre-estimate of the loss that might have been caused by a particular breach by a particular customer or that the costs actually incurred by the Bank as a result of a particular late payment were relatively small. "*The fact that those categories of costs could not be recovered in an action for damages did not alter that conclusion. Further, neither the fact that the late payment fees were not genuine pre-estimates damage not the fact that the amounts charged were not disproportionate to the actual loss suffered by itself rendered the late payment fees penalties*".[10]

[9] [2016] HCA 28

The decision did not displace the principles articulated in the 2012 *Andrews* High Court decision, notably the correctness of the application of the penalty rule to both breach of contract at law and in equity. In responding to criticism of the Supreme Court in *Cavendish* that Andrews represented a significant departure of the doctrine of penalties, Gageler J remarked, "*the statement is wrong and appears to be based on a misunderstanding of Andrews*."

Summary

In summary, these proceedings mean that in Australia:

- a clause is more likely to be a penalty under Australia law than under English law;
- breach of contract is not required (unlike the position under English law);
- legitimate interests will extend beyond monetary interests;
- the words "*extravagant and unconscionable*", and "*exorbitant*" must be determined by reference to the circumstances of each case. It is not enough that a sum lacks proportion; it must be out of all proportion to any legitimate interest of the innocent party to the enforcement of the primary obligation.

In *Grocon Construction (Qld) Pty Ltd v Juniper Developer No. 2 Pty Ltd. [2015] QSC 102* the Supreme Court of Queensland held that a liquidated damages clause was not a penalty where the obligation to pay liquidated damages depended solely upon the failure to achieve Practical Completion by the Date for Practical Completion because this was a breach of a single obligation notwithstanding that it may be consequential on a number of other minor breaches, and the loss suffered by the Employer for this breach was not disproportionate to the amount of the liquidated damages. The case was distinguished from

[10] The High Court also found that the late payment fees did not contravene statutory prohibitions against unconscionable conduct, unjust transactions and unfair contract terms.

Tel: + 44 (0)20 8614 6200
Fax: + 44 (0)20 8614 6222
Email: info@corbett.co.uk
www.corbett.co.uk

Andrews and *Paciocco* on the basis that the payment in those cases could be breached many times and in many ways with each breach having different consequences. The decision was appealed. In *Grocon Construction (Qld) Pty Ltd v Juniper Developer No. 2 Pty Ltd. [2015] QCA 291* the Court of Appeal applied the *Dunlop* test and confirmed that the liquidated damages clause was not extravagant and unconscionable in amount in comparison with the greatest loss that could be conceivably proved.

Conclusion

The penalties rule is changing and we can expect to see new and interesting cases debating the topic. The law on penalties is currently wider in Australia than that in the UK where more emphasis is placed on the freedom of contract.

Note: In 2013/2014 there was much speculation that time bars and other similar stipulations might be unenforceable as penalties in Australia broadly on the basis that (i) the penalty doctrine is not restricted to breach of contract or monetary interest, (ii) the requirement to give notice (the primary stipulation) will mean the loss of an entitlement to claim if no notice is give (the collateral stipulation), and/or (iii) the loss of an entitlement to payment will be the same amount regardless of the period of delay. Although many articles were written on this topic we are not aware of this having yet been tested in the courts. We would be interested to hear of any cases of which you are aware that have considered such arguments.

Article Author

Victoria Tyson

Email: victoria.tyson@corbett.co.uk