Briefing note July 2016

Update: The Law on Penalties

The High Court of Australia on 27 July 2016 delivered its decision in *Paciocco v Australia and New Zealand Banking Group Ltd*[1], its latest consideration of the penalties doctrine.

The majority of the High Court found that in assessing whether a clause is a penalty, the court is to have regard to the legitimate interests of the innocent party in the enforcement of the clause. This echoes the approach taken recently by the UK Supreme Court and emphasises the freedom of parties to conclude bargains which include mechanisms for the protection of commercial interests in accordance with their risk appetites and without being constrained by the requirement to prove financial loss.

In respect of the late payment fee charged by the bank, the majority found that the costs of provisioning for losses, regulatory capital and collection were legitimate interests of the bank. This justified the late payment fee. It was not determinative that the late payment fee was disproportionate to the actual loss suffered and did not represent a genuine pre-estimate of damages.

Whilst the decision is clear, the reasoning may give rise to further debate as the High Court delivered five separate judgments which seek to reconcile the decision in *Paciocco* with the previous authorities in relation to penalties, including the seminal decision of *Dunlop*[2], the High Court's own decision in *Andrews*[3] and the landmark decision of the UK Supreme Court in *Cavendish v Makdessi*[4] (a case in which Clifford Chance (London) acted).

The law on penalties in Australia and the UK heralds from the same seminal case – *Dunlop*. Accordingly, the fundamentals of the legal doctrine have, for many years, been aligned. Historically:

- the question as to whether a clause was a penalty (and, therefore, unenforceable) only arose where there was a breach of contract;
- a clause was unlikely to be a penalty if it reflected a genuine pre-estimate of the loss likely to be suffered on breach;
- a clause was likely to be a penalty if it was "extravagant" or "exorbitant", having regard to the greatest conceivable loss that could be proved; and
- the relevant time for assessment of the loss was at the time of entry into the contract, not at the time of breach.

In recent years, the law in the UK and Australia has diverged following the Australian High Court decision in

A*ndrews* and the UK Supreme Court decision in *Cavendish*.

Divergence in UK and Australia

In the UK, the Court in *Cavendish* affirmed that the doctrine of penalties only arises upon breach of contract (and in respect of secondary obligations).

However, the Court recast the century-old test, which centred on "genuine pre-estimates of loss", in favour of a test focused on whether a clause is "proportionate", having regard to the innocent party's "legitimate interests" (financial or otherwise) in enforcement of the relevant underlying primary obligation. This emphasised the narrow application of the penalties doctrine in the UK.

In addition, it held that a clause intended to "deter" a breach of contract would not necessarily be a penalty clause (in contrast to a clause intended to "punish" for a breach).[5]

In contrast, in Australia, no breach of contract is required to engage the penalties doctrine. This was established in *Andrews* and was not disturbed in *Paciocco* (although in *Paciocco* French CJ and Gageler J each commented on the divergence between the UK and Australia in this respect).[6] As *Paciocco* involved a breach of contract, it was not necessary for the Court to address this issue.

Paciocco does, however, provide further guidance in relation to the test to be applied in Australia in determining whether a clause is penal.

Paciocco

At first instance,[7] the Federal Court determined that fees imposed by the bank on late payment by its customers were penalties. It was held that the amount imposed by the relevant clause was extravagant in relation to the likely loss, having regard to the minimal loss that was actually sustained by the bank.

The Full Court of the Federal Court[8] overturned this decision on the basis that the appropriate analysis of loss flowing from the breach or failure should be performed at the time of entering into the contract, and not having regard to the actual loss sustained. The Court endorsed the view that both the potential direct and indirect losses that could be suffered by the bank (the "maximum conceivable loss") could be considered when determining the amount to charge upon late payment by its customers.

Four of the five judges of the High Court in the decision delivered on 27 July 2016 upheld the decision of the Full Court.

Whilst each judge delivered separate judgments, each majority judge considered the approach endorsed in *Cavendish*.

Keane J found, citing *Cavendish*, that the question to be addressed in order to distinguish a penalty from a provision that is protective of a legitimate interest is:[9]

> *"whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract."*

Kiefel J (with whom French CJ agreed in relation to penalties) did not expressly endorse the approach in *Cavendish*[10] but, generally consistent with that approach, found that:

- the distinction drawn in *Dunlop* between liquidated damages and a penalty does not mean that if no pre-estimate is made at the time a contract is entered into a sum stipulated will be a penalty, nor does it mean that a sum reflecting, or attempting to reflect, other kinds of loss or damage to a party's interests beyond those directly caused by the breach will be a penalty; and[11]
- the question is whether a provision for the payment of a sum of money on default is out of all proportion to the interests of the party which it is the purpose of the provision to protect. This interest may be of a business or financial nature.[12]

Gageler J considered that the approach endorsed in *Cavendish* may lead to the same result, but that the inquiry should be framed in terms of whether the stipulation in issue is properly characterised as having no purpose other than to punish.[13]

Implications

Each of the approaches endorsed by Keane, Kiefel (French CJ agreeing) and Gageler JJ narrow the application of the penalties doctrine and give greater scope for parties to determine how to protect their commercial interests without the interference of the courts.

Parties are no longer constrained to somewhat artificial assessments of the losses likely to be recoverable in the event of breach or required to refrain from drafting clauses that deter parties from breaching their obligations. Parties with a sufficient risk appetite can probably afford to be more aggressive in their negotiations and drafting than they could previously.

Whilst parties may have greater certainty that clauses will not be struck down as penalties, the separate reasoning of the members of the majority, and the fact that each clause must be considered by reference to the circumstances in which it is to operate, still leaves room for argument between parties.

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1 *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28
2 *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1914] UKHL 1
3 *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205
4 *Cavendish Square Holding BV v Makdessi; ParkingEye Limited v Beavis* [2015] UKSC 67; [2016] 2 All ER 519
5 *Cavendish* at [32] per Lord Neuberger and Lord Sumption
6 *Paciocco* at [7]-[10] per French CJ and at [119]-[127] per Gageler J
7 *Paciocco v Australia and New Zealand Banking Group Ltd* [2014] FCA 35
8 *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50; 236 FCR 199
9 at [270]
10 Kiefel J refers to the test at [54]
11 at [30]
12 at [29]
13 at [166]

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