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Précis Paper

Penalties Law Developments and Finance Contracts

A discussion of finance and contractual penalties, and recent developments in the area

Discussion Includes

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Précis Paper

Penalties Law Developments and Finance Contracts

1. In this edition of BenchTV, Gregory Burton SC (Barrister, 5 Wentworth Chambers, Sydney) and Andrew Smorchevsky (Barrister, 5 Wentworth Chambers, Sydney) discuss finance and penalties, recent developments in the area, and the difference in the positions taken up by Australia and the UK on the scope of the law of contractual penalties.

<u>General overview of penalty law in the context of finance contracts</u>

2. The past few years has confirmed a divergence between the UK Supreme Court and the High Court of Australia on the scope of the law of contractual penalties.

3. In essence, in Australia the doctrine is seen as an example of principles of equitable unconscientiousness which can in principle be applied to a contractual term whether or not there has been a breach of contract. In the UK, the underlying principle is expressed in similar language but is applied only to the contractual consequences of a breach of the contract by one party.

<u>Australia: *Paciocco v ANZ* [2016] HCA 28</u>

4. *Paciocco v ANZ* [2016] HCA 28 was the second round to reach the High Court of a challenge to certain bank fees and charges as penalties.

5. In the Full Federal Court (Allsop CJ, Middleton and Besanko JJ) [2015] FCAFC 50, the decision of Gordon J at first instance [2014] FCA 35 was overturned in relation to credit card late payment fees, which her Honour had held to be a penalty (with customers entitled to recover the difference between the fee and ANZ's proved actual loss), and upheld in relation to non-payment, over-limit, honour and dishonour fees, which her Honour had held not to be penalties.

6. The High Court [2016] HCA 28 upheld the decision of the Full Federal Court, with the High Court's consideration being limited to the late payment fee. The main focus of principle for the Court was on the basis for and scope of the doctrine of penalties in relation to contracts. The High Court confirmed and further explained the test which it had laid down in related litigation in *Andrews v ANZ Banking Group Ltd* (2012) 247 CLR 205, [2012] HCA 30.

7. The first step is to apply ordinary principles of contract interpretation to find whether or not the contractual term (considered at time of entry into the contract) is accessory (collateral)

to a primary obligation - in effect a security for performance of the primary obligation (be that a major or minor obligation).

8. If it is so found, then the court must examine factors that include whether or not the amount stipulated to be paid is a genuine pre-estimate of damage, is extravagant and unconscionable in relation to the greatest provable loss, and is payable on the occurrence of a range of events of varying degrees of seriousness. This is to ascertain whether or not the amount of the payment is "out of all proportion" with the payee's "legitimate interests", but strict proportionality is not required. Legitimate interests are not restricted to the avoidance of damage resulting from non-compliance. They may extend to broader commercial interests including maintenance of profits from use of its assets. See particularly Kiefel J (French CJ agreeing) at [28]-[29], [33], [42]-[48], [54], [57], [62], Gageler J at [127], [145], [157]-[166], [169], [172], [176], Keane J at [216], [221], [240], [243], [254], [256], [259], [270], [273], [278]-[279], [283]-[284].

9. The broad definition of legitimate interests was a corollary to the High Court's recognition (declared in *Andrews* and recognised in *Paciocco*: Gageler J at [119]) that the doctrine in equity could in principle extend beyond its classical operation at common law of payment stipulations for a breach of contract, to include the ending of contracts without a breach (eg, by exercise of a right of early termination or surrender) and other events which were neither a breach of contract nor another event which it was the responsibility or obligation of the relevant party to avoid.

10. Extension beyond breach of contract had been considered, but not determined, in earlier High Court authority, mainly involving finance leases and similar types of finance contracts. There the Court had extended the doctrine beyond traditional "liquidated damages" provisions to more elaborate terms that set out in substance (irrespective of legal form) rights on specified breaches (such as recovery and re-sale of leased items, or payment of other monies). These rights were potentially different from what would be recovered at general law for some of the breaches specified: *O'Dea v Allstates Leasing System (WA) PL* (1983) 152 CLR 359 at 368, 373, 375, 395-396, 400; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, particularly per Mason and Wilson JJ at 185-186, 192 et seq, Deane J at 197 et seq, but cf Dawson J at 211, 213-216; *Ringrow PL v BP Australia PL* (2005) 224 CLR 656, [2005] HCA 71 at [12].

11. Some of these cases had recognised the operation of similar principles governing relief against forfeiture, elaborated in *Stern v McArthur* (1988) 165 CLR 489, and further expounded in *Tanwar Enterprises PL v Cauchi* (2003) 217 CLR 315, [2003] HCA 57. The doctrines are applied at different times: penalties by reference to circumstances at time of entry into the contract; relief against forfeiture after entry into the contract, for example, at a time of non-performance: see the discussion in the *Linfield Developments* case mentioned below at [325], [356]-[357].

12. The High Court in *Paciocco* agreed by a 4:1 majority (French CJ, Kiefel, Keane and Gageler JJ, Nettle J dissenting) with the Full Federal Court's analysis that Gordon J had conflated what was required to be taken into account in assessing what was a penalty with what could be recovered *if* the payment amount was found to be a penalty.

13. When assessing whether a payment was a penalty, the range of "legitimate interests" was taken into account. If the amount was found to be a penalty, the payee was restricted to its actual proved loss, which may be less.

14. The inference from the High Court's reasoning is that inability to prove actual loss, but ability to prove (by expert evidence or otherwise) the scope of financial, commercial or other legitimate interests affected by the manner of performance or non-performance of the other party, is a sound rationale for the fixing of a payment in those circumstances. Because the finance institution, for example, cannot prove its actual loss in these types of transaction it may have a legitimate interest, depending on the nature of the contract, to fix a uniform payment.

15. Keane J at [216], [223] referred to one legitimate interest. It might be impossible to demonstrate the actual operating cost increase from a customer's default. But the finance institution would have a legitimate interest in maintaining revenues "at the level of profitability required by [the institution's] shareholders". So cross-subsidisation within the overall fee structure to cushion against non-performance was not precluded. The court needed to consider the evidence (in this case expert) concerning, in this case, the costs of loss provisioning and regulatory capital requirements, even though these were part of normal operating costs: Kiefel J at [59], [65]-69], Gageler J at [172]-[173], Keane J at [279]. When that evidence was taken into account, it could not be concluded that the fees were "out of all proportion" to the bank's legitimate interests: Kiefel J at [57] and use of this phrase in passages from Gageler and Keane JJ cited above. The type of costs permitted to be considered included fixed, variable and incidental costs: Gageler J at [174].

16. The fact the bank had not attempted to calculate its actual loss was not fatal; but, if such a calculation was undertaken, it would tend to suggest the relevant payment term was not a penalty: see, eg, Keane J at [241]-[242], [245]. Policy factors, including the difficulty of determining what level of interest and charges would be "reasonable" and the values of commercial certainty and freedom of contract, mitigated against allowing too ready an intervention by courts: per Keane J at [214], [220], [250]-[252], [263]-[264].

17. The High Court upheld the lower Courts' findings that there was no statutory unconscionability under section 12CB of the *ASIC Act 2001 (Cth)* and its Victorian fair trading legislative equivalent. Keane J (with French CJ and Kiefel J agreeing and Gageler J writing a largely congruent opinion) at [213]-[215], [217]-[220], [286]-[291] held that "huge disproportion"

between actual costs and the fees and the disparity of bargaining power put forward as touchstones of unconscionability were economy-wide and did not of themselves render the fees unconscionable. The fees were materially the same as ANZ's competitors and there was no suggestion of market skewing or abuse, concealment or pressure or of any inability to understand or other vulnerability of the customer. There was no jurisdiction under these provisions to determine a "reasonable" fee.

18. The High Court did not need to address whether any of the fee-recovery claims were statute-barred, which raised questions (decided in favour of the claimant by Besanko J in the Full Federal Court) as to whether the extension of causes of action based upon mistake to the time when the mistake could with reasonable diligence have been discovered applied to mistakes of law. Nettle J at [374] endorsed Besanko J's reasoning.

<u>UK: *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Ltd v Beavis* [2015] UKSC 67</u>

19. In *Cavendish Square* and *Parking Eye* the majority of the UK Supreme Court at [40]-[43], [129]-[130], [239]-[241] criticised the extension declared in *Andrews* of the doctrine of penalties in equity beyond breach of contract, while recognising a substantially similar test to that in Australian law for assessing whether or not a payment was a penalty *including* "the legitimate interests" benchmark extending beyond provable loss. The two cases were at the opposite ends of the spectrum in terms of amount: favourable pre-emptive buyout provisions in an advertising agency sale transaction, compared with an exit fee in a parking station.

20. The Supreme Court, however, like the High Court in *Paciocco*, recognised that the actual decision in each case, in the way it came before the final appellate court, did not require the extension of the doctrine beyond breach of contract which had occurred in both cases: see remarks of French CJ in *Paciocco* at [5], [7] and references there given, and also Gageler J at [119]-[127] and Keane J at [253].

21. The Supreme Court also disagreed with the High Court that a penalty could be enforced to the extent of the actual loss of the party not in contractual breach. In this respect the High Court's decision was consistent in outcome with the line of reasoning of Deane J in *AMEV-UDC Finance Ltd v Austin* 162 CLR at 200 et seq in preference to the majority reasoning in that decision.

<u>Implications of the divergence</u>

22. In practical terms, the area of divergence may not be significant in many commercial contexts, where the fee or other payment or consequence will usually be triggered by a breach of contract.

23. However, finance contracts, such as leases or conditional sales, are likely to be a major area where the divergence will make a difference. In finance leases one often finds provisions requiring the payment of money for early surrender of leased equipment or to obtain cancellation or early payout of the lease, which may or may not be the same as provisions governing what happens if the lease is breached by, for example, non-payment of rent or other finance charges. Sometimes the provisions apply where there is a breach but one not serious enough under the general law to entitle the financier to treat the contract as repudiated or at an end, and the amounts to be paid under that provision exceed what would be payable as general law damages for the breach and may approach what would be payable as loss of bargain damages if the general law entitled the financier to treat the contract as repudiated or at an end.

24. The more significant practical differentiation between the UK and Australian outcomes may be in relation to recovery of the differential between the amount found to be a penalty and actual proved loss where it is difficult for the payee to discharge its (at least evidential) onus to prove actual loss or where actual loss that is provable in terms of recoverable damage (as opposed to damage that is not recognised at law, is not within contractual causation tests, or is too remote) is small compared to the range of interests taken into account in calculation of the impugned payment. On onus see Gageler J in *Paciocco* at [167] and McDougall J in *Arab Bank v Sayde*, below, at [111].

Area for case development

25. The area of exploration will be on the scope of "legitimate interests" and the nature and scope of evidence required. There is little definitive guidance in *Paciocco* as to content of the phrase and what comes within it. It seems that precision in identifying the costing of "legitimate interests" is not required. Rather, one must demonstrate a reasonably-based estimation that the payment obligation is not "out of all proportion" to the estimated cost to the identified "legitimate interests" of the primary obligation not being performed or the primary right (eg, to terminate early) being exercised. Often this will require expert evidence in addition to lay evidence about the nature of the business, the industry in which it sits and the costs and risk profiles.

Applications in appellate authority since *Paciocco*

26. The NZCA has endorsed the approach of the High Court, noting its similarity to that of the UKSC except on the scope of the doctrine beyond breach of contract, in *Wilaci PL v Torchlight Fund No 1 LP (in rec)* [2017] 3 NZLR 293, [2017] NSCA 152 at [79] et seq. The Court found that a late payment fee did not have a predominant purpose of punishing the defaulter. The Court emphasised at [93], [98] that legitimate interests of the lender will "reflect a raft of considerations", including the value of credit, the market in which it is provided, the nature of

risk to the lender (does it have a loan book across which to spread risk), the level of risk pre- and post-default, costs of recovery, opportunity costs, reputational costs.

27. In *Arab Bank Aust Ltd v Sayde Developments PL* [2016] NSWCA 328 the NSWCA held that a 2% default interest rate on late payment under a commercial loan facility was not a penalty. The Court, reversing the primary judge in the District Court, found that the distinction drawn by the primary judge necessarily involved assessment at and after time of default, which was not permissible: at [81]-[87]. Characterisation was by reference to the evidence rather than any "weak" presumption arising from the same charge for different events covered by the contract term: at [76], [100].

28. The evidence showed that the costs taken into account were real and foreseeable at time of entry into the facility and the stipulated rate could not be characterised as extravagant or unconscionable. The experts for each party identified relevant costs incurred by the bank as relating to capital adequacy, provisioning and reserves, and staff and general overheads. There was the economic reality of enhanced credit risk on default. See at [36], [88]-[95], [105]-[107].

29. Sackville AJA pointed at [8]-[9] however to the costs of expert evidence imposed by the penalty rule in its current application and pointed at [2]-[5] and [10] to the arguments canvassed in *Cavendish Square* for abolition of the doctrine.

30. A similar conclusion on default interest was reached by a differently-constituted NSWCA in *Wu v Ling* [2017] NSWCA 322 at [117]-[123].

31. In *Melbourne Linh Son Buddhist Society Inc v Gippsreal Ltd* [2017] VSCA 161 the Victorian Court of Appeal, applying *Paciocco*, by majority found that a fixed establishment fee for a loan facility was a penalty in circumstances where the loan did not proceed.

32. The majority (Kyrou JA, Cameron AJA) focused at [191] et seq on the fact that the fee did not reduce when the amount of the advance was reduced by two-thirds from the facility maximum, as could occur if, for instance, the valuation of the security property did not support a higher loan amount. There was no evidence that the fixed amount was commensurate with any legitimate commercial interest of the lender if the loan did not proceed. On the evidence, it appeared to be a punishment of the borrower for not proceeding. As a percentage of the advance the fixed amount was disproportionate. The risk of loan default was priced into the loan return, not this fee. The majority did not consider the characterisation of the same fixed amount if the loan did proceed. Maxwell P dissented at [3]-[15] on the ground there was insufficient opportunity, given the way the issue emerged, for evidence of legitimate interests beyond consequences of the breach to be placed before the court in order for alleged disproportionality properly to be determined.

33. *Australia Capital Financial Management PL v Linfield Developments PL* [2017] NSWCA 99, (2017) 18 BPR 36,683 involved a non-money obligation. In a contest where, by reason of other matters, a developer's call option was held entitled to be exercised over land free of a lender's right to register a mortgage when the borrower/purchaser went into administration (triggering the right to exercise the call option), the NSWCA held at [328] et seq and [358] et seq that the call option right was not a penalty, upholding the primary decision.

34. Here the call option right did meet the first step in the *Paciocco* test because it imposed an additional detriment on the purchaser on the failure of the primary contractual stipulation of what happened on the purchaser going into administration.

35. Going to the second step, the Court assumed that, where a non-monetary right was involved, it might be permissible to look in hindsight to the actual value of the land when the stipulation was intended to operate or, alternatively, to look prospectively at date of contract at what that value would likely be. The assumption did not need to be tested to conclusion, because on the value at date of exercise the exercise price did not satisfy the *Paciocco* test of extravagance in disproportion to value, so it could not be concluded that there was no protection of a legitimate interest of the developer who held the call option; a mere lack of proportion was not sufficient.

<u>The "take-away message"</u>

36. The recent case law has confirmed the need for care in drafting clauses which confer, in substance despite their form of words, a financial or a non-financial advantage on a financier if there is a breach of a financing contract or if there is a procedure for ending the finance contract early (or similar non-breach situations).

37. In summary, take care that the financier client knows what legitimate organisational and commercial interests it is seeking to advance or protect by the clause and has the evidence (which may include expert opinion) about that matter to justify the clause. Such evidence may include knowing the industry and market context and constraints and monitoring them, so that the clause may change for new or renewed finance facilities if circumstances require.

38. This becomes even more important if the impact from the particular circumstance being protected against has small financial impact from the particular transaction; that is, actual provable loss or impact from the particular instance is small, but the impact on the business's interests is significant and needs protection.

39. Direct proportionality does not need to be demonstrated with precision; but there must be enough evidence to show that there is not significant disproportion between the benefit from enforcement of the clause to the financier and the interests which such benefit is intended to protect or compensate.

BIOGRAPHY

Gregory Burton SC

Barrister, 5 Wentworth Chambers, Sydney

Gregory Burton SC practises primarily in commercial/equity matters, at trial and appellate levels, from 5 Wentworth Chambers, with a focus on corporations, finance and securities, insolvency, insurance, trusts and property. He took silk in 2004. He is also a long-standing mediator and arbitrator, expert determiner, domain name dispute determiner for auDA, and has authored and edited books, articles and commentary, and spoken, on aspects of commercial law/equity, public law and ADR. He is Procurator (church counsel) for the Presbyterian Church of Australia, federally and in some States, and chairs, or has chaired or been involved with, Dispute Panels for various organisations. He is a recently-appointed part-time Senior Member in NCAT's Commercial and Consumer Division and also sits in NCAT's Appeal Panel.

Andrew Smorchevsky

Barrister, 5 Wentworth Chambers, Sydney

Prior to coming to the bar in 2017, Andrew was a solicitor at Whittens & McKeough where he worked on Supreme Court and Federal Court matters involving commercial contractual disputes, shareholder oppression, securities class action litigation, consumer law penalty proceedings, and interlocutory and final injunctive relief, as well as other matters involving corporate law, equity and trusts, insolvency, insurance and employment law. Andrew was the tipstaff to Justice White of the Supreme Court of New South Wales in 2015.

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