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The penalty doctrine: *Andrews v Australia and New Zealand Banking Group Ltd*

Introduction

On 5 December 2011, Justice Gordon of the Federal Court of Australia delivered an important judgment dealing with the penalty doctrine: *Andrews v Australia and New Zealand Banking Group Ltd* [2011] FCA 1376. The case is a representative action brought by three applicants on behalf of a much larger group of ANZ Bank customers.

By way of indication of the importance of the case, the High Court of Australia on 11 May 2012 took the rarely-performed step of allowing the appeal (and cross-appeal) on the core issues in Gordon J's judgment to bypass the Full Court of the Federal Court of Australia and proceed directly into Australia's final court of appeal, the High Court. As expressed in the Court's orders, these issues are 'the scope of the equitable jurisdiction to relieve against penalties and the question of whether a person can only be relieved against a penalty if it becomes payable for breach of contract.'

The case deals with the enforceability of a variety of fees charged by the ANZ Bank ('ANZ'). The decision has wider implications for similar fees charged by other banks and financial institutions. Given that the Australian law relating to penalties shares its heritage with the law applying in other common law jurisdictions, the case will be of interest to lawyers who practise in the building, construction and engineering sector around the world. In this sector, liquidated damages provisions are the norm in both the standard form contracts and bespoke contracts and arguments regarding penalties often arise in defence to a principal seeking to levy liquidated damages.

The applicants in *Andrews v ANZ* claim that a variety of fees imposed by ANZ under the terms of certain of its banking products constitute penalties and are therefore void or unenforceable. They have also sought repayment of all or part of the fees paid.

Her Honour found that four out of 17 types of fees charged by ANZ to its customers are capable of being characterised as penalties, with the consequence that they might not be enforceable. The Court also found that various other types of fees – honour fees, dishonour fees, 'over-limit' fees and non-payment fees – are not capable of being characterised as penalties. In doing so, Gordon J said (at [4]):

> 'The law of penalties is a narrow exception to the general rule that the law seeks to preserve freedom of contract, allowing parties the widest freedom, consistent with other policy considerations, to agree upon the terms of their contract. Equity, however, continues to play a role in the law of penalties, a law which is confined to payments for breach of contract.'

What was Gordon J asked to decide?

Her Honour determined specific separate questions concerning whether each of the 17 identified fees charged by ANZ was capable of being characterised as a penalty. Broadly speaking, the separate questions were:

(a) Was the fee payable upon breach of any or all of the agreements between the applicants and ANZ?

(b) In the alternative:
- was the occurrence or default of occurrence of the events set out in the provisions, as a matter of substance, treated by ANZ and the applicant who incurred the fee, as lying within the area of obligation of that applicant in the sense that it was the applicant's responsibility to see that the event did or did not occur; and
- was that applicant obliged contractually to pay or forfeit or suffer the retention of the fee upon or in default of the occurrence of the event?

(c) If the answer to either (a) or (b) above was yes, was the fee capable of being characterised as a penalty by reason of that fact?

The 17 fees were divided by the parties into four broad categories:

- *Saving exception fees* – dishonour, honour and non-payment fees in relation to retail or personal overdraft and savings accounts;
- *Card exception fees* – over-limit fees and late-payment fees in relation to credit cards;
- *Commercial card exception fees* – commercial card over-limit fees and commercial card late-payment fees incurred on business credit cards; and
- *Business exception fees* – honour fees, dishonour fees and non-payment fees incurred in relation to business savings and overdraft accounts.

Her Honour confirmed the Australian position that, in order for a fee to be a penalty, it must be payable upon a breach of contract (at [58]–[59] and [78]–[79]):

> 'Put another way, the law of penalties requires the Court to determine whether the payment for non observance of the contract is payable *in terrorem*. That is, as a punishment to deter breach of the contractual obligation...
>
> As ANZ submitted, there is extensive and long standing authority in Australia and the United Kingdom that the law of penalties has no application to a contractual provision requiring a payment for the happening of an event that does not constitute a breach of contract...
>
> The law of penalties, confined (as it is) to payments for breach of contract, is a narrow exception to the general rule whereby the law seeks to preserve freedom of contract, allowing the parties the widest freedom, consistent with other policy considerations, to agree upon the terms of their contract...
>
> Courts have consistently rejected a jurisdiction in equity to interfere with contractual freedom on the generalized ground that the provision in question is harsh or constitutes a hard bargain... Instead, courts have developed equitable and common law principles in particular, well recognised, circumstances to prevent contracts being used as a means of taking unfair advantage of persons in positions of vulnerability, particularly the principles relating to unconscionable conduct, undue influence and duress...'

Her Honour acknowledged that the law of penalties in Australia is governed by the decision of the High Court of Australia in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 ('*Ringrow*') which in turn confirmed that the test and guidelines set down by Lord Dunedin in the House of Lords decision in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 ('*Dunlop*') continued to represent the law applicable in Australia.

The rule against penalties: a narrow exception

Her Honour considered the following questions:

- Can contracting parties agree in advance what amounts will be payable if one party acts in a way the contract does not intend?
- If so, are there any limits on their ability to do so?
- And do those limits only apply to payment obligations triggered by a breach of the contract?

The law relating to penalties supplies an answer to these questions.

In a lengthy judgment on the preliminary question of the characterisation of the fees in issue, Justice Gordon undertook a detailed survey of the history of the common law rule against penalties commencing from the beginning of the 14th century, continuing through the late 16th and early 17th centuries, before dealing with developments from the end of the 17th century to the 18th century including consideration of the Statutes of William lll (1697) and Anne (1705) which were practical and procedural in that they streamlined relief against penalties. These provisions form part of the law of Victoria via the Instruments Act 1958. She concluded her historical review with a consideration of developments in the 19th century in England and Australia.

The Judge affirmed that the rule against penalties is a narrow exception to the general principle of freedom of contract pursuant to which parties may shape their contractual relationship – and allocate risk and reward – as they see fit. She rejected attempts to significantly expand the scope of the common law rule.

The modern principle recognised by *Dunlop* and *Ringrow* is that a contractual provision requiring the payment of a stipulated sum on breach of the contract will be unenforceable if it is a penalty. A liquidated damages clause will generally be a penalty if a party can demonstrate that the clause imposes a burden on the breaching party which is inconsistent with a genuine pre-estimate, made at the time the parties

contracted, of the loss that would result from a breach of the relevant obligation. The law allows the contract to compensate fairly for breach by 'codifying' a damages regime. Generally, it does not allow the contract to punish breaches or permit the innocent party to profit from them.

Having said that, how does the law treat a clause which imposes an obligation to pay an amount when a party engages in conduct which the contract does not prohibit but seeks to discourage so as to protect or advance the interests of the other party? This was a key issue in the ANZ proceeding.

Some of the contract terms attacked in the proceeding imposed an obligation on a customer to pay money to ANZ on the occurrence of a certain event, such as overdrawing an account beyond a previously approved limit. On their face, such provisions did not appear to provide for payment to be made on breach and so the bank argued that they were not capable of amounting to a penalty, whether or not the amount payable comprised a genuine pre-estimate of loss.

However, the Court was asked by the applicants to find that an obligation to pay money may be characterised as a penalty if the obligation to pay arises on the occurrence of an event that is not in itself a breach. After a careful analysis of the historical position as well as precedent, her Honour held that it cannot.

Her Honour considered the decision of the High Court of Australia in *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, where only one judge, Deane J (in dissent), considered that the rule against penalties could extend beyond payments triggered by breach of contract and where the majority held that a provision requiring payment on the occurrence of a specified event (but not upon breach) cannot be a penalty.

Some contracts oblige a party to make a payment if the other party chooses to terminate the contract upon the occurrence of an event of default. The event of default may or may not comprise a breach of the contract. Does the law of penalties apply to such contracts? In *Andrews v ANZ*, the Judge considered the earlier decision of *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406 where, at first instance, Brereton J of the New South Wales Supreme Court held that the law of penalties is not confined to circumstances where the event of default relied on comprises a breach, but that it extends to cases where a contract is terminated on the occurrence of an event of default, which falls short of breach.

Gordon J rejected this analysis, which had in any event been overturned by the New South Wales Court of Appeal (see [2008] NSWCA 310; the High Court granted special leave to appeal but the matter was settled before the appeal hearing commenced). She confirmed the orthodox view that the law of penalties is of a narrow compass and is concerned with the consequences of contractual breaches.

Gordon J then applied that rationale to the regulatory framework within which the modern contract between banker and customer operates. Her Honour analysed the legislative and regulatory framework within which banks operate and provide credit as well as the terms and conditions, both express and implied, that formed the relevant contracts between each applicant and ANZ.

Her Honour determined that, in the modern context, when a customer seeks a withdrawal or payment from their account by giving an instruction to ANZ that has the effect of overdrawing the customer's account, it is construed as a request by the customer for an advance or loan from the bank, and the bank has a discretion to approve or disapprove that transaction. Pursuant to the terms between the customer and ANZ, ANZ was entitled to charge a fee immediately upon determining to honour the transaction thereby temporarily increasing the overdraft limit.

A question of construction

Whether a particular provision amounts to a penalty is ultimately to be determined by the words of the contract and the rules of contractual construction. Is the obligation triggered by breach of some obligation imposed by the contract?

In *Andrews v ANZ*, one type of fee – which a customer had to pay if they made a withdrawal or payment from their ANZ account with the effect of overdrawing the account beyond an approved limit – was held *not* to be a penalty. This was because, properly construed, the contract did not prohibit such an overdrawing. It merely provided that the bank had no obligation to permit it. Thus the fee in question was not triggered by breach but instead by the bank's election to permit the overdrawing. An argument that the fee should be regarded as a penalty as it formed part of a

contractual mechanism to discourage certain conduct by customers was rejected.

Another type of fee, a late-payment fee, was expressed to be chargeable if certain amounts on a credit card statement were not paid within a set period of time. In this case, Her Honour held that the late-payment fee was payable as a direct result of an account holder's breach. As a matter of construction of the contract, it obliged the customer to pay on time and the fee was payable if that obligation was breached.

On the other hand, Her Honour found that fees imposed as a result of and as a consequence of late payment of amounts due in relation to credit cards were imposed by ANZ as a result of the customer's breach of the relevant provisions. When a fee is imposed upon a customer in circumstances where the customer has breached the contract by failing to take a required step, in this instance making a payment within a defined period, it is capable of being characterised as a penalty.

Her Honour noted that it was yet to be determined whether the fee is a penalty. That was to be determined at a later hearing yet to be arranged. To be a penalty, the fee must be found to be extravagant and unreasonable and out of all proportion to the likely damage suffered by ANZ (*Ringrow*).

Conclusion

As was noted above, Gordon J's decision has been appealed by the applicants to the High Court of Australia.

Subject to the outcome of this appeal, *Andrews v ANZ* clarifies the law regarding penalties and rejects attempts to increase the reach of the principle beyond the realm of contractual breach. It endorses an approach to contract drafting which seeks to avoid the imposition of payment on other obligations directly by reference to one party's breach.

It will, in due course, fall to be decided whether the particular fees, which Gordon J found were capable of constituting penalties as they were triggered by breach, are in fact to be so characterised having regard to the burden they imposed on customers compared with the loss incurred by the bank due to the breach.

Interestingly, the judgment records that ANZ had conceded that the fees in question were not a genuine pre-estimate of loss. This concession is apparently to the effect that the parties to the particular customer contract did not actually turn their mind, at the time the contract was formed, to the loss that might be suffered by the bank if that customer failed to comply with the relevant obligations. There was no actual attempt to pre-estimate loss in respect of the specific contract. In the context of a mass market retail product of this sort, this is not a surprising concession on the part of ANZ. It would usually be impractical to undertake such an exercise.

It remains to be determined whether the relevant bank fees may be justified by demonstrating that:

- such a pre-contractual assessment was undertaken by the bank on a 'global' basis across all existing and potential customers; and
- looked at objectively, and irrespective of whether any pre-contractual assessment was in fact conducted for a particular contract or even the class of contract, the fees are not disproportionate to the costs or other losses likely to be incurred by the bank, either with respect to the particular customer or across a whole population of customers.

These important legal and factual issues – which have significant practical implications – are yet to be resolved. The outcome of the High Court's deliberations on these matters will therefore be of great interest to construction lawyers in Australia and around the world.

Notes

1 The transcript of the High Court proceedings in the application for removal, [2012] HCATrans 104, is available via: **www.austlii.edu.au**.

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