Breach no longer necessary: The High Court's reconsideration of the penalty doctrine

Richard Manly SC*

In 1915 the House of Lords delivered reasons for judgment in Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd in which it set out the applicable test and guidelines to determine whether a stipulated sum payable on breach of a contract was to be treated as liquidated damages and enforceable, or a penalty and hence unenforceable. That test was universally applied throughout the common law world. The High Court of Australia's decision in 2012 in Andrews v Australia and New Zealand Banking Group has recast the test. This article reviews the first instance decision of Gordon J from the Federal Court of Australia together with the High Court decision and concludes that the latter is unsatisfactory, as it will be difficult to apply to a wide variety of commercial transactions and thereby lead to uncertainty and confusion in an area of contract law that had been trouble free for nearly a century.

INTRODUCTION

In Australia and throughout the common law world the principles and guidelines "governing the identification, proof and consequences of penalties in contractual stipulations"[1] have been settled for nearly 100 years.

In 2011 Gordon J, sitting in the Federal Court of Australia,[2] determined preliminary questions[3] in a complex proceeding where bank customers sued the Australia and New Zealand Banking Group Ltd (ANZ) seeking orders setting aside a variety of fees charged by that bank on the ground that those fees were penalties. Her Honour found that 13 of the 17 fees in question could not be characterised as penalties because the customers were liable to pay those fees irrespective of any breach by them of the bank's terms and conditions. This finding was consistent with the orthodox common law test for penalties established in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79, and followed the New South Wales Court of Appeal decision in *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2008) 257 ALR 292[4] which had confirmed that a breach of contract was a necessary ingredient to enliven the penalty doctrine.

In its reasons for judgment, on the recent appeal from the decision of Gordon J, the High Court of Australia[5] has reshaped the accepted common law penalty rule for Australian conditions and declared

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[1] *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] 224 CLR 656 [12].

[2] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 533; 86 ACSR 292; (2012) 288 ALR 611. See also Baker G and Sheldon M, "A Timely Look at the Law of Penalties" (2012) 23 (2) JBFLP 141. A similar claim has unsuccessfully been litigated in England throughout 2008-2010. See *Office of Fair Trading v Abbey National Plc* [2008] EWHC 875 (Comm) (Andrew Smith J); [2009] EWCA 116 (CA); [2009] UKSC 6 (SC).

[3] The power of the Federal Court to make an order for the determination of separate questions is provided in *Federal Court Rules 2011*, r 30.01(1).

[4] This decision is in accord with the position in the United Kingdom: see *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399; [1983] 2 All ER 205.

[5] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002; (2012) 290 ALR 595. The *Andrews* decision has been cited in – *Kellas-Sharpe v PSAL* [2011] QCA 371; on appeal at [2012] QCA 37. Special leave to appeal to the High Court of Australia was refused on 6 June 2013, see [2013] HCA Trans 133; *Complete Business Strategies Pty*

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that one important aspect of the *Dunlop* test no longer applies, namely the necessity to establish a breach of contract before the penalty doctrine can be invoked.

In *Andrews*, the High Court summarised the "settled aspects of the penalty doctrine"[6] and stressed that in order to decide if a contractual stipulation operates as a penalty, it is essential to consider the substance of the clause rather than its form. That exercise requires construing the agreement as a whole,[7] which requires the legal form of the contractual arrangement to be ignored and its actual substance considered.

The removal of the requirement that there be a breach of contract before the penalty doctrine can be engaged is a major development in the common law of Australia regarding contractual stipulations for agreed sums, more commonly known as liquidated damages clauses.

According to recent Australian commentary[8] the *Andrews* decision could have wide ranging ramifications for commercial transactions including the drafting of commercial contracts. In particular, commercial arrangements in the financial services sector, the equipment finance industry, take-or-pay clauses in long term energy and resources contracts,[9] as well as information technology, mining and services contracts. In the building and engineering sector, in particular, liquidated damages clauses are the norm in both standard form and bespoke contracts. Arguments regarding penalties are often raised by contractors who seek to defend themselves against the levying of liquidated damages for delayed completion of a project.[10]

Ltd v AFA Wealth Pty Ltd [2013] QSC 43; *Zomojo Pty Ltd v Hurd (No 2)* [2012] FCA 1458; *Sun North Investments v Dale* [2013] QSC 44; *Love v Brien* [2012] WASC 457; *Casama Group Pty Ltd v Four Sisters Pty Ltd* [2012] VSC 376; *Cedar Meats Pty Ltd v Five Star Lamb Pty Ltd* [2013] VSC 164.

[6] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [8].

[7] *O'Dea v All States Leasing System (WA) Pty Ltd* (1983) 152 CLR 359 at 368, 375 and 399.

[8] The commentaries include Mills K, Morris A and O'Brien T, *Andrews v ANZ – the High Court and the Doctrine of Penalties* (King & Wood Mallesons, 6 September 2012) available at http://www.mallesons.com/publications/marketAlerts/2012/Pages/Andrews-v-ANZ-the-High-Court-and-the-doctrine-of-Penalties.aspx. Harding-Farrenberg R and Sheldon M, *Andrews v ANZ: Do All Contracts Need to be Rethought?* (Corrs Chambers Westgarth Lawyers, 13 September 2012) http://www.corrs.com.au/thinking/insights/andrews-v-anz-do-all-contracts-need-to-be-rethought/. Hanson C and Anderson K, *High Court Widens Scope of Penalty Doctrine* (Freehills, 10 September 2012) http://www.herbertsmithfreehills.com/-/media/Freehills/A-100912.PDF; Klimt S and Smythe N, "When is a Penalty Clause not a Penalty Clause?" (2012) Issue 146 *Australian Construction Law Newsletter* 51; Davenport P, "Andrews v ANZ and Penalty Clauses" (2012) Issue 147 *Australian Construction Law Newsletter* 32; Davenport P and Durham H, *Construction Claims* (3rd ed, The Federation Press, New South Wales, 2013) pp 314-325; Mason A, "Liquidated Damages and Penalties in Construction Contracts" (2012) Issue 146 *Australian Construction Law Newsletter* 6; Duggan G, "Penalty Doctrine Revisited" (2013) 87 ALJ 27; Ottaway A, "Relief against Penalties" (2013) (March) *Law Society Journal* 55; Chew A, Starkoff D and Sheldon M "The Effect of Andrews v ANZ: Going Beyond Bank Fees – It's about Performance Too!" (2013) 30 *International Construction Law Review* 187; Bond J, "Contrary to What You might have Heard, a Properly Drafted Contractual Timebar will not Attract the Penalty Doctrine" (2013) 32 *The Arbitrator and Mediator* 69; Mason B, "Revitalising a Withered Vine: Equity's Penalty Doctrine" (2013) LMCLQ 233; Dharmananda K and Firios L, "Penalties Arising without Breach: The Australian Apogee of Orthodoxy" (2013) LMCLQ 145; Easton P, "Penalties Percolating through the Construction Industry: Andrews v Australia and New Zealand Banking Group Ltd" (2013) 29 BCL 233; Goldberger J, "Australian Contract Law: A Case Law Update" (2013 26 *Commercial Law Quarterly* 8 at 23-29; Harder S, "The Relevance of Breach to the Applicability of the Rule Against Penalties" (2013) 30 JCL 52. Baker and Sheldon, n 2; Barnett K, "Bank Fees May Be Illegal Penalties" (2012) 37 *Alternative Law Journal* 283; Prince T, "The Doctrine of Penalties" (2012-2013) *Bar News (NSW)* 21; Peel E, "The Rule Against Penalties" (2013) LQR 15; Carter J, Courtney W, Peden E, Stewart S and Tolhurst GJ, "Contractual Penalties: Resurrecting the Equitable Jurisdiction" (2013) 30 JCL 99; Robinson L, "Fees? Not So Simple: Andrews v ANZ" (2012) 16 UWSLR 161; Gray A, "Contractual Penalties in Australian Law After Andrews: An Opportunity Missed" (2013) 18 *Deakin Law Review* 1; Taylor B, "The High Court's Expansion of the Doctrine of Penalties in Andrews v ANZ Banking Group" (2013) 28 *Australian Banking and Finance Law Bulletin* 106.

[9] A "take or pay" clause in a contract obliges a buyer to order a minimum quantity of goods from the seller each month irrespective of whether the buyer needs the goods. If the buyer fails to order the minimum quantity, the buyer must pay for that minimum quantity: see *M&J Polymers v Imerys Minerals* [2008] EWHC 344 (Comm); *E-Nik Ltd v Department for Communities and Local Government* [2012] EWHC 3027 (Comm); *Cedar Meats Pty Ltd v Five Star Lamb Pty Ltd* [2013] VSC 164.

[10] See eg, *State of Tasmania v Leighton Contractors Pty Ltd* (2006) 15 TasR 243; ter Haar R and ter Haar C, *Remedies in Construction Law* (Informa Law, London, 2010) p 185 for instances in United Kingdom cases where liquidated damages clauses have been held to be a penalty and thereby unenforceable. *Bramall and Ogden Ltd v Sheffield City Council* (1983) 29 BLR 72;

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This article argues that the removal of the breach requirement from the penalty doctrine will give rise to an increase in challenges to contractual stipulations.[11] This leads to uncertainty, confusion and increased costs to the contracting parties. It also impacts on the risk sharing obligations negotiated and agreed by the participants in the contract. However, as the penalty doctrine requires that for a stipulated sum to be penal it must be "extravagant and unconscionable" in amount,[12] it is questionable that there will be an increase in the incidence of stipulated sum clauses being found to be penal. This aspect of the penalty doctrine remains and will always have to be applied to the contractual stipulation (save where the sum is payable for an additional service) to determine if it is penal in character. In that circumstance, it is submitted, the removal of the breach requirement will otherwise have little effect on the outcome of an application of the reformulated *Dunlop* test as determined by the High Court in *Andrews*.

Part one of this article sets out the *Dunlop* test and discusses its long held acceptance across numerous common law jurisdictions, including within Australia prior to the *Andrews* decision.

Part two considers the scope of the Federal Court decision in *Andrews v Australia and New Zealand Banking Group Ltd*. It will also explore Gordon J's treatment of the common law test that bound her (as a single judge), that the rule against penalties is a narrow exception to the freedom of contract principle; the legal framework applicable to the banker-customer relationship that governed the parties, as well as the ultimate question of construction of the agreement between banker and customer that had to be undertaken.

Part three will analyse the landmark decision of the High Court in *Andrews*. This part will consider the historical development of the penalty rule, the scope of the High Court decision and its approval of the first instance decision of Brereton J in *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406. The High Court in *Andrews* provided two examples from the cases, one old and the other more recent, by way of explanation of the application of the reformulated penalty test to situations involving alternative stipulations and in particular the task of characterisation of the stipulated sum clause in question. These two cases are reviewed together with some other old cases and a fairly recent New South Wales Court of Appeal decision to assess the application of the reformulated penalty rule.

Part four discusses the impact the reformulated penalty rule is likely to have in Australian practice. This part also seeks to apply the High Court decision in *Andrews* to the facts of a recent Victorian Court of Appeal decision and an English Commercial Court decision to determine if the outcomes in those cases would be different.

Part five discusses some problems that arise from the approach adopted by the High Court with reference to that court's nomination of the little known 1966 New South Wales Court of Appeal decision in *Metro-Goldwyn-Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717, (1966) 85 WN (Pt 1) (NSW) 468 as being an example of the operation of the reformulated penalty rule in circumstances where, properly construed, the relevant contract made provision for an alternative stipulation. This part also considers the consequences that flow to commercial transactions in practice following the *Andrews* decision. Finally, this part concludes with commentary on what issues remain for Gordon J to decide to finalise the proceeding in the Federal Court.

Stanor Electric v R Mansell (1988) CILL 399 and *Braes of Doune Windfarm (Scotland) Ltd v Alfred McAlpine Business Services Ltd* [2008] BLR 321. See also the cases referred to in Manly R, "The Benefits of Clauses that Liquidated, Stipulate, Pre Estimate or Agree Damages" (2012) 28 BCL 246 at 262 fn 81; Davenport, n 8; Mason A, n 8.

[11] The risk, that every price payable under a contract could be the subject of judicial control, was foreshadowed in 1975 by the English Law Commission when it reported on penalty clauses. The Law Commission: *Penalty Clauses and Forfeiture of Monies Paid* (Working Paper No 61, London, 1975) p 16.

[12] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 87.

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THE DUNLOP TEST

The starting point for any discussion of the penalty rule must be Lord Dunedin's statement of the principles and guidelines from the *Dunlop* decision.[13] The four rules which constitute the *Dunlop* test are:

1) Though the words "penalty" or "liquidated damages" used in contract may prima facie be supposed to mean what they say, the expression used is not conclusive. The court must find out whether the payment stipulated is in truth a penalty or LDs.
2) The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of LDs is a genuine covenanted pre estimate of damage.
3) The question whether a sum stipulated is penalty or LDs is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of **the breach**.
4) To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:
   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**.
   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.
   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.

   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 probably that pre estimated damage was the true bargain between the parties.

A breach of contract is a necessary requirement of rules 3, 4(a), 4(b) and 4(d) of the *Dunlop* test. This requirement can therefore be considered a fundamental part of the long held penalty test.

The long held Common Law position

The test and guidelines promulgated in *Dunlop* have long provided the foundation for the law of penalties adopted and applied throughout the common law world: England,[14] Australia,[15] Canada,[16] Hong Kong,[17] New Zealand,[18] Northern Ireland,[19] Ireland,[20] and Singapore.[21] It has also been applied

[13] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 86-88.

[14] *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] BLR 271.

[15] *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656.

[16] *Gunning v Thorne Riddell* [1990] BCJ No 36; *Pattison v Mundry* [1999] OJ No 65; *Domain Forest Products Ltd v GMAC Commercial Credit Corp* (2007) 29 BLR (4th) 1; see also *Andrews v Australia and New Zealand Banking Group Ltd* [2011] 86 ACSR 292; (2012) 288 ALR 611 [60].

[17] *Philips Hong Kong v Attorney General of Hong Kong* (1993) 61 BLR 41; [1993] 1 HKLR 269; *Re Mandarin Container* [2004] 3 HKLRD 554 at 549; see also *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [60].

[18] *Camatos Holdings Ltd v Neil Civil Engineering (1992) Ltd* [1998] 3 NZLR 596 at 606-607; see also *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [60].

[19] *Fernhill Properties Northern Ireland Ltd v Paul Mulgrew* [2010] NICh 20; *Lombank Ltd v Kennedy* [1961] NI 192 [215].

[20] *O'Donnell v Truck and Machinery Sales Ltd* (1998) 4 IR 191.

[21] *CLASS Medical Centre Pte Ltd v Ng Boon Ching* (2010) 2 SLR 386; *Edward Jason Glenn v Australia and New Zealand Banking Group* [2012] SGHC 61.

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in Scotland where the legal system operates as a mixture of civil law and common law elements.[22] In the United States penalty clauses are treated slightly differently by the various States. Under the *Uniform Commercial Code*[23] and the *Restatement 2d Contract*[24] a breach of contract is a prerequisite to engagement of the penalty doctrine.

Ringrow foreshadowed reconsideration of the Dunlop test

In the Australian context, the High Court made it clear in 2005 in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 that:

> The law of penalties, in its standard application, is attracted where a contract stipulates that on breach the contract-breaker will pay an agreed sum which exceeds what can be regarded as a genuine pre estimate of the damage likely to be caused by the breach.[25]

However, while neither party in *Ringrow* put the validity of the *Dunlop* test in doubt, the High Court foreshadowed that an occasion for reconsideration or reformation may arise at a later date.[26]

This foreshadowed reconsideration and reformation occurred in 2012 with the *Andrews* decision where the High Court[27] unanimously decided that there was no historical jurisprudential basis for limiting the application of the penalty test to stipulated sums payable upon a breach of contract. It based its decision on what it described as "the operative distinction" between an obligation to pay a sum of money as security for the performance of a contractual obligation and an obligation to pay a sum of money for the enjoyment of an additional right or service. The doctrine of penalties applies to the former obligation but not the latter obligation.[28] The court also made it clear that the penalty rule is a rule of equity and not a rule of law.

THE PROCEEDING IN ANDREWS

The proceeding in *Andrews* is a representative action brought in the Federal Court of Australia pursuant to Pt lVA of the *Federal Court of Australia Act 1976* (Cth) by three applicants on behalf of 38,000 group member customers against the ANZ.

The applicants in *Andrews* claim that the 17 types of fee charged by the ANZ under the terms of its agreements regarding credit card accounts, deposit accounts, commercial credit card accounts and business accounts each constitute a penalty and are therefore unenforceable. They have also sought repayment of all or part of the fees paid to the ANZ. The potential damages claim is in excess of $200 million, and the significance of the decision is heightened by the fact that there are six proceedings pending in the Federal Court against other banks which raise the same issues as the *Andrews* litigation.[29]

In the presentation of the case, the 17 types of fees charged by ANZ were divided into four broad categories and identified as "exception fees":[30]

1. **Saving exception fees** – dishonour, honour and non-payment fees charged in relation to Access Advantage accounts and Access Advantage cheque accounts;

[22] *Eurocopy Rentals Ltd v Tayside Health Board* (1996) SLT 224; *Granor Finance Ltd v Liquidator of Eastore Ltd* (1974) SLT 296; *United Dominions Trust (Commercial Ltd v Bowden* (1958) (Sh Ct) 10; *United Dominions Trust (Commercial) Ltd v Murray* (1966) SLT (Sh Ct) 21.

[23] Article 2, Pt 7, subsection 718.

[24] Section 356.

[25] *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 [10], see the discussion in *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [52]-[58].

[26] *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 [12].

[27] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [49, 78].

[28] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [10-15], [79-80]. See also Mason A, n 8 at 12.

[29] See *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [3].

[30] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53 at 142; 86 ACSR 292 at 377; (2012) 288 ALR 611 at 696; Sch B lists all of the "exception fees".

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2. **Card exception fees** – over limit and late payment fees charged in relation to credit card accounts;
3. **Commercial card exception fees** – commercial card over limit and late payment fees charged in relation to business credit card accounts; and
4. **Business exception fees** – honour, dishonour and non-payment fees charged in relation to business savings and overdraft accounts.

What was Gordon J asked to decide?

Gordon J conducted a trial limited to determining separate preliminary questions[31] concerning whether each of the 17 types of exception fees was capable of being characterised as a penalty.

Gordon J found that four "late payment fees" out of the 17 types of exception fees were capable of being characterised as penalties because they were payable as a consequence of a breach by the customer of the terms of their agreement with the ANZ.[32]

Her Honour also found that the remaining 13 other types of exception fees, namely the honour fees,[33] dishonour fees,[34] "overlimit" fees[35] and non-payment fees[36] – were not capable of being characterised as penalties ("the non breach fees"). In doing so, Gordon J said:

> 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.[37]

Gordon J found that the "non breach fees" were charged by the ANZ irrespective of any breach of contract by the applicants. Also, that the occurrence of the event(s) upon which the "non breach fees" were charged (ie overdrawing the account or credit limit or attempting to do so) was not an event(s) which the applicants had an obligation or responsibility to avoid under their contracts with the ANZ.[38] Gordon J held that, in the circumstances, it was not necessary to answer the question whether the "non breach fees" were a penalty at common law on the basis that they were extravagant or unconscionable having regard to the greatest possible loss that could have been suffered by the ANZ.

The ultimate decision in the proceeding may well have wide implications for similar fees charged by other banks and financial institutions as well as for a broad range of commercial transactions in general within the Australian commercial community. The outcome of the *Andrews* litigation will be closely monitored in New Zealand where an *Andrews* based claim was issued against the ANZ on 25 June 2013. It is contemplated that other banks will shortly be served with court proceedings.[39]

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[31] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53 at 140; 86 ACSR 292 at 375; (2012) 288 ALR 611 at 694, Sch A lists the four separate questions.

[32] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [5], [243], [247], [252], [259], [267], [268], [312].

[33] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [5], [169], [181], [183], [185], [187], [193], [324], [336], [348].

[34] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [5], [205], [208], [209], [221], [222], [328], [353].

[35] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [5], [280], [281], [291]-[293], [307], [308].

[36] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [5], [214], [215], [331].

[37] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [4].

[38] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292 [205]-[208]; and see *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [22].

[39] Litigation Lending Services, *Fair Play on Fees* (25 June 2013) http://www.litigationlending.com.au/public/download/2562013.Fair.Play.on.Fees.lodges.Court.Documents.The.Battle.Begins.pdf.

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The test applied by Gordon J

Gordon J acknowledged that the law of penalties in Australia is governed by the decision of the High Court in *Ringrow*[40] which in turn had confirmed that the test and guidelines set down by Lord Dunedin in *Dunlop*[41] "continue to express the law applicable in this country."[42]

Accordingly, Gordon J adopted the position that, for any of the 17 exception fees to be characterised as a penalty, it must be payable upon the event of a breach of contract by the customer.

The rule against penalties: A narrow exception

In addressing the separate question of the characterisation of the 17 types of exception fees in issue, Gordon J undertook a detailed analysis of the history of the common law penalties doctrine commencing from the beginning of the 14th century, continuing through the late 16th and early 17th centuries; then dealing with developments from the end of the 17th century to the 18th century including consideration of the Statute of William lll (1696)[43] and the Statute of Anne (1705)[44] which were practical and procedural in effect rather than technical. Those statutes had the effect of streamlining the relief that was available against the imposition of penalties.[45] The provisions of these ancient statutes are not mere historical curiosities. They form part of the present law of Victoria.[46] Gordon J concluded her historical review with a consideration of common law developments in the 19th century in England and Australia.

Her Honour affirmed that the penalties doctrine is a narrow exception to the general principle of freedom of contract by which parties are free to shape their contractual relationship – and thereby allocate risk and reward – as they see fit.[47] However, the applicants submitted that Gordon J should follow the reasoning of Brereton J in the *Integral* case and find that the obligation on customers to pay the fees to the ANZ may be characterised as a penalty if that obligation arose on the occurrence of an event that was not itself a breach of contract. After a careful analysis of the historical position Gordon J held that such a payment, absent a breach of contract by the customer, could not amount to a penalty. Her Honour rejected the applicants' attempts to significantly expand the scope of the penalties doctrine and considered herself bound[48] by the decision in *Interstar* which had affirmed that breach of contract was a necessary element of the penalty test.

The issue in the *Interstar* appeal was whether the penalties rule could be applied in circumstances where the right to terminate an agreement pursuant to a contractual provision was not dependent on any breach of contract but rather on the happening of a nominated event entitling termination. In the first instance decision, Brereton J[49] held that the relevant clause (cl 20.3(c)) was penal in nature even though it did not depend on a breach of the contract to be operative. The New South Wales Court of Appeal overturned this decision on appeal, as is discussed in part three of this article.

The ANZ's contract terms which provided for payment of the exception fees were attacked in *Andrews* on the ground that they imposed an obligation on the applicants to pay fees on the occurrence of a certain event(s), such as overdrawing an account beyond a previously approved limit. On their face, such provisions did not stipulate payment of a fee to be made on the occurrence of a breach of

[40] *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] 224 CLR 656.

[41] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79.

[42] *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] 224 CLR 656 [12].

[43] Statute of William lll (1696) 8 and 9 Will 3 c 11 (*The Administration of Justice Act 1696* entitled *"An Act for the Better Preventing of Frivolous and Vexatious Suits"*).

[44] Statute of Anne (1705) 5 and 5 Anne c 16 (*The Administration of Justice Act 1705*).

[45] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [26].

[46] See s 30 of the *Instruments Act 1958* (Vic).

[47] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [4], [35].

[48] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; [2011] 86 ACSR 292 (2012) 288 ALR 611 [75], [76].

[49] *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406.

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contract by the customer and (rather, in response to an accommodation offered by ANZ) the ANZ argued the fees were therefore not capable of amounting to penalties, irrespective of whether the stipulated sum comprised a genuine pre-estimate of loss.[50]

Legal framework for banker-customer relationship

Her Honour considered that the separate questions could not be answered in isolation. It was essential to analyse the legislative and regulatory framework within which banks operate and provide credit as well as the terms and conditions, that formed the relevant contracts between each applicant and the ANZ.[51]

Whether a particular provision of ANZ's contract(s) was to be characterised as a penalty was ultimately to be determined by the words of the contract and the rules of contract construction. Was the obligation on the applicants to pay any of the 17 types of exception fees triggered by a breach of some obligation imposed by the contract each applicant had with ANZ?

Her Honour determined that, when a customer seeks to make a withdrawal or payment that has the effect of overdrawing that customer's account, that instruction, properly construed, was a request for an advance or loan, which ANZ had a discretion to approve or disallow. Pursuant to the terms of the contract(s) between the applicants and the ANZ, the ANZ was entitled to charge a fee immediately upon determining to honour the transaction and thereby temporarily increasing the applicants' overdraft limit. This scenario was not capable of being characterised as a penalty.[52]

By contrast, another type of exception fee – the four late payment fees[53] – were expressed to be chargeable if certain amounts on a credit card statement were not paid on time. As a matter of construction, the ANZ's contract, obliged the applicants to pay on time and the fee was payable if that obligation was breached. In this case, Gordon J held that the late payment fees were payable as a direct result of an applicants' breach of their contracts with ANZ and thereby attracted the penalty doctrine.

Gordon J made the important point that it was yet to be determined in the Federal Court proceeding whether each of the four late payment fees was in fact a penalty at common law. That issue is to be determined at the resumption of the trial before Gordon J in December 2013.

Appeal to the Full Court

The applicants appealed to the Full Court of the Federal Court against Gordon J's decision that the 13 "non breach fees" could not be characterised as a penalty.

INTRODUCTION TO THE HIGH COURT CHALLENGE

Upon application, the High Court, acting pursuant to s 40(2) of the *Judiciary Act 1903* (Cth), removed the application for leave to appeal before the Full Court of the Federal Court to the High Court.[54] It is only when the issues are important and require the High Court's urgent decision that an order for removal will be made.[55]

[50] "The ANZ accepted that in considering the law of penalties, the exception fees did not constitute a genuine pre estimate of damage." *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [3]; see also *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [26].

[51] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 [2].

[52] Essentially this is the reasoning adopted by Gordon J for her finding that the honour fees, dishonour fees, overlimit fees and non payment fees were not a penalty.

[53] *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; 86 ACSR 292; (2012) 288 ALR 611 at 244-252, 253-259, 260-268, 309-312, and Sch B *Identified Exception Fees* (B) (iii), (iv), (v) and (C) (ii).

[54] *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA Trans 104 (French CJ, Crennan J).

[55] *Beinstein v Beinstein* [2003] 195 ALR 225 [45].

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What was the High Court asked to decide?

The appeal "concern[ed] the nature and scope of the jurisdiction to relieve against penalties and the question whether relief is available only after the penalty is imposed upon a breach of contract."[56] In particular, the High Court was required to decide whether the New South Wales Court of Appeal decision in *Interstar* correctly stated the law in Australia with respect to penalties and whether that court had correctly held that the modern doctrine of penalties had become wholly a doctrine of the common law, rather than of equity.[57]

The decision of the High Court

Settled aspects of the penalty doctrine

Early in the reasons for judgment the High Court set out what it regarded as the "settled aspects of the penalty doctrine":[58]

> 10.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.

This somewhat cumbersome formulation translates to there being a necessity, in construing a contract, to distinguish between an obligation to pay a sum of money as security for the performance of a contractual obligation to which the penalty doctrine applies (eg a liquidated damages clause in a building contract) and an obligation to pay a further sum of money for the enjoyment of an additional right or service to which the penalty doctrine does not apply (eg the exercise of an option).

Following its recitation of the "settled aspects" the High Court described the distinction made in *Dunlop* between a penalty and a genuine pre estimate of liquidated damages, as "a product of centuries of equity jurisprudence" that had been applied recently by the High Court in *Ringrow*.[59] The High Court then pointed out that the dispute in *Andrews* required "attention at an anterior stage of analysis – identification of those criteria by which the penalty doctrine is engaged."[60] As the decision says nothing to otherwise detract from the penalty rule expressed in *Dunlop* and affirmed in *Ringrow* it can be assumed that once the exercise of characterisation of the provision has been made by application of the "settled aspects" that one then applies the orthodox test provided in *Dunlop* to decide if the relevant stipulation amounts to a penalty.

The reasons for judgment analyse "the *Interstar* decision"[61] and refers to Gordon J's conclusions as to the scope of the penalty doctrine which was properly based on the decision in *Interstar*. In *Interstar* the New South Wales Court of Appeal had decided that the primary judge, Brereton J had erred:

a) in denying that the penalty doctrine had ceased to be a rule of equity and now was wholly legal in nature;[62] and

[56] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [18].

[57] *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2009) 257 ALR 292 at 320.

[58] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [8]-[12].

[59] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [15].

[60] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [15].

[61] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [29]-[32].

[62] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [31]; *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2008) 257 ALR 292 at 320.

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b) in concluding that the penalty doctrine was not limited to the failure of stipulations which were breaches of contract.[63]

The High Court determined that both findings by the Court of Appeal were wrong.[64]

First appeal point

The necessity for breach of contract

The reasons for judgment consider the historical nature of penal bonds and the circumstances when equity has intervened in their operation.[65]

The High Court considered the historical use of the term "condition" where used in the operation of penal bonds, and held it was not referrable to breaches of contract.[66] Rather, the relevant application of "condition" in the historical context was that penal bonds were to secure performance as they operated as an acknowledgement of indebtedness, ie a promise to pay a sum of money if the condition in the bond was not performed.[67]

In the early common law, the bond even if regarded as penal, acted to secure strict performance of the primary obligation the subject of the bond. Accordingly, payment of money was conditional on non performance of the desired act. The stipulated sum was able to be recovered in full even if it exceeded the value of the stipulated act.[68]

An action in debt for the sum of the bond was the remedy for enforcement of the bond at law; whereas equity looked at what was involved in satisfaction of the condition for which the bond was given as security. Unless the failure of the condition was compensable there was no basis for equity to intervene.[69] The High Court held that the courts of equity relieved against stipulations which were penal conditions in bonds and said:

> the requirement that equity intervene to ensure the recovery of no more than compensation, accommodated the "fundamental principle" of modern contract law to redress breach by adequate compensation.[70]

The High Court concluded that "it does not follow … that in a simple contract the only stipulations which engage the penalty doctrine must be those which are contractual promises broken by the promisor."[71]

Limited scope of the penalty doctrine

The judgment enquires into the correctness of the submission by the ANZ that the penalty doctrine has limited scope absent a breach of contract.

The High Court reviewed a variety of early English cases, academic commentaries and more recent English decisions[72] before deciding that the requirement of breach of contract was not a necessary part of the test to determine whether a contractual stipulation for an agreed sum is or is not to be characterised as a penalty. In its restatement of the penalty test for Australia it strongly

[63] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [31]; *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2008) 257 ALR 292 at 324.

[64] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [32].

[65] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [33]-[43].

[66] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [35].

[67] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [36].

[68] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [37]-[38].

[69] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [40].

[70] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [44].

[71] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [45].

[72] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [33]-[45].

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disapproved of the New South Wales Court of Appeal decision in *Interstar*[73] which had been accepted as representing a clear statement of affirmation that the law in Australia specifically on the point, and approved the first instance decision of Brereton J in *Integral*.[74] Accordingly, it is appropriate to briefly consider the *Integral* case.[75]

Integral

Interstar was a finance company, engaged in the business of lending and procuring of loan monies on the security of mortgage. Integral was a "mortgage originator" who found and presented to Interstar applications for loan finance to be secured by mortgage. If a loan was made to an applicant by Interstar then Integral managed the ongoing servicing of that loan in return for a commission fee. Integral entered into two Loan Origination and Management Agreements (the Agreement) with Interstar.

Under each Agreement, Interstar agreed to pay Integral an upfront fee on settlement of a loan introduced by Integral and an ongoing "originator's fee" calculated as a percentage of the outstanding balance of the loan payable monthly (ie trailing commission).

Clause 6 of each Agreement included an obligation on Integral "to act honestly in its dealings with all parties and not engage in misleading, deceptive or unethical conduct".

Clause 20.1 of each Agreement entitled Interstar to terminate the Agreement in various circumstances including the insolvency of Integral, a breach of the agreement by Integral or a change in control of Integral.

Clause 20.3 provided for the consequences of termination and cl 20.3(c) provided that upon termination Integral shall have no further entitlement to receive any trailing commissions.

In March 2006 Interstar gave Integral notice under each Agreement that it was exercising its rights of termination under cl 20.3(c) because it had formed the opinion that Integral had engaged in deceptive conduct in relation to loan application files. The consequence was that Integral was no longer entitled to receive trailing commissions under each Agreement.

Integral contended that Interstar was not entitled to terminate the Agreements and alternatively, if it was, cl 20.3(c) was void as a penalty as its effect was to cause cessation of the payment of trailing commission payments which had been earned. The sufficiency of the grounds for termination was not an issue before Brereton J.

The decision of Brereton J on the penalty issue

Brereton J found that cl 20.3(c) of the Agreement was void as a penalty.[76] He concluded that contractual provisions such of cl 20.1 of the Agreement entitling a party to terminate a contract on the happening of various nominated events was susceptible to the law of penalties because they:

> serve to secure the interests of the second party in receiving performance of the main promise of the contract … Their effect is that the first party's entitlement to continue to enjoy the benefit of the contract is conditional upon its not committing any event of default. …[77]

Brereton J[78] expressed the opinion that the penalties test was not limited in its application to circumstances where a contract was terminated for breach but that its scope extended to circumstances where a contract was terminated pursuant to a contractual right to do so upon the occurrence of a contractually nominated event of default which the non terminating party had, in substance, an obligation to avoid.

[73] *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* [2009] 257 ALR 292.

[74] *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406.

[75] *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406.

[76] *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406 [79].

[77] *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406 [71].

[78] *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406 [74]-[76].

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The opinion of Brereton J was accepted by the High Court.[79] Conversely, the High Court held that the Court of Appeal in *Interstar* "misunderstood the scope of the penalty doctrine".[80]

Substance over form

Following the decision in *Andrews*, a clause providing for payment of a stipulated sum can now be challenged as penal, absent a breach of contract. The High Court held that an important integer in the analysis is that it is always necessary to have regard to the substance of the contractual provision that is the subject of attack rather than the form of the provision. The High Court said these were significant considerations, and inter alia:

> They are not displaced by fixing solely upon a breach of contract by the party seeking relief from an alleged penalty.[81]

The courts have historically maintained that the question whether a contractual stipulation is a penalty is one of substance and not form.[82] This question is determined by an enquiry into the "real nature of the transaction."[83] This will provide a fresh challenge to the machinations of creative draftspersons of commercial contracts.

Second Appeal point

Is the rule against penalties a rule of equity or law

In considering this issue the High Court reviewed the historical development of "the common law action of assumpsit."[84] The court concluded that in *Interstar* "the Court of Appeal thus had no basis for the proposition that the penalty doctrine is a rule of law and not of equity".[85] As part of its analysis the High Court considered the judgment of Mason and Wilson JJ in *AMEV-UDC*[86] where their Honours had set out the following five propositions distilled from the historical development of the penalty doctrine:

1) equity would only relieve where compensation could be made for the actual damage suffered by the party seeking to recover the penalty;
2) the actual damage suffered by the party was assessed in an action at common law, such as an action of covenant, or upon a special issue quantum damnificatus which could be joined in an action on the case …
3) the expression "actual damage" seems to have been used in contradistinction to "agreed sum" or "liquidated" or "stipulated" damages, not by way of opposition to damage which was recoverable at law;
4) there seems to have been no instance of equity awarding compensation over and above the amount awarded as common law damages, other than cases in which equity would not relieve against the penalty; and
5) relief was granted, in the case of penal bonds, where there was no express contractual promise to perform the condition (see *Hardy v Martin* (1783) 1 Cox 26 [29 ER 1046]) though it seems such a promise could in many cases readily be implied.

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[79] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [49].

[80] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [50].

[81] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [49].

[82] *Clydebank Engineering and Ship Building Co v Don Jose Rama Yzquierdo Y Castaneda* [1905] AC 6 at 15; *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1951] AC 79 at 86-87 and 92; *Campbell Discount v Bridge* [1962] AC 600 at 642; *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359 at 368; *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [49].

[83] *Clydebank Engineering and Ship Building Co v Don Jose Rama Yzquierdo Y Castaneda* [1905] AC 6 at 9; *Esanda Finance Corporation v Plessnig* (1989) 166 CLR 131 at 138.

[84] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [51]-[63].

[85] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [63].

[86] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [64]-[68]; and *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 at 190.

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The High Court in *Andrews* questioned the fifth proposition and found that:[87]

> the implication into a bond of an "express contractual promise to perform the condition" tends to obscure the path taken by the common law courts in developing the action in assumpsit.

To round out the analysis on this issue the High Court then briefly examined "the *Dunlop* case,"[88] and remarked that the litigation in *Dunlop*:

> illustrates the place of the penalty doctrine in a court where there is a unified administration of law and equity but equitable doctrines retain their identity.[89]

By way of "conclusion"[90] to the two issues under consideration in the appeal the High Court stated that:

> the restrictions upon the penalty doctrine urged by the Court of Appeal in *Interstar* should not be accepted.[91]

The High Court considers the "further issue"

Having dealt with the two issues the subject of the appeal, the High Court considered a "further issue"[92] arising from the findings of Gordon J.

The "further issue" was expressed in the following terms:

> whether the requirement to pay the fees in question [ie the exception fees] was not enjoyed by the ANZ as security for performance by the customer of its other obligations to the ANZ, or whether the fees were charged by the ANZ, as specified in pre existing arrangements with the customer, and ANZ, respectively, for the further accommodation provided to the customer by its authorising payments upon instructions by the customer upon which the ANZ otherwise was not obliged to act, or upon refusal of that accommodation.[93]

The High Court provides examples

To explain the "operative distinction" between a contractual stipulation for an agreed sum for an additional service and security for the fulfilment of a condition highlighted by the "further issue", the High Court referred to two cases by way of example.[94]

The first example is the old English case of *French v Macale* (1842) 2 Drury and Warren 269.[95] In that case the court provided the example of a lease of grazing land which provided for the tenant to pay two guineas an acre to rent the land and a further two guineas an acre if the tenant decided to plough the land and plant a crop. The court found that such a provision in a lease did not constitute a penalty because to plough and crop the land, is not inconsistent with the contract which provides that, should the tenant make such use of the land, he will pay an extra sum of money.

The second example is the New South Wales Court of Appeal decision in *Metro-Goldwyn-Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717[96] where a film exhibitor, Greenham, was contractually

[87] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [66].

[88] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [69]-[77].

[89] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 AL JR 1002 [77].

[90] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [78]-[83].

[91] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [78].

[92] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [79].

[93] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [79].

[94] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [80].

[95] *French v Macale* (1842) 2 Drury and Warren 269 at 275-276; *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [80]. The example used by Holmes JA in *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 at 726 bears a striking resemblance to *French v Macale*.

[96] . See also the case note by Baxt R, "Contract – Film Hired – Four Times Hire Payable for Additional Exhibition – Not a Penalty" (1968) 41 ALJ 508. The *MGM* case was decided prior to the 1986 decision of *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 where the oppression and unconscionability of the stipulated sum were reinvigorated as important elements of the *Dunlop* test.

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licensed by cl 9 of the film hiring agreement with MGM (the agreement was in a standard form prescribed under the *Cinematograph Films Act 1935-1938*) to screen a film once only and required by cl 56(a) of the agreement to pay four times the original fee for each subsequent screening of the film.

Clause 9 provided:

> The Exhibitor shall within the period of hire exhibit the films set out in the Schedule in the theatre and shall not exhibit any of the said films, or allow, or suffer, any of the said films to be exhibited or used at any other place or at any time not authorised by or pursuant to this Agreement without the written consent of the Distributor.

Clause 56 provided:

> (a) If the Exhibitor without the consent in writing of the Distributor exhibit or permit to be exhibited any film on or at any date or time or at any place note authorised by this Agreement the Exhibitor shall pay as hire for each such exhibition, four times the amount of the hire calculated in accordance with clause 54 as if each day on which the film was so exhibited or permitted to be exhibited were an authorised exhibition date on which the Exhibitor without excuse had failed to exhibit.

MGM sued for sums due by reason of 12 unauthorised screenings of the film. Greenham pleaded that the fourfold fee was a penalty and unenforceable. At first instance, the defence of penalty was successful on appeal. The majority in the NSW Court of Appeal (Jacobs and Holmes JJA) found that the fourfold hiring fee proposed to be charged for 12 subsequent screenings of the film was not a penalty.

Jacobs JA held that cl 56 was not a penalty and in so concluding considered the general nature of the arrangement intended to be made between MGM and Greenham.

Clause 9 of the agreement provided an obligation on the exhibitor to exhibit the films in the theatre and there was an obligation not to exhibit them at any other place or time unless authorised by written covenant.

His Honour opined that:

> The primary subject matter, therefore, of the contract was the exhibition of the film in question upon a particular night of the week and on one occasion only.[97]

Greenham had no right to exhibit the film otherwise than on one authorised occasion. If he did so, then Jacobs JA found that he must be taken to have exercised an option so to do under the agreement. The agreement provided the option in cl 56, and he found it could be exercised in one event only, namely that a hiring fee at four times the usual hiring fee would apply.

In terms of construing cl 56 his Honour asked:

> What then was to happen if there was a performance outside the contract, whether it be at a different place or at a different time or on more than one occasion?[98]

Jacobs JA concluded that all of these contingencies were in the nature of additional performances because the right to the initial performance endured. He construed cl 56 as one that provided for payment of an additional hiring fee in the event of an additional showing of the film, and that because such extra showings were discouraged a "very large hiring fee" was provided. Further, he found that cl 56 was not one dealing with damages, but rather, one dealing with the price of an option.[99]

Holmes JA held that cl 56 was not penal on the basis that the exhibition of the film by Greenham on 12 unauthorised occasions was not a breach of the agreement and therefore the law of penalties had no application.[100]

The basic consideration was whether cl 56 applied to what was to happen in the event of breach of the agreement in respect of exhibitions of the film at times and/or places or dates not authorised.

[97] *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 at 723.

[98] *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 at 723.

[99] *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 at 723; *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [82].

[100] *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 at 727.

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His Honour found that the extra exhibitions of the films were ones which were covered by the agreement though at such places, times and/or dates which were not referred to in the special terms in either the schedule to the printed form or the schedule to the agreement between the parties.

His Honour considered that cl 56 did contemplate exhibitions not authorised by the agreement provided they took place with the consent in writing of MGM. Clause 56 also dealt with the situation of extra unauthorised showings of the film; which generated a fourfold fee.

Wallace P was in dissent. He decided the case on the construction and effect of cl 56 which he decided was a penalty which operated upon breach of the contract. He found the clause was "neither an option to exhibit at an unauthorised time, subject to paying a multiple rate, nor pre-estimation of liquidated damages."[101]

He decided cl 56 was a penalty because it operated as a sanction for breach if films were shown at unauthorised times. Further, the fourfold fee was extravagant and not a genuine pre estimate of loss consequent upon any breach of the contract.[102]

Wallace P stated:

> There could in a relevant sense be no genuine pre-estimation of damages for breach because the minds of the parties did not go to the making of the contract – it was "an elaborate fixed menu of stipulations and conditions", [to quote Lord Radcliffe (AC) at p 626 in *Bridge v Campbell Discount Co Ltd* [1962] 1 All ER 385; [1962] AC 600] provided for them by statutory authority.[103]

The effect of the decision of the majority in the *MGM* case is that if a contract provides two primary stipulations as alternatives then the penalty issue will not arise because performance of either stipulation will not give rise to a breach of the contract.

What can be gleaned from the High Court's reliance on *MGM*? It seems that a contractual stipulation of even a very large fee (eg a fourfold increase in fee), where it is proposed to be levied for the supply of an additional right or service (eg pursuant to the exercise of an option) rather than as a form of security for an existing obligation, cannot be characterised as a penalty and will be enforced.

Some further examples

By way of explanation of the High Court's application of the ruling in *Andrews*, a few further examples from the decided cases are considered.

In *Helicopters Pty Ltd v Bankstown Airport Ltd* [2010] NSWCA 178[104] the New South Wales Court of Appeal considered the operation of cl 4.1(e) in a sublease:

> (e) The tenant does not have the right to give a Dispute Notice if the tenant has not paid all rent and other moneys payable under this lease.

In 1998 the respondent leased Bankstown airport from the Commonwealth for a term of 49 years. The lease obliged it to pay an outgoing to the Commonwealth in lieu of land tax. In 2000 the respondent subleased part of the airport to the appellant for a term of 25 years. The sublease entitled the respondent to have the rent reviewed every two years, but the appellant could only object to the respondent's rent review notice if it had paid all rent and outgoings then owing to the respondent.

In March 2006 the respondent initiated a rent review and the appellant objected to its rent review notice. However, at that time the appellant owed the respondent $7,756.48 for outgoings in lieu of land tax.

At first instance the judge held that the unpaid outgoings prevented the appellant objecting to the rent increase. On appeal, the appellant argued, inter alia, that cl 4.1(e) was penal in its operation and thereby unenforceable. It was submitted cl 4.1(e) was a penalty because the loss of the appellant's

[101] *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 at 720.

[102] *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 at 720-721.

[103] *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 at 721.

[104] See also Thomson J, Warnick L and Martin K, *Commercial Contract Clauses: Principles and Interpretation* (Thomson Reuters, Sydney, 2012) p 656.

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right to challenge the rent review notice was disproportionate to its breach in failing to pay the outgoing in lieu of land tax. Handley AJA determined the issue was whether a condition precedent to a contractual right was within the penalty doctrine. His Honour found that cl 4.1(e) did not stipulate for a payment on breach. Rather, the clause will only operate when the appellant attempts to give a Notice of Dispute under cl 4.1. So long as the appellant owed nothing at the time when it gives the Notice of Dispute the challenge to the rent review could proceed.

Clause 4.1(e) was found to not fall within the penalty doctrine as no additional amount was payable on breach and it only imposed a condition on the appellant's right to give a Notice of Dispute.[105]

Pomeroy: Alternative stipulations

The High Court[106] endorsed the collection of principles and discussion in the American text authored by John Norton Pomeroy[107] where "alternative stipulations" are explained in the following manner:

> §437 **Stipulations not Penalties – Alternative Stipulations**
>
> Such being the general test by which to determine the nature of a penalty, there are certain kinds of stipulations not unfrequently inserted in agreements which have been judicially interpreted and held not to be penalties, and therefore not subject to be relieved against by courts of equity. The nature and effect of these stipulations I shall briefly explain. The first instance is that of a contract by the terms of which the contracting party so binds himself that he is entitled to perform either one of two alternative stipulations, at his option; and if he elects to perform one of these alternatives, he promises to pay a certain sum of money, but if he elects to perform the other alternative, then he binds himself to pay a larger sum of money. To state the substance of the agreement in briefer terms, the contracting party may do either of two things, but is to pay higher for one alternative than for the other. In such a case equity regards the stipulation for a larger payment, not as a penalty, but as liquidated damages agreed upon by the parties. It will not relieve the contracting party from the payment of the larger sum, upon his performance of the latter alternative to which such payment is annexed; nor, on the other hand, will it deprive him of his election by compelling him to abstain from performing which alternative he may choose to adopt.

This discussion is consistent with the statement in *Andrews* of what the High Court referred to as the "settled aspects of the penalty doctrine" and the "operative distinction".

A number of cases are cited in *Pomeroy* to support the "alternative stipulations" analysis and they include *French v Macale*, which is said by *Pomeroy* to be "the leading case".[108] These cases (mentioned below) further illuminate the application of the principles of penalty to alternative stipulations and the High Court's consideration of the "further issue".

In *Parfitt v Chambre* (1872) LR 15 Eq 36 at 39-40 an award of arbitrators directed that the defendant pay to the plaintiff an annual life annuity of £1,200. In order to secure the annuity, the defendant should within two months purchase, such an annuity and, if the annuity was not purchased by then, in addition to the annuity, pay a further sum of £100 on the last day of the second month, and a like sum of £100 on the last day of each successive month, until the annuity is purchased. The award added:

> These monthly payments are to be considered as additional to the payments due in respect of the annuity, and as a penalty for delay in the purchase and securing of the same.

---

[105] *Helicopters Pty Ltd v Bankstown Airport Ltd* [2010] NSWCA 178 [34]-[44]. The issue has been considered as regards time bar clauses in construction contracts with the same result. See *City Inn Ltd v Shepherd Construction Ltd* (2003) BLR 468. But note this case applied the *Dunlop* test whereby breach of contract is a necessary element of the penalty test. See also the discussion in Andrews N, Clarke M, Tettenborn A and Virgo G, *Contractual Duties: Performance, Breach, Termination and Remedies* (Sweet and Maxwell, London 2011) [25-050] [25-051]; and Davenport, n 8; Davenport and Durham, n 8; Bond, n 8; and Easton, n 8.

[106] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [81].

[107] Symons SW and Pomeroy JN, *A Treatise on Equity Jurisprudence* (5th ed, Bancroft-Whitney Company, San Francisco 1941) Vol ll, § 437, pp 211-214.

[108] Symons, n 107, p 212.

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The defendant failed to purchase the annuity. A proceeding was issued to recover £600, one half-year's instalment of the annuity, and also £700 for seven monthly payments unpaid of the £100 additional payment. The plaintiff argued that the contract was one in the alternative, either to purchase and settle an annuity or to pay an annuity plus £100 a month, until purchase and settlement. The defendant argued that the provision for the £100 per month was a penalty, and should not be enforced, and that the plaintiff was only entitled to recover the £600, with nominal damages for the delay.

Bacon VC held that the arrangement was not a penalty because the defendant could have relieved himself of the obligation to pay the higher additional amount of £100 per month by securing the annuity.

In *Hardy v Martin* (1783-1796) 1 Cox 27 the plaintiff and defendant had been partners as brandy merchants. The plaintiff decided to leave the partnership and sold his interest in the lease and goodwill to the defendant for £300. The plaintiff agreed to a restraint of trade for 19 years to the effect of not selling any quantity of brandy less than six gallons within the cities of London and Westminster or five miles thereof or to permit any person to do so in his name. He provided a bond of £600 as security.

The defendant brought an action on the bond and was successful. The plaintiff thereafter took action seeking an account of the defendant's actual damages and an order that upon payment of those damages the defendant be restrained by injunction from recovering the amount of the bond. The question was whether the court would relieve against the bond. Lord Loughborough found that a penalty is never considered to be the price for doing what a man had expressly agreed not to do. The court will moderate the damages to the real injury. Accordingly, the plaintiff succeeded.

In the American case of *Smith v Bergengren* (1891) 153 Mass 236 the defendant covenanted not to practice medicine in a certain town so long as the plaintiff should be in practice there, provided, however, that he should have the right to do so at any time after five years by paying the plaintiff $2,000, but not otherwise. The court held that this sum was neither liquidated damages nor a penalty, but was a price fixed for what the contract permitted the defendant to do.

Conclusion

Two matters arose from the *Andrews* decision. First, removal of the "breach" requirement from the penalty test, and secondly, the proper analysis to be applied to determine when "alternative stipulations" can be construed as penal.

In its unanimous judgment, the High Court in *Andrews*[109] has decided that, Australian law no longer requires a breach of contract before the penalty doctrine can be engaged. It has thereby significantly widened what has been understood and accepted without question at appellate level for almost a century to be one crucial aspect of the test to apply to determine whether a contractual stipulation for an agreed sum is a penalty.

The removal of the "breach" requirement from the penalty test will give rise to an increase in the legal challenges to the payment of stipulated sums.

Secondly, the High Court decision in *Andrews* means that a contractual stipulation which requires an exorbitant payment in return for the supply of a further service may not be able to be characterised as penal. As was the case in the *MGM* decision, much will depend on the proper construction of the contract. However, as the discussion in *Pomeroy* makes clear the proper analysis in each instance is to consider the nature and effect of the stipulation provided for in the contract. The old cases referred to in *Pomeroy* and in particular *French v Macale*, bear out this point that if the contracting party may do either of two things but is to pay a higher price for one alternative over the other, then equity will regard the stipulation to pay the higher price as liquidated damages and not as a penalty.

Practical application of the reformulated penalty test to recent decisions

Removal of the breach requirement from the penalty doctrine means it will be much easier for contracting parties to raise the penalty defence to challenge as unenforceable the payment of a

[109] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [45], [78].

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stipulated sum. Will the removal of the breach requirement from the penalty doctrine and the emphasis by the High Court upon the "operative distinction" make any difference to the determination of whether a contractual stipulation for an agreed sum is in fact penal in its operation? It is clear that the penalty doctrine is a narrow exception to the freedom of contract principle but the *Andrews* decision is a departure from what had been accepted as orthodoxy for nearly one hundred years. This orthodoxy had provided the commercial community with an accepted degree of certainty when drafting contractual provisions providing for payment of stipulated sums upon breach of contract. That form of drafting now has a large question mark hanging over it. The answer to the question posed above must therefore be, Yes, but with the rider that the future is far from clear.

The High Court has provided no guidance to determine the "operative distinction" whether a particular contractual stipulation for an agreed sum may or may not be characterised as penal. Two recent decisions from the Victorian Court of Appeal and the English Commercial Court decided prior to *Andrews* are now considered in view of the *Andrews* reformulated penalty test to assess if different outcomes would apply.

Ange v First East Auction Holdings Pty Ltd

The facts in *Ange v First East Auction Holdings Pty Ltd* [2011] VSCA 335 are relatively straight forward.

Over the course of their marriage, Mr and Mrs Ange bought and sold a number of paintings and had used the auction agent Bonhams (the trading name of the respondent in the appeal) a number of times.

In February 2009, following the breakdown of the marriage, Mrs Ange contacted Bonhams regarding the storage of some paintings. Bonhams agreed to store the paintings and provided her with a standard form Consignment Agreement, which attached its General Conditions of Business. This agreement was received but not signed by Mrs Ange (the February 2009 Consignment Agreement).

Between February and March 2009, there were discussions between Mrs Ange and Bonhams about Mrs Ange consigning some of the stored paintings for sale by auction. As part of those discussions, Bonhams advised Mrs Ange that if she withdrew the paintings from the auction after committing to consign them then substantial withdrawal fees would be charged.

On the last day for inclusion in the auction catalogue, Mrs Ange, after speaking to her lawyer, agreed to consign some of the paintings for sale in the auction. Bonhams made some amendments to its copy of the February 2009 Consignment Agreement to reflect the negotiations. Those amendments referred to the General Conditions and stated that they were attached and included an acknowledgement that Mrs Ange had read and accepted them. The agreement was signed by Mrs Ange but did not attach the General Conditions.

Mrs Ange thereafter notified Bonhams that the paintings had to be withdrawn from the auction by reason of Mr Ange having obtained an injunction from the Family Court to restrain the sale of the paintings. Bonhams then withdrew the paintings from auction and made demand on Mrs Ange for payment of its withdrawal fee totalling $731,280.

Was the withdrawal fee a penalty?

Hargrave J, at first instance held that the withdrawal fee was not a penalty, as the penalties rule only applied to contract terms requiring payment of a stipulated sum in the event of a breach of contract. The withdrawal of the paintings was not a breach of contract but a permitted act pursuant to the provisions of the agreement.[110] Mrs Ange appealed from that decision.

The Court of Appeal applied *Interstar* and held that "a term of a contract that imposes an obligation on a party to pay money on the happening of a specified event which is not a breach of a contract does not constitute a penalty".[111]

[110] *First East Auction Holdings Pty Ltd v Ange* [2010] VSC 72.

[111] *Ange v First East Auction Holdings Pty Ltd* [2011] VSCA 335 [91].

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Despite the large amount of the withdrawal fee, the Court of Appeal found it was not a penalty. This was because the General Conditions permitted Mrs Ange to withdraw the paintings from the auction, but subject to the payment of the withdrawal fee. The withdrawal of the paintings from the auction by Mrs Ange was therefore not in breach of the contract and the fee payable could not be a penalty.

The Court of Appeal[112] stated that even if the circumstances were different and the withdrawal of the paintings was a breach of contract and the penalties rule applied, it would still have found the withdrawal fee was not a penalty. This was because the withdrawal fee was not out of all proportion or so extravagant to the likely loss which Bonhams could suffer.

Further, the Court of Appeal examined the evidence led at trial by Bonhams as to its actual loss, assuming that the withdrawal fee was penal.

By withdrawing the paintings from auction, Bonhams lost the 20% buyer's commission that it would have earned if the paintings had sold. Bonhams and Mrs Ange had agreed that there was no seller's commission. Ordinarily, a seller's commission of 12% would have been payable.

The Court of Appeal found that "it has not been established that the withdrawal fee was 'so extravagant and unconscionable … in comparison with the greatest loss that could conceivably be proved to have followed from the breach' that it amounted to a penalty".[113]

In *Ange* the contract stipulated for payment of a withdrawal fee; ie an agreed sum. The court found that this sum was neither *extravagant nor unconscionable*. Looking at the case from a post *Andrews* perspective invites consideration of the "settled aspects of the penalty doctrine".

In *Ange*, the stipulated sum of $731,280 was payable as security for the performance of a contractual obligation and not for the enjoyment of an additional right or service. Accordingly, the penalty doctrine applies to the contractual stipulation and it is necessary to determine whether the agreed sum was *extravagant and unconscionable* in the circumstances of the case. In the absence of such a finding the contractual stipulation for an agreed sum will not be penal. It is submitted that the decision of the High Court in *Andrews* would not change the outcome of the *Ange* case.

Azimut-Benetti Spa v Healey

In *Azimut-Benetti Spa v Healey* [2010] EWHC 2234 (Comm), a yacht builder, entered into a written contract with Shoreacres Ltd to construct and deliver a luxury yacht. Shoreacres Ltd was a company wholly owned by the defendant, Healey. The price for the yacht was €38 million payable in instalments. Healey provided a personal guarantee for the construction cost and paid a deposit of €500,000.

The contract provided Azimut with the right to terminate the contract if Shoreacres Ltd failed to pay any instalment due. The contract also contained the following clause.

> 16.3 Upon lawful termination of this contract by [Azimut] it will be entitled to retain out of the payments made by [Shoreacres] and/or recover from [Shoreacres] an amount equal to 20% of the contract price by way of liquidated damages as compensation for its estimated losses (including agreed loss of profit), and subject to that retention [Azimut] will promptly return the balance of sums received from the [Shoreacres] together with [Shoreacres'] supplies if not yet installed in the yacht.

In addition, the contract included a term that the liability of Healey as guarantor, was not to be released as the result of any "irregularity, illegality, unenforceability or invalidity in whole or in party" of the contract.

Shoreacres Ltd defaulted on the first instalment of the purchase price of €3.3 million (10% of the contract price less deposit) and, as a result, Azimut terminated the contract and sued to recover 20% of the contract price minus the deposit paid of €500,000, totalling €7.1 million, alternatively for the first payment instalment of €3.3 million. Azimut pursued Healey for payment under the guarantee by way of application for summary judgment for the total sum of €7.1 million, alternatively €3.3 million.

[112] *Ange v First East Auction Holdings Pty Ltd* [2011] VSCA 335 [125-135].

[113] *Ange v First East Auction Holdings Pty Ltd* [2011] VSCA 335 [130].

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An application for summary judgment provides a means by which a plaintiff (Azimut) may obtain judgment before trial upon making an application supported by an affidavit on the ground that the defendant (Healey) has no defence to the whole or part of the claim the plaintiff makes.

It is a prerequisite to the defendant filing answering affidavit material that the plaintiff has first verified its cause of action on affidavit. Usually a defendant will show cause by one of two means:

1) it will allege that on the plaintiff's own material the plaintiff is not entitled to judgment; or
2) it will file an affidavit which discloses facts which, if proven at trial, would amount to a good defence at law.

Azimut submitted that Healey had no real prospect of successfully defending the claim because cl 16.3 was a genuine liquidated damages clause and therefore Healey should not be given leave to defend the proceeding.

Healey resisted the application on the basis that cl 16.3 was a penalty and extensive evidence would need to be adduced at trial to prove this. In addition, Healey argued that as cl 16.3 was a penalty and unenforceable, there was no liability on which the guarantee could fasten.

Blair J sitting in the Commercial Court concluded that the issue of whether 20% of the contract price was a genuine pre estimate of damage did not justify a trial. He adopted the "commercial justification test" from the Court of Appeal decision in *Murray v Leisureplay* [2005] EWCA Civ 963[114] that "a clause may be commercially justifiable provided that its dominant purpose is not to deter the other party from breach".

Blair J proceeded on the basis that insofar as a clause operates on a breach of contract, it may be neither a genuine pre estimate of loss nor a penalty. Instead, provided that its "dominant purpose" is not to deter the other party from breach, it can be commercially justifiable and thereby enforceable.[115]

This demonstrates that English courts are increasingly willing to adopt a far more flexible approach toward the interpretation of liquidated damages clauses in commercial contracts rather than adhering strictly to the classic *Dunlop* dichotomy of genuine pre estimate of loss versus penalty. Australian courts have not followed this approach and in the opinion of Sir Anthony Mason, are unlikely to do so unless the High Court decides otherwise.[116]

Blair J took into consideration the commercial reasons outlined in the exchange of negotiations leading to the contract and found that cl 16.3 was "not even arguably a penalty",[117] because:

1) looking at the clause as a whole and not just the figure of 20%, the dominant purpose of the clause was not to deter breach of contract but "to strike … a balance between the interests of the parties should [Azimut] lawfully terminate";
2) the clause had a clear commercial and compensatory justification for both parties;
3) both parties were legally represented during negotiations; and
4) the contract had been freely entered into.

In those circumstances Blair J found that in a commercial contract of the kind under consideration the agreement of the parties should be upheld. Accordingly, he dismissed the penalty argument and held Azimut was entitled to summary judgment for €7.1 million. He also decided the issue of whether if he had found in favour of Healey on the penalty defence, he nevertheless would have granted Azimut summary judgment for €3.3 million. He ruled that he would do so.

---

[114] *Azimut-Benetti Spa v Healey* [2010] EWHC 2234 (Comm) [27]. The commercial justification test has been developed in England in cases such as *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752 at 764, *Cine Bes Filmcilik Ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 [15], *Murray v Leisureplay* [2005] EWCA Civ 963 [38], [117], *Euro London Appointments Ltd v Claessens International Ltd* [2006] EWCA Civ 385 [30], *M&J Polymers v Imerys Minerals Ltd* [2008] EWHC 344 (Comm) [45], *Azimut-Benetti Spa v Healey* [2010] EWHC 2234 (Comm) [27], *E-Nik Ltd v Department for Communities and Local Government* [2012] EWHC 3027 (Comm) [25]; *Cavendish Square Holdings BV v Talal El Makdessi* [2012] EWHC 3582 (Comm) [25]-[27]; see also Baron PD, "The Doctrine of Penalties and the Test of Commercial Justification" (2008) 34 UWALR 42. This test has not been adopted by any court in Australia.

[115] *Azimut-Benetti Spa v Healey* [2010] EWHC 2234 (Comm) [27]; and see Mason A, n 8 at 10.

[116] Mason A, n 8 at 10.

[117] *Azimut-Benetti Spa v Healey* [2010] EWHC 2234 (Comm) [29]; and see *Murray v Leisureplay* [2005] EWCA Civ 963 [29].

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If the *Andrews* decision was applied to these facts this result would possibly be different. There are a number of competing factors. The contractual stipulation for an agreed sum, cl 16.3, does not in the circumstances operate to impose an additional detriment on Healey or Shoreacres Ltd in circumstances where there has been a failure of a primary obligation under the contract (ie payment of the first instalment). The purpose of cl 16.3 was to strike a balance between the interests of the parties should the contract be terminated for breach. Here, it is relevant that in the event of termination of the contract, Azimut was under an obligation, to set off the balance of sums received. Accordingly, the agreed sum would not be *extravagant and unconscionable*. Further, based on the amount of the agreed sum could cl 16.3 be viewed as one proffered by Azimut as security for and "in terrorem" of compliance with the primary obligation of Healey or Shoreacres Ltd to pay the instalments? On the basis of the evidence of the parties commercial negotiations which Blair J set out in some detail[118] the answer would have to be, No.

However, the primary stipulation was that Healey make payments of the price in agreed instalments. The collateral stipulation is set out in cl 16.3, namely payment of 20% of the contract price (less amounts already paid) consequent upon a breach by Healey. This amounted to €7.1 million. If compensation could be paid to Azimut for the prejudice suffered by it not receiving its first payment instalment of €3.3 million (10% of the contract price less deposit) on time then to the extent that the additional benefit to Azimut of the operation of cl 16.3 exceeds the amount of that compensation then it will be a penalty. On the basis that the first payment instalment of €3.3 million more accurately reflects the actual value to Azimut of the work done at the time of termination of the contract as compared to the sum of €7.1 million it is well open to argue that under the circumstances the difference between the two amounts is excessive compensation and therefore a penalty.

The competing interests make the outcome far from clear but the discrepancy between the two figures tips the scales in favour of the conclusion that cl 16.3 operates as a penalty.

CONSEQUENCES OF THE ANDREWS DECISION

The significance of the *Andrews* decision to Australian commerce is potentially far reaching.[119] For instance, stipulated sums payable under a whole range of commercial contracts may now need to be reconsidered; eg fees payable under contracts for services, transport, shipping, construction, franchise agreements and leases.[120]

It is an open question whether the reconstituted penalty doctrine will have any effect on liquidated damages clauses in the standard form building, construction and engineering contracts in wide use throughout Australia, because the liquidated damages entitlement only crystalises on the contract breach of delayed completion. Professor Carter has expressed the view that "it is difficult to understand how, under the modern law, the question can be asked whether a payment is 'liquidated damages' without also assuming that the payment has fallen due on breach of contract".[121] Davenport[122] argues that *Andrews* will have "most profound implications for construction law and adjudication" because it may be used to avoid the draconian effect of time bar provisions in construction contracts and those provided pursuant to the Building and Construction Industry Security of Payment legislation.[123]

[118] *Azimut-Benetti Spa v Healey* [2010] EWHC 2234 (Comm) [5]-[13].

[119] See the commentary above, n 8.

[120] Mills, Morris and O'Brien, n 8.

[121] Carter J, *Carter on Contract* (looseleaf service, LexisNexis, Butterworths, Australia, 2002) 43-160.

[122] Davenport, n 8, p 32; and Davenport and Durham, n 8. See also Easton, n 8. The contrary view is put by Bond, n 8.

[123] Bailey J, *Construction Law* (Informa Law, London, 2011) Vol 1, p 505 states "A contractual provision will only be effective as a time bar where the provision makes it clear that if a claim is not made or notified within a particular period, or by a particular time, no claim may be made thereafter." Each State and Territory has enacted security of payment legislation: *Building and Construction Industry Security of Payment Act 1999* (NSW); *Building and Construction Industry Security of Payment Act 2002* (Vic); *Building and Construction Industry Payments Act 2004* (Qld); *Building and Construction Industry*

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By way of further example, Klimt and Smythe[124] suggest that the types of transactions which may be effected are service level abatement clauses[125] in contracts for major projects, construction, information technology and clauses for services in general; provisions in financial services contracts which apply if the contract is in arrears or over limit; rights to terminate a contract which carry with them the loss of accrued rights, eg the loss of future trailing commissions; and fees payable on contingent events in business and consumer telecommunications, utilities and financial services contracts such as early termination fees, switch fees and break costs.

Clauses that previously were thought to operate so as to avoid the penalty rule such as take or pay clauses, provisions in hire purchase agreements and chattel leases which deal with payments due upon termination; clauses providing for discounts for punctual payment, and certain interest provisions in finance documents are now open to question as being penal in their operation and thereby unenforceable.[126]

Gordon J's task is not yet complete

The High Court made it clear it was not deciding whether the particular ANZ contractual stipulations for the exception fees in issue in the Federal Court proceeding were or were not capable of being characterised as penalties.[127] The court said the question did not arise because of the way the proceeding came to the High Court, but remained a "live issue" for the further trial in the Federal Court.[128]

The "further issue" was not a matter the High Court needed to enquire into or discuss. However, the reasons for judgment make it tolerably clear that upon an application of the "settled aspects of the penalty doctrine" and the "operative distinction" to the exception fees the applicants in the Federal Court proceeding before Gordon J will be hard pressed to establish that the fees charged by the ANZ were penal.

What next?

Following the decision by the High Court, Gordon J will have to decide whether any of the ANZ contractual stipulations for the exception fees, suggested to be in excess of $200 million, are in fact to be now characterised as penal having regard to the financial burden they imposed on the applicants compared with the loss incurred by ANZ by honouring the various transactions taking into account whether they were "extravagant and unconscionable".

These legal and factual issues have significant practical commercial implications which have been referred to earlier.

The next stage of the trial proceeding before Gordon J will involve the application of the restated Australian penalty rule to those exception fees characterised by her Honour as being of a "non breach" type together with those she has already found could be characterised as penal. Her Honour's judgment on that issue will provide further guidance on the application of the High Court's reformulation of the penalty test in *Andrews* and the limitations of that reformulated penalty rule in Australia. Further, given the possible damages exposure for the ANZ if it is unsuccessful in its defence

(Security of Payment) Act 2009 (ACT); *Construction Contracts Act 2004* (WA); *Construction Contracts (Security of Payments) Act 2004* (NT); *Building and Construction Industry Security of Payment Act 2009* (SA); *Building and Construction Industry Security of Payment Act 2009* (Tas).

[124] Klimt and Smythe, n 8.

[125] A service level agreement is one that specifies the supplier's obligations regarding the level or quality of services or goods to be delivered. It makes the service provider accountable to supply at a particular quality, standard or performance level. In the event of non performance abatement of payments may apply. See eg, Victorian Government Procurement, *What is Covered by this Contract* (updated 2 August 2013) http://www.procurement.vic.gov.au/CA2575BA0001417C/pages/state-purchase-contracts-it---t---voice-data-and-video-communications-telecommunications-carriage-services-what-is-covered-by-this-contract.

[126] Dharmananda and Firios, n 8 at 148-149.

[127] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [23], [78], [79], [83], [84].

[128] *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; 86 ALJR 1002 [83].

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it is highly likely there will be further appeals from the final judgment of Gordon J which may give the High Court another opportunity to reconsider or reform the *Dunlop* test.[129]

Conclusion

In *Andrews* the High Court has determined that a breach of contract is no longer a necessary integer to enliven the penalty doctrine and confirmed that the rule against penalties is a rule of equity and therefore very flexible. In doing so it overruled *Interstar*. In determining whether a contractual stipulation is penal it is necessary for the court to consider the substance of the contractual provision rather than its form.

The High Court stressed that there is an "operative distinction" between an obligation to pay a sum of money as security for the performance of a contractual obligation (eg liquidated damages) to which the penalty rule applies and on the other hand an obligation to pay a sum of money for the enjoyment of an additional right or service (eg the exercise of an option) which does not attract the penalty doctrine.

In conclusion, therefore, the *Andrews* decision has widened the circumstances in which contractual stipulations can be categorised as penal and therefore unenforceable. Under the reformulated test, any stipulated sum clause is now open to challenge on the basis of penalty. Given the High Court's primacy within the Australian legal system, the judgment may be expected to receive consideration in other common law jurisdictions, such as the United Kingdom, Canada, New Zealand,[130] much of the United States, Ireland, Northern Ireland, Hong Kong and Singapore. However, the reformulated test for penalties will be difficult to implement as demonstrated by the *MGM* case example relied on by the High Court where there was no unanimity of opinion by the members of the New South Wales Court of Appeal.

[129] As a result of the replacement of the retiring Gummow and Heydon JJ with Gaegler and Keane JJ, any future decision on the penalty test will be made by a differently constituted High Court.

[130] See above, n 39.

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