

# Penalties in Commercial Contracts since *Andrews v ANZ*

Keynote address for the Annual One Day CLE Seminar: Business Law

Saturday 12 March 2016

Sydney, NSW

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## Introduction

- 1 The doctrine of penalties was settled law in Australia, and many other jurisdictions for many years. The test was derived from *Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Company Ltd*<sup>1</sup> (*'Dunlop'*). A particular sum, stipulated to be payable upon breach of contract, would be regarded as a penalty if it “exceeds what can be regarded as a genuine pre-estimate of the damage likely to be caused by the breach”<sup>2</sup>. That test inquired whether, for example, the stipulated sum was “extravagant and unconscionable ... in comparison to the greatest amount that could conceivably be proved to have followed from the breach”.<sup>3</sup>
- 2 One question left open on the authorities was whether the penalty doctrine was capable of application where a pre-stipulated sum was payable upon an event that did not amount to breach.<sup>4</sup> That question was answered “yes” by the High Court in *Andrews v Australia and New Zealand Banking Group Ltd*<sup>5</sup> (*Andrews (HC)*).

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<sup>1</sup> *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited* [1915] AC 79.

<sup>2</sup> *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] 224 CLR 656, [10].

<sup>3</sup> *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited* [1915] AC 79, 86.

<sup>4</sup> *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] 224 CLR 656, [36].

<sup>5</sup> (2012) 247 CLR 205.

- 3 *Andrews v Australia and New Zealand Banking Group Ltd (Andrews)*<sup>6</sup> was brought as a representative action by approximately 38,000 customers of ANZ, alleging that certain fees charged by ANZ were penalties, and were therefore void or unenforceable. The proceeding was led by Mr Andrews, and was instituted in the Federal Court of Australia. It was primarily run as a ‘test case’, and a number of other matters concerning similar allegations were put on hold whilst the Court delivered its verdict.
- 4 This case has been the subject of five separate court hearings over the past 6 years. The case was initially heard in the Federal Court<sup>7</sup>. There was an appeal to the High Court<sup>8</sup>. The High Court ordered the proceeding to be remitted to the Federal Court<sup>9</sup> (*Paciocco*). The decision on remitter was then subject to appeal in the Full Federal Court<sup>10</sup> (*Paciocco (FFC)*), and has recently been heard by the High Court<sup>11</sup> (*Paciocco (HC)*).
- 5 This paper will analyse the history of the proceeding, with a summary of each decision to date. In particular, the focus will be on the Late Payment Fees specific to consumer credit card accounts. These Late Payment Fees have been held, by various Judges, to constitute a penalty. This paper will explore the different approaches taken by different Judges throughout the course of this lengthy litigation, and will specifically analyse the points of distinction between each Judgment.

### **A brief history of the law of penalties**

- 6 The doctrine of penalties was settled law in Australia for a number of years. The principle was based on the seminal judgment of Lord Dunedin in *Dunlop*, where he proposed three tests of construction to assist in determining if a particular stipulated sum payable is penal in nature. I set out the tests, from his Lordship’s judgment:

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<sup>6</sup> (2011) 211 FCR 53.

<sup>7</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53.

<sup>8</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

<sup>9</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249.

<sup>10</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 321 ALR 584.

<sup>11</sup> Transcript of Proceedings, *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCATrans 009, 010.

- 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 not 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”<sup>12, 13</sup>.

7 Those rules of, or approaches to, construction have been consistently referred to in a number of Australian High Court cases. Prior to *Andrews (HC)*, the most recent High Court case to apply these tests was *Ringrow Pty Ltd v BP Australia Pty Ltd*<sup>14</sup>.

8 The application of these tests to the present case was considered in each judgment of each Court. The ways in which they were applied will be seen, to some extent, throughout this paper.

### **The initial proceedings**

9 The proceeding began in the Federal Court of Australia, as a representative action of approximately 38,000 customers of ANZ, led by Andrews. The applicants alleged that certain fees charged to them were void or unenforceable as the terms and conditions relating to the fees were penal in nature. The fees in question were “fees for overdrafts, overdrawn accounts, dishonour fees and overlimit credit card accounts (the **Exception Fees**)<sup>15</sup>”. The Federal Court was asked to determine whether the Exception Fees imposed by ANZ were capable of classification as penalties.

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<sup>12</sup> *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited* [1915] AC 79, 87, citing *Lord Elphinstone v Monkland Iron and Coal Co* 11 App. Cas. 332.

<sup>13</sup> *Ibid*, 87.

<sup>14</sup> (2005) 224 CLR 656.

<sup>15</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53, [1].

10 Gordon J at first instance delivered a necessarily lengthy judgment in the proceeding (*Andrews*), in which her Honour undertook a detailed analysis of the history of the law of penalties; the current state of the law of penalties in Australia, including the requirement for breach and the role of equity; the regulatory framework relevant to the Exception Fees; and the differences between each of the Exception Fees.<sup>16</sup>

11 In Gordon J's consideration of whether the relevant Exception Fees were to be classified as penalties, Her Honour was asked to consider three separate questions. The questions had been drafted specifically for each type of Exception Fee and were set out in Schedule A of the judgment. For our purposes, they can be discussed generically, and may be summarised as follows:

- 1) was the relevant Exception Fee payable upon breach of a term or condition of the contract between the customer and ANZ?
- 2) was it "the responsibility of the applicants to see that the circumstances occasioning the imposition of the exception fees did not arise?"<sup>17</sup>
- 3) if the answer to either of the questions was yes, was the relevant Exception Fee capable of being characterised as a penalty by virtue of that fact.

12 Gordon J ultimately found that only the Late Payment Fees (Exception Fees Nos 7-9 and 11) were "capable of being characterised as a penalty"<sup>18</sup>. Her Honour concluded that none of the Honour Fees, the Dishonour Fees, the Overlimit Fees, and the Non-Payment Fees was "capable of being characterised as a penalty"<sup>19</sup>. The primary reason for the finding that those fees were not penalties was that, in respect of each, both the prior questions that her Honour was asked to resolve were answered in the negative. Those Fees were not incurred as a result of a breach of contract by the customer. Nor was the event which triggered them something which the customer had an obligation or responsibility to avoid. For the purposes

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<sup>16</sup> *Ibid*, [6].

<sup>17</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, [20].

<sup>18</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53, [5].

<sup>19</sup> *Ibid*, [5].

of this paper, it is not necessary to delve further into her Honour's reasons in relation to the Exception Fees that were not found to have constituted a penalty. This paper will focus on the Late Payment Fees.

13 The Late Payment Fees were specific to a customer's Credit Card Account. In essence, a customer was charged a Late Payment Fee if they had not paid the minimum monthly payment plus any amount due immediately, within 28 days of the statement date<sup>20</sup>. The first question for decision was seen to be "whether the Late Payment Fee was imposed by ANZ as a result of [the customer's] breach of those provisions"<sup>21</sup>.

14 ANZ contested the proposition that the Late Payment Fees were capable of classification as penalties. The substance of ANZ's argument was that:

properly characterised, the late payment fee was a fee charged by ANZ, as part of the operation of the account, in respect of credit extended to the customer for a period of time beyond that previously agreed with the customer and for the increased risk of default in repayment of the amounts borrowed.<sup>22</sup>

15 Gordon J rejected ANZ's submission. Her Honour concluded that "it is a fee imposed by ANZ on a customer when it fails to make a payment within the stipulated time"<sup>23</sup>. In reaching the conclusion that the Late Payment Fee was payable as a "direct result of Andrews' breach"<sup>24</sup>, Gordon J stated:

Contracts may, and often do, contain stipulations which do not necessarily give rise to a breach or give rise to the possibility of one consequence but not another. Here, the stipulation ... did not give rise to an imposition of a Late Payment fee. It did, however, give rise to the *possibility* of at least one of the consequences stipulated ... If the non-payment of the Monthly Fee

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<sup>20</sup> Ibid, [236].

<sup>21</sup> Ibid, [239].

<sup>22</sup> Ibid, [244].

<sup>23</sup> Ibid, [249].

<sup>24</sup> Ibid, [243].

continued until after day 28, the Late Payment Fee was imposed ... Thus, it is capable of being a penalty.<sup>25</sup>

- 16 Following a detailed analysis of the law of penalties in the United Kingdom and Australia, Gordon J made some relevant remarks as to the general state of the law. Her Honour noted that “parties to a contract are entitled (and often do) stipulate in the contract an amount that will be payable by one to the other in the event of breach”.<sup>26</sup> In addition, Gordon J observed that “these clauses are generally enforceable provided they fix a sum which is a genuine pre-estimate of loss or damage”.<sup>27</sup> ANZ accepted that the Exception Fees did not constitute a genuine pre-estimate of damage.<sup>28</sup> In relation to the law of penalties, Gordon J observed that “the state of the authorities is that the law of penalties is applicable where the agreement is terminated for breach of contract”.<sup>29</sup> It was on this basis that her Honour held that the Late Payment Fee was a penalty, as it was imposed as a direct result of Andrews’ failure (and breach) to pay the minimum monthly payment.

### **Andrews v ANZ: the High Court**

- 17 Following the decision of Gordon J in the Federal Court, Andrews appealed to the Full Court of the Federal Court. Under s 40(1) and (2) of the *Judiciary Act 1903* (Cth), the High Court ordered that the “penalty” issues in that appeal be removed from the Full Federal Court into the High Court of Australia. The appeal to the Full Court also concerned claims of unconscionability, unfair contract terms, and unjust transactions, under various State and Commonwealth statutes. These elements of the appeal were not removed to the High Court. The High Court judgment is only concerned with:

The claim ... that certain provisions in contracts between the ANZ and the applicants are void or unenforceable as penalties, and that the applicants and group members are entitled to

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<sup>25</sup> Ibid, [243].

<sup>26</sup> Ibid, [48].

<sup>27</sup> Ibid, [48].

<sup>28</sup> Ibid, [3].

<sup>29</sup> Ibid, [63].

repayment of fees charged to them under those provisions, as moneys had and received by the ANZ to their use.<sup>30</sup>

18 The appeal was conducted on the basis that Gordon J had not been required to determine whether the fees were “capable” of characterisation as a penalty, if her Honour had already found that there was no breach on the part of the customer, nor the occurrence of an event which the customer had an obligation to avoid. This followed from the wording and structure of the separate questions.

19 The High Court (French CJ, Gummow, Crennan, Kiefel and Bell JJ) handed down a joint judgment. The Court reaffirmed settled principles of the law of penalties, noting:

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.<sup>31</sup>

20 The decision of the High Court focused on the scope of the penalty doctrine, specifically on the decision in *Interstar Wholesale Finance Pty Ltd v Integral Homes Pty Ltd* (***Interstar***)<sup>32</sup>. Whilst The Court noted that Gordon J was correct to regard herself as bound by that decision, it held that the “restrictions upon the penalty doctrine urged by the Court of Appeal in *Interstar* should not be accepted”<sup>33</sup>.

21 The High Court held that it is not correct that “in a simple contract the only stipulations which engage the penalty doctrine must be those which are contractual promises broken by the promisor”<sup>34</sup>. Thus, their Honours said:

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<sup>30</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, [6].

<sup>31</sup> *Ibid*, [10].

<sup>32</sup> (2008) 257 ALR 292.

<sup>33</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, [78].

<sup>34</sup> *Ibid*, [45].

The primary judge erred in concluding, in effect, that in the absence of contractual breach or an obligation or responsibility on the customer to avoid the occurrence of an event upon which the relevant fees were charged, no question arose as to whether the fees were capable of characterisation as penalties.<sup>35</sup>

22 The High Court held that contractual breach is not the sole method by which the penalty doctrine can be engaged. Their Honours also concluded that the equitable basis of the penalties doctrine remained alive, and had not been subsumed into the common law.

23 The High Court concluded that the Exception Fees were capable of being characterised as penalties. However, it declined to decide whether they were, in fact, penalties. That question was remitted to the Federal Court for consideration in light of the High Court's findings.

#### *Criticism of this decision*

24 The decision of the High Court has received significant criticism from both commentators and other courts. Broadly speaking, the criticism can be divided into three main categories:

- 1) that the doctrine of penalties was previously settled law, supported by a number of Australian High Court decisions, as well as United Kingdom decisions;
- 2) the lack of apparent reasoning of the Court for making such a significant change; and
- 3) the lack of consideration of the implications or effect that the decision might have on commercial contracts in the future.

25 The criticisms relate, one way or another, to what has been said to be a radical expansion of the doctrine of penalties, from what was previously settled law. The critics assert that it had been widely accepted "that the question of whether a damages clause is a penalty or a genuine pre-estimate of damage must occur in the context of a breach"<sup>36</sup>. This view is said to have been supported by the High Court, Australian State Courts, and United Kingdom

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<sup>35</sup> Ibid, [78].

<sup>36</sup> Anthony Gray, 'Contractual Penalties in Australian Law after *Andrews*: An Opportunity Missed' (2013) 18 *Deakin Law Review* 1, 12.



decisions. Carter has argued that “any decision which broadens the reach of the penalty concept must be controversial”<sup>37</sup>.

26 One of the greatest difficulties that commentators have had with the High Court’s decision is that (to quote Carter again):

there is no consideration of the implications of the decision for current drafting practices, or the ways in which transactions are typically structured. Moreover, by providing criteria for establishing a prima facie case for a penalty with no statement of principles for what might push it across the line or rebut that prima facie position, no lawyer or court in the country could feel comfortable in making a judgment as to the efficacy of any provision that might fall within the reach of the initial criteria.<sup>38</sup>

27 This is said to present major problems for lawyers in the drafting of commercial contracts, in attempting to determine what fees or terms and conditions may now constitute a penalty. As the Court did not make a decision as to whether the fees in question were penalties, but only noted that an absence of breach did not preclude them from classification as penalties, it is difficult to determine from this decision what would make a particular term a penalty. As noted by Carter, lawyers in Australia are presently reviewing standard form contracts and other precedents in the light of the High Court’s decision, “but without being clear in what they need to do”<sup>39</sup>.

28 I find it difficult to see that the practical effects of *Andrews (HC)* are as extreme as some commentators have expressed. The *Dunlop* test has not been overruled; its scope has simply expanded, but it remains operative today. The test now operates in such a way that clauses requiring a stipulated sum to be payable, even in the absence of a breach of contract, may be classified as a penalty. On this basis, any clause which provides for a sum stipulated to be payable on the breach or failure of a covenant, may constitute a penalty. This applies to all types of contracts. In its judgment, the High Court stated that the equitable doctrine to relieve

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<sup>37</sup> J W Carter et al, ‘Contractual Penalties: Resurrecting the Equitable Jurisdiction’ (2013) 30 *Journal of Contract Law* 99, 101.

<sup>38</sup> *Ibid*, 112.

<sup>39</sup> *Ibid*.

against penalties applies to stipulations which are penal in nature, even in the absence of a contractual breach.<sup>40</sup> This flows from the historical origins of the doctrine, and equity's ability to relieve against the enforcement of penal bonds. Whilst it is correct to say that drafters must exercise increased caution in preparation of commercial contracts, the current state of the law is not as uncertain as has been suggested.

- 29 The High Court has also been criticised for what some commentators see as its failure to provide sufficient reasons for its departure from the well-established penalty doctrine. It was postulated by Carter et al that “any decision by an ultimate court of appeal ought to be relevant, sympathetic, to generally held views, positive in its contribution and expressed in reasoning which is readily understood”<sup>41</sup>. Those critics say that it is difficult to find in *Andrews (HC)* a statement of “policy rationale”, or some other similar reasoning. This aspect of the criticism of the High Court by commentators was succinctly stated by Carter:

That the High Court should have chosen to resolve an issue which was not previously regarded as controversial without full explanation of the relationship with its own prior decisions, and what goals Australian contract law seeks to achieve, undermines the judgment. So also does the failure to address the question of why the penalties doctrine should be extended beyond breach.<sup>42</sup>

- 30 In addition, the decision has been criticised by the UK Supreme Court. In *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Limited v Beavis*<sup>43</sup>, the Supreme Court was required to decide whether a particular term or condition could be classified as a penalty, in the absence of breach of contract. After noting the persuasive force that decisions of the Australian High Court hold in the United Kingdom, the Supreme Court ultimately did not follow the High Court's decision in *Andrews (HC)*. The Supreme Court criticised the High Court's decision for concluding that the equitable jurisdiction is still alive and well, and had not withered on the vine.

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<sup>40</sup> *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, [45].

<sup>41</sup> Carter et al, above n 37, 128.

<sup>42</sup> Carter et al, above n 37, 128.

<sup>43</sup> [2015] UKSC 67.

31 In addition, the Supreme Court disagreed with the High Court’s “redefinition” of a penalty. In their leading joint judgment, Lord Neuberger and Lord Sumption (with Lord Carnwath agreeing) said:

The High Court’s redefinition of a penalty is, with respect, difficult to apply to the case to which it is supposedly directed, namely where there is no breach of contract. It treats as a potential penalty any clause which is ‘in the nature of a security for and in terrorem of the satisfaction of the primary stipulation’. By a ‘security’ it means a provision to secure ‘compensation ... for the prejudice suffered by the failure of the primary stipulation’. This analysis assumes that the ‘primary stipulation’ is some kind of promise, in which case its failure is necessarily a breach of that promise.<sup>44</sup>

### **The remit to the trial judge: *Paciocco v ANZ***

32 As a result of the High Court decision in *Andrews (HC)*, the case was remitted to Gordon J in the Federal Court for consideration of whether the Late Payment Fees were properly classified as a penalty.<sup>45</sup> The Applicants in this proceeding were Mr Paciocco and one of his companies, Speedy Development Group Pty Ltd (**SDG**). The Applicants held four accounts with ANZ: a consumer deposit account and two consumer credit card accounts held by Mr Paciocco, and a business deposit account held by SDG. The terms and conditions of those accounts entitled ANZ to charge certain fees, including honour, dishonour, overlimit and non-payment fees (the **Exception Fees**).

33 In addition to their penalty arguments, the Applicants also contended that, if the Exception Fees were found to not constitute a penalty, they were in breach of various State and Commonwealth statutes, as amounting to unconscionable conduct, unjust transactions, and/or unfair contract terms. These statutory claims will not be explored in this paper.

34 The pleadings of the Applicant were constructed differently to the pleadings in the initial proceedings in *Andrews*. The Applicants “alleged that the Exception Fee Provisions were

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<sup>44</sup> *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Limited v Beavis* [2015] UKSC 67, [42].

<sup>45</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249.

penalties at common law and, further or alternatively, penalties in equity<sup>46</sup>. The need to consider whether the fees were penalties separately at common law and in equity followed from the High Court's decision, where their Honours noted that equitable doctrine of penalties had not been subsumed into common law.

35 Gordon J summarised the key findings in *Andrews (HC)*. I set out below those of present relevance:

First, the penalty doctrine in equity has not been subsumed into the common law.<sup>47</sup>

Second, the law of penalties was not confined to payments (or other obligations) imposed upon breach of contract.<sup>48</sup>

Third, as a matter of substance, the collateral or accessory stipulation operates "in the nature of a security for, and in terrorem of, the satisfaction of the primary stipulation"<sup>49</sup>.

Eighth, the distinction between a penalty and a genuine pre-estimate of liquidated damages made by Lord Dunedin in *Dunlop ...* was a product of equity and remained applicable.<sup>50</sup>

36 Following her summary of the High Court's judgment, Gordon J considered the primary issue for consideration to be, whether,

as a matter of construction of the relevant contract, was the requirement to pay the fee to be regarded as security for performance by the customer of other obligations to ANZ or was it a fee charged in accordance with pre-existing arrangements according to whether ANZ chose to provide something more and further to the customer<sup>51</sup>

37 The underlying question for determination by Gordon J was: "Was each Exception Fee a penalty at law and further or alternatively, a penalty in Equity?"<sup>52</sup> Gordon J concluded that the Late Payment Fee was payable upon breach by the customer of his contractual obligation to make payment by a stated date. It was not, as submitted by ANZ, "a fee payable upon a

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<sup>46</sup> Ibid, [13].

<sup>47</sup> Ibid, [25] citing *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, [51].

<sup>48</sup> Ibid, [26] citing *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, [78].

<sup>49</sup> Ibid, [27] citing *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, [10].

<sup>50</sup> Ibid, [32] citing *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, [15].

<sup>51</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, [38].

<sup>52</sup> Ibid, [104].

further period of credit extended by the bank to the customer because of the absence of timely payment".<sup>53</sup> In accordance with the test stipulated in *Andrews (HC)*, Gordon J held:

At law and in equity, the collateral stipulation was, as a matter of substance, to be viewed as security for, or in terrorem of, the satisfaction of the primary stipulation. That conclusion flows from the expression language of the provision ... the subject matter of the stipulation ... and the fact that the stipulation was not a fee payable upon a further period of credit necessarily extended by the bank to the customer because of the absence of timely payment.<sup>54</sup>

The primary stipulation in this case was the payment of the minimum monthly amount, with the secondary stipulation being the putative penalty.

38 To my mind, one of the possible consequences of the decision in *Andrews (HC)*, and the subsequent resurgence of the equitable doctrine, is the requirement to assess the actual loss that equity will provide relief for. On this basis, there would be a two-part exercise:

- 1) First, a determination as to whether the fee is in fact a penalty. This requires the possible loss to be assessed on a forward-looking basis, as at the time of entry into the contract. The fee will be a penalty if the amount is extravagant or unconscionable in comparison to the maximum conceivable loss.
- 2) Next, if it is determined that the fee is penal in nature, there would be an assessment of the loss actually suffered as at the date of breach. Equity, regarding the penal sum as in substance a security for loss, would provide relief only to the extent that there was no proved actual loss suffered by the Bank.

39 The analysis of Gordon J as to whether the fee was in truth a penalty at common law and in equity turned on whether it could be considered extravagant and unconscionable in amount compared to the maximum loss that could reasonably be thought to flow from the breach. Her Honour noted that the circumstances in which the Late Payment Fee might become payable, made it difficult for any consequent loss to be calculated with certainty. In the further appeals

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<sup>53</sup> Ibid, [113].

<sup>54</sup> Ibid, [116].

to the Full Federal Court and the High Court, there was significant discussion as to whether such estimation or calculation should be made before or after the event. This will be further explored later.

40 Gordon J said, with respect correctly, that the onus falls on the “Applicants to prove that the stipulated sum was extravagant and unconscionable”<sup>55</sup>. However, of course, the Respondent could adduce evidence to show that the fee was not extravagant and unconscionable. Gordon J stated that an assessment of the loss is to be done on a “forward-looking” basis.<sup>56</sup> In assessing the loss or damage, “equity assesses the quantum of loss or compensation based on what is just and equitable, or fair and reasonable, in all the circumstances”.<sup>57</sup> Finally, where a stipulation is held to be a penalty, it is “unenforceable only to the extent that the amount stipulated to be paid exceeded the quantum of the relevant loss or damage which can be proved to have been sustained by the breach”<sup>58</sup>. To put it another way, ANZ could recover or retain the amount of loss or damage that is quantifiable, with the remainder of the stipulated amount being considered a penalty and unenforceable at law and in equity.

41 In order to determine whether the Late Payment Fees were extravagant or unconscionable, it was necessary for Gordon J to consider facts and matters specific to each fee. Those facts and matters fell into three categories: first, specific aspects of the Exception Fee Provisions; second, the inherent circumstances of the event; and third, the state of mind of ANZ.

42 In the first category, Gordon J said it was of particular importance for each Late Payment Fee that the same amount was payable whether the payment was 1 day or 1 year late, and regardless of the actual minimum monthly amount due. As to the ‘inherent circumstances’, Gordon J paid particular attention to the fact that there was an inequality of bargaining power between the Bank and Mr Paciocco, specifically, there was no opportunity for negotiation and the contracting parties were not on equal footing. In relation to the third category, Her Honour considered it irrelevant to make an inquiry as to ANZ’s particular state of mind, because the

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<sup>55</sup> Ibid, [45].

<sup>56</sup> Ibid.

<sup>57</sup> Ibid, [48].

<sup>58</sup> Ibid.

assessment as to whether a fee is a genuine pre-estimate of damage is an objective test.<sup>59</sup> Whilst ANZ had “admitted that the late payment fee was not a genuine pre-estimate of damage”<sup>60</sup>, the relevant question remained “to what extent (if any) did the amount stipulated to be paid exceed the quantum of the relevant loss or damage ... sustained by the breach”<sup>61</sup>. The subjective intention of ANZ was irrelevant to that question.

43 The parties engaged expert witnesses to give opinions as to whether the Late Payment Fee was extravagant and unconscionable. They undertook what purported to be a quantitative assessment of the loss that each fee was intended to compensate. Their calculations varied considerably. As Gordon J observed, “they were like ships passing in the night”.<sup>62</sup>

44 In relation to one of the Late Payment Fees, Mr Inglis, the expert engaged by ANZ, assessed the costs incurred by ANZ in relation to the events giving rise to the Late Payment Fee to be between \$5 and \$73. He calculated those costs on the basis of three elements: accounting provisions (i.e., for bad or doubtful debts), regulatory capital and operational costs. Gordon J held that this was an incorrect method of assessment, in particular in relation to his inclusion of provision and regulatory capital costs.<sup>63</sup> In contrast, Mr Regan, the expert engaged by the Applicants, assessed the equivalent costs at \$2.60. Gordon J preferred the expert evidence of Mr Regan, and concluded that the loss or damage was approximately \$3, to be rounded to the nearest half dollar.<sup>64</sup> It is not necessary today to delve into the calculations of the respective losses of all the Late Payment Fees. It is sufficient to note that in all cases Gordon J accepted the methodology of Mr Regan in calculating the loss or damage suffered.

45 As a result, Her Honour concluded that all the Late Payment Fees charged to Mr Paciocco and SDG constituted penalties at common law, and in equity. She stated:

The liability to pay the late payment fee was payable on breach and further and alternatively, was collateral (or accessory) to a primary stipulation (to make a payment by a particular date)

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<sup>59</sup> Ibid, [126].

<sup>60</sup> Ibid, [129].

<sup>61</sup> Ibid.

<sup>62</sup> Ibid, [132].

<sup>63</sup> Ibid, [171].

<sup>64</sup> Ibid, [173].

in favour of ANZ. That collateral stipulation, upon failure of the primary stipulation, imposed upon the customer an additional detriment in the nature of a security for, and in terrorem of, the satisfaction of the primary stipulation which was extravagant, exorbitant, and unconscionable.<sup>65</sup>

46 Whilst it is not the focus of today's paper, it is relevant to note that the Honour, Dishonour, Non-Payment and Overlimit Fees imposed upon the customer were held not to constitute a penalty at common law or in equity. None of those fees was "collateral (or accessory) to a primary stipulation in favour of ANZ".<sup>66</sup> Therefore, they were not penal.

### **The appeal to the Full Federal Court**

47 ANZ appealed against the finding of Gordon J that the Late Payment Fees constituted penalties at common law and in equity. Mr Paciocco and SDG appealed against her Honour's findings in relation to the Honour, Dishonour, Non-Payment and Overlimit fees, alleging that they too constituted penalties at common law and in equity. The Full Court (Allsop CJ, with Besanko and Middleton JJ agreeing) dismissed the appeal brought by Mr Paciocco and SDG, and upheld ANZ's appeal. The results of the appeal brought by Paciocco and SDG are not relevant to the discussion, with the focus being on the Late Payment Fees.

48 ANZ based its appeal on a number of grounds. Its main points of contention were: first, the characterisation of the late payment fee; second, the conclusion by the primary Judge that the fee was prima facie a penalty; third, her Honour's conclusion that the fee was extravagant or unconscionable; fourth, questions of an evidentiary nature as to the maximum conceivable loss; and fifth, evidentiary questions concerning actual costs incurred.<sup>67</sup> The most significant findings of the Full Court are in relation to the second and third categories of appeal, and thus will form the focus of the discussion.

49 In relation to the first contention, the Full Court agreed with Gordon J's characterisation of the Late Payment Fee as penal. The second and third contentions were considered together by the Full Federal Court. ANZ argued that Gordon J had wrongly calculated the loss on an "after

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<sup>65</sup> Ibid, [373].

<sup>66</sup> Ibid, [374].

<sup>67</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 321 ALR 584, [81].



the event” basis, as opposed to a “forward-looking” calculation. ANZ submitted that her Honour had erred in undertaking an analysis “of actual loss from the breaches”,<sup>68</sup> and that the correct approach:

Was founded upon the need to show, by an *ex ante* analysis at the time of entry into the contract, that the stipulation was extravagant and unconscionable in comparison with the greatest loss that could conceivably be proved to follow from such a breach.<sup>69</sup>

This was directly relevant to whether the fee was to be considered extravagant and unconscionable, and thus in determining whether the fee constituted a penalty.

50 The Full Court paid particular attention to the entrenched dichotomy between “penalty” and “genuine pre-estimate of loss”, which was affirmed from *Dunlop*.<sup>70</sup> Paciocco and SDG attempted to argue that the parties must have specifically addressed the concept of “genuine pre-estimate of loss” directly.<sup>71</sup> The Court rejected this argument. The Court held that for something to be considered a genuine pre-estimate of loss, it is not necessary for the parties to have actually addressed it in such a way, that is, “for the parties to have set the figure by reference to likely loss”.<sup>72</sup>

51 The Court discussed the origins and historical application of the dichotomy, propounding that the difficulties associated with this dichotomy “are avoided if the notion of a genuine pre-estimate of loss is recognised ... to be the reflex of a penalty”.<sup>73</sup> The court noted with approval, the broad approach by the Primary Judge in recognising this dichotomy. It stated:

The requirement for extravagance and unconscionability and its distinction from a genuine pre-estimate of damage must require the latter concept to be a broad objective one, not limited to a clause expressly said to be a genuine pre-estimate of damage or containing a sum actually fixed in amount by reference to contemporaneous considerations concerned with such. Rather, if extravagance and unconscionability, on the one hand, and a genuine pre-estimate, on the

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<sup>68</sup> Ibid, [93].

<sup>69</sup> Ibid, [92].

<sup>70</sup> Ibid, [95].

<sup>71</sup> Ibid, [102].

<sup>72</sup> Ibid, [101].

<sup>73</sup> Ibid, [100].

other, are to operate as the relevant universe of discourse, the latter must be a descriptive phrase used to explain a sum paid upon breach of a term or pursuant to a collateral stipulation upon the failure of the primary stipulation that is not extravagant and not out of all proportion to the compensation for the breach or failure of the stipulation.<sup>74</sup>

52 ANZ submitted that Gordon J had erred in her approach to the expert evidence. The Full Court summarised those submissions as follows:

The burden of these complaints crystallised in the proposition of the asserted fundamental error of the primary judge: failing to undertake a forward looking or ex ante analysis at the date of contracts to assess the greatest loss that could be conceivably proved by breach of the provision in question in order to assess whether the fee was extravagant or unconscionable.<sup>75</sup>

53 ANZ contested Gordon J's classification of the fee as "prima facie a penalty" at law and in equity, and her Honour's reasoning leading to that conclusion. Gordon J had concluded that the fee was prima facie a penalty, by reference to the damage that was alleged to have been caused by the breach. The Full Court said that this approach was inherently flawed, because the determination of whether a particular fee can be considered prima facie a penalty "is not assisted by knowing what the damages from the particular breach or failure were".<sup>76</sup> Her Honour's undertaking of an after the event analysis in determining whether the fee was prima facie a penalty was held to be incorrect by the Full Federal Court. The relevant "question is to be assessed as at the time of entry into the contract"<sup>77</sup>, on a forward-looking basis. Allsop CJ noted that it is not necessary for the calculation to be a "genuine pre-estimate of loss", when calculating what the likely loss to be suffered is.

54 The Full Court referred to the second and third rules of construction articulated in *Dunlop* by Lord Dunedin, and set out above. In *Dunlop*, there was a provision for a £5 liquidated damages charge if a particular retailer sold Dunlop's tyres below the list price. The House of Lords found that the fee was not a penalty, as it was not extravagant or exorbitant in the circumstances.

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<sup>74</sup> Ibid, [25].

<sup>75</sup> Ibid, [112].

<sup>76</sup> Ibid, [116].

<sup>77</sup> Ibid, [95].

55 In regard to the second rule of construction, the Full Federal Court held that this was not a case where there was a demand for a larger sum upon failure to pay a smaller sum.<sup>78</sup> The Full Federal Court stated that the relevant question as to whether a particular fee is penal

is to be assessed by reference to the question whether it is extravagant or exorbitant by reference to the obligee's legitimate interest in the performance of the contract assessed by the greatest loss that could conceivably be proved to have followed from a breach or failure to comply.<sup>79</sup>

The Court concluded that "the fee was not conclusively a penalty by the second rule of construction".<sup>80</sup>

56 In relation to the third rule of construction, the Full Court noted that whilst the primary judge may not have been wrong to consider the application of the rule, her utilisation of actual damages in determining whether the presumption set out in this rule should be applied, was in error.<sup>81</sup>

57 Following their determination that the Primary Judge erred in concluding that the fee was prima facie penal in nature by reference to damage actually suffered, the Court turned to whether the fee could properly be considered as extravagant and unconscionable. The Court noted that "the object and purpose of the doctrine of penalties is vindicated if one considers whether the agreed sum is commensurate with the interest protected by the bargain"<sup>82</sup>. An assessment of whether the fee is extravagant and unconscionable is an essential element in determining whether a fee is penal, which "must be done as at the time of entry into the contract".<sup>83</sup>

58 The Full Court reviewed the evidence of the expert witnesses, Mr Regan and Mr Inglis. Allsop CJ concluded that it was not possible to take the view from Mr Regan's analysis that the Late Payment Fee "was extravagant or exorbitant by reference to the greatest conceivable loss

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<sup>78</sup> Ibid, [137].

<sup>79</sup> Ibid, [137].

<sup>80</sup> Ibid, [138].

<sup>81</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 321 ALR 584, [132].

<sup>82</sup> Ibid, [103].

<sup>83</sup> Ibid, [147].

that might be caused by breach of the term in question”.<sup>84</sup> He noted that Mr Regan had failed to undertake a forward-looking analysis, so that his evidence would not support the conclusion that the fee in question was extravagant or exorbitant.<sup>85</sup> Instead, Allsop CJ said, Mr Regan had made an assessment of the actual damages caused by the breach. Allsop CJ referred to decisions such as *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo Y Castaneda*<sup>86</sup>, where Lord Davey had said it was “perfectly irrelevant and inadmissible for the purpose of shewing the clause to be extravagant ... to admit evidence ... of the damages which were actually suffered”.<sup>87</sup> On the whole, the Full Court preferred the expert evidence of Mr Inglis, further noting that when assessing loss or damage it is appropriate to consider all the circumstances, including a consideration of interest charges and other fees, which Mr Regan had failed to undertake.

59 Mr Inglis included in his calculation of the loss or damage referable to the various fees, costs such as theoretical accounting costs, provisioning costs, regulatory capital costs, and collection costs. ANZ said, based on his evidence, that the fees were “not demonstrated to be extravagant, exorbitant or unconscionable”<sup>88</sup>. The Full Court held that costs of those kinds were properly to be taken into account in undertaking the forward-looking analysis of loss.

### ***Paciocco v ANZ: the High Court***

60 ANZ and Mr Paciocco / SDG each sought special leave to appeal to the High Court against the findings of the Full Federal Court. Special leave was granted by the High Court on 11 September 2015. The appeals were heard by 5 members of the High Court on 4<sup>th</sup> and 5<sup>th</sup> February 2016. Whilst there has been no judgment delivered to date, it is appropriate to consider the arguments raised by both parties in relation to the Late Payment Fees.

61 Mr Paciocco and SDG alleged that the Full Court had erred in holding that the Late Payment Fees were not penalties. There were three main elements in their submissions:

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<sup>84</sup> Ibid, [150].

<sup>85</sup> Ibid, [150].

<sup>86</sup> [1905] AC 6

<sup>87</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 321 ALR 584, [116]; citing *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6, 17.

<sup>88</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 321 ALR 584, [187].

- 1) What is the current status of the second *Dunlop* test, which was the subject of contention in previous proceedings?
- 2) What is the relevance of the tests of remoteness of damage in determining whether a particulate late payment fee is a penalty or a genuine pre-estimate of loss?
- 3) In determining whether a stipulated sum is penal, what evidence can be taken into account when determining the amount of the stipulated sum?<sup>89</sup>

62 In oral submissions, in relation to the first element, Mr Paciocco and SDG submitted that the High Court's decision in *Andrews (HC)* did not "take away from the application of the *Dunlop* case in cases of the simple kind to which we are referring".<sup>90</sup>

63 As to Late Payment Fees, Mr Paciocco and SDG submitted that Gordon J had been correct to exclude provisional costs and costs of regulatory capital,<sup>91</sup> and that the Full Court erred in its approach to collection costs.<sup>92</sup> Thus, they submitted that Gordon J had been correct in concluding "that the late payment fees were extravagant and unconscionable in comparison with the greatest (non-remote, recoverable) loss that could be proven to follow from any late payment by the first appellant".<sup>93</sup>

64 ANZ accepted that the question of whether a fee is extravagant and unconscionable is essential in the analysis of whether that fee is a penalty. However, ANZ submitted that the Full Court had been correct to conclude that the fee was not extravagant and unconscionable. It submitted that the relevant "test is whether the fee ... is extravagant or unconscionable in comparison to the maximum conceivable loss".<sup>94</sup> On the evidence given by Mr Inglis at trial, the collection costs for certain late payment fees calculated on a forward-looking basis,

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<sup>89</sup> Lucio Robert Paciocco and Speedy Development Group Pty Ltd, 'Appellants' Submissions', Submission in *Paciocco v Australia and New Zealand Banking Group Ltd*, M220 of 2015, 16 October 2015, [3].

<sup>90</sup> Transcript of Proceedings, *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCATrans 009 (4 February 2016) 8.

<sup>91</sup> Lucio Robert Paciocco and Speedy Development Group Pty Ltd, 'Appellants' Submissions', Submission in *Paciocco v Australia and New Zealand Banking Group Ltd*, M220 of 2015, 16 October 2015, [49].

<sup>92</sup> *Ibid*, [51].

<sup>93</sup> *Ibid*, [55].

<sup>94</sup> *Australia and New Zealand Banking Group Ltd*, 'Respondent's Submissions', Submission in *Paciocco v Australia and New Zealand Banking Group Ltd*, M220 of 2015, 6 November 2015, [36].

exceeded the amount of the fee.<sup>95</sup> ANZ submitted that it was therefore not possible to conclude, on Mr Inglis' evidence, that the fee is extravagant or unconscionable. In calculating the relevant losses, ANZ contended that all the costs arise within the "usual course of things", in accordance with the test in *Hadley v Baxendale*<sup>96</sup>, and are not unusual costs.

## Conclusion

65 The High Court's ruling in this case will be of major significance in this country. It is difficult at this point to comment on which way the Court might rule, given the contrary conclusions reached by Gordon J and the Full Court as to whether the Late Payment Fees are penalties.

66 Given the substantial criticism of the High Court's first decision, as to the significant changes made to the doctrine of penalties, it is to be hoped that the decision by the High Court will be well-reasoned, with any further changes to the law as it is presently understood being supported by a clear policy rationale. The law of penalties, thought to have been settled for many years, was altered significantly by the previous High Court decision. It will be extremely interesting to see which way the High Court goes in *Paciocco (HC)*. Regardless of the outcome, it will have lasting effects in the commercial world, as perhaps (at last!) some clarity will be provided to drafters of commercial contracts.

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<sup>95</sup> Ibid, [36].

<sup>96</sup> (1854) 2 CLR 517.