Client Update
Penalty Doctrine Considered by High Court of Australia after *Cavendish*

LONDON
Tony Dymond
tdymond@debevoise.com

Gavin Chesney
gchesney@debevoise.com

Samuel Pape
spape@debevoise.com

In November 2015, the UK Supreme Court delivered its decision in *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis* [2015] UKSC 67. It was the first time in more than a century that England's highest court had considered the rule against penalties in contracts, and the outcome was hailed by some as a significant recasting of the law as it had been understood. In a recent decision concerning the validity of late-payment fees in credit card terms and conditions, the High Court of Australia has again considered the question of penalties under Australian law. The judgment in *Paciocco and another v Australia and New Zealand Banking Group Ltd* [2016] HCA 28 confirms that the approach to determining whether a clause is a penalty is similar in England and Australia, with one important difference. The judgment also provides a helpful example of how the common law principles are applied in practice.

THE ISSUES IN *PACIOCCO*

The action was brought by an individual, Mr. Lucio Paciocco, and his company as representatives of a class of around 43,000 customers of the Australia and New Zealand Banking Group Ltd (the "ANZ"), one of Australia's largest banks. The terms and conditions of the banking and credit accounts required them to pay fees of AUS $20 or AUS $35 in the event of failure to make the required minimum repayments by their due dates.

THE DECISIONS AT FIRST INSTANCE AND ON APPEAL BEFORE THE FULL COURT

At first instance, the primary judge in the Federal Court of Australia struck down the banking fees as penal. The judge found that the fees were charged as "security for, or in terrorem of, the satisfaction of the primary stipulation" and that "each of [the sums charged] is extravagant and unconscionable".

On appeal, the Full Court of the Federal Court disagreed, holding that the fees were not in the nature of penalties, having regard to the legitimate interests of the ANZ in the performance of the terms for payment. The Full Court found that the judge at first instance ought to have accepted evidence from the bank that its legitimate interests included certain loss-provision costs, regulatory-capital costs and collection costs, even though those sums may not have been recoverable in an action in damages, or that the late payment fees were not necessarily genuine pre-estimates of damages. The Full Court also dismissed arguments that the fees were unenforceable under certain applicable statutory prohibitions on unconscionable conduct, injustice or unfairness.

THE MAJORITY'S DECISION IN THE HIGH COURT

By a four-to-one majority, the High Court of Australia dismissed the appeal and upheld the decision of the Full Court. In their judgments, their Honours in the majority accepted that the punishment of the customers was not the sole purpose of the late payment fees, and that the fees were not "out of all proportion" to the interests of the ANZ affected by nonpayment of the minimum payments by their due date.

Instead, their Honours accepted that the Court could have regard to a broad range of potential legitimate interests that were protected by the late payment fee scheme. In doing so, the majority adopted an approach which accords with the test established last year by the UK Supreme Court in Cavendish. In that case (discussed in our client update of 10 November 2015, accessible here), the UK Supreme Court held that:

> The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance.

However, the laws of Australia and England may differ with regards to the scope of contractual provisions in which the law of penalties is engaged:

- In *Cavendish*, the UK Supreme Court drew a distinction between "primary" obligations and "secondary" obligations and held that the rules on penalties do not apply at all to primary obligations, as "it is not a proper function of the penalty rule to empower the courts to review the fairness of the parties' primary obligations". Instead, the penalty rule applies only to "secondary"

obligations, which seek solely to define the measure of compensation (as an alternative to a standard claim in damages) payable by a party in the event of breach of a primary obligation.

- In *Paciocco*, the High Court of Australia noted that the UK Supreme Court's judgment diverged from the Australian approach in *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53. In *Andrews*, the High Court of Australia held that there is no reason in principle why the primary stipulation to which a penalty is collateral cannot consist of the occurrence or nonoccurrence of an event which is neither a breach of contract nor another event which it is the responsibility or obligation of the party subjected to the penalty to avoid. *Paciocco* held that, notwithstanding the decision of the UK Supreme Court, Andrews remains the correct approach under the law of Australia.

THE FUTURE OF THE RULE ON PENALTIES IN COMMON LAW JURISDICTIONS

The decision in *Paciocco* confirms that the law of penalties remains alive across different common law jurisdictions and suggests some convergence in the standard to be applied to determine whether a clause will be struck down as penal. Indeed it is suggested that the decision is an illustration of the general trend of the courts of several common law jurisdictions becoming increasingly reluctant to interfere with contractual provisions freely agreed by the parties. In doing so, the courts seek to reinforce the commitment to freedom of contract that is the touchstone of the law of contract in England and other common law jurisdictions.

* * *

Please do not hesitate to contact us with any questions.