GREENWAY CHAMBERS

CONTRACTUAL PENALTIES AND DEFAULT INTEREST

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Seminar Notes

The traditional doctrine of penalties

1 Traditionally, the doctrine of penalties has been thought to apply only where an innocent party terminated a contract for the other party's breach and then sought to rely upon a clause requiring the payment of a specified sum. Thus, in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ said:

> *"10 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.*
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> *11 The starting point for the appellant was the following passage in Lord Dunedin's speech in Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd:*
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> > *'2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage …*
> >
> > *3. The question whether a sum stipulated is penalty or liquidated damages 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''.

12 … The formulation has endured for ninety years. It has been applied countless times in this and other courts. In these circumstances, the present appeal afforded no occasion for a general reconsideration of Lord Dunedin's tests to determine whether any particular feature of Australian conditions, any change in the nature of penalties or any element in the contemporary market-place suggest the need for a new formulation." [emphasis added]

2 In *Integral Home Loans Pty Ltd and Anor v Interstar Wholesale Finance Pty Ltd and Anor* [2007] NSWSC 406, Brereton J set forth a comprehensive summary of the authorities on penalties and identified (at [19]) 3 separate and distinct classes of case (expressed in language pertinent to a hire-purchase contract) in which it might be argued that the doctrine should apply, namely:

"· First, those in which a liability to pay a stipulated sum is imposed in the event of the hirer/lessee terminating the contract in accordance with its terms by returning the goods to the owner/lessor;

· Secondly, those in which a liability to pay a stipulated sum is imposed in the event of the owner/lessor exercising a right to terminate the contract upon an 'event of default' (such as death, insolvency, or issue of execution against the lessee) where there is no contractual promise that such event of default will not occur – which is the present case; and

· *Thirdly, those in which a liability to pay a stipulated sum is imposed in the event of the owner/lessor exercising a right to terminate the contract for breach by the hirer/lessee."*

3 The third class of case identified by Brereton J represents, of course, the traditional situation in which the doctrine of penalties is applied: see, for example, *Esanda Finance Corporation Limited v Plessnig* (1989) 166 CLR 131. In addition, in *Integral*, Brereton J held that the doctrine of penalties also applied to the second class of case: at [74] and [78].

4 Although it may traditionally have been thought that the first class of case would not attract the operation of the doctrine of penalties, Brereton J made a number of observations in *Integral*, which suggested that it might. His Honour said:

> *"38 As to the first class of case, Viscount Simonds and Lord Morton of Henryton* [in Bridge v Campbell Discount Co Ltd [1962] AC 600] *approved Associated Distributors Ltd v Hall, to the effect that had the position been (as the Court of Appeal had accepted) that the hirer had exercised his option to terminate the contract by returning the goods, no question of penalty would have arisen. Lord Denning however disapproved Associated Distributors, in its application to the second as well as the first class of case (at 629):*
>
> > *'The Court of Appeal acknowledge that, in some cases, there is room for the intervention of equity. They accept that, where the hiring is terminated because the hirer is in breach, equity will relieve him from payment of the penalty: see Cooden Engineering Co. Ltd v Stanford. But they say that when it is terminated for any other reason, as, for instance, if the hirer gives notice of termination himself, or if he dies, there is no equity to relieve him or his executors from the rigours of the law: see Associated Distributors, Ltd v Hall. The jurisdiction of equity is confined, they say, to relief against penalties for breach of contract and does not extend further. Applied to this case it means this: If the appellant, after a few weeks, finds himself unable to keep up the instalments and, being a conscientious man, gives notice of termination and returns the car, without falling into arrear, he is liable to pay the penal sum of £206 3s 4d without relief of any kind; but if he is an unconscientious man who falls into arrear without saying a word, so that the respondents re-take the car for his default, he will be relieved from payment of the penalty. Let no one mistake the injustice*

> *of this. It means that equity commits itself to this absurd paradox: It will grant relief to a man who breaks his contract but will penalise the man who keeps it. If this be the state of equity today, then it is in sore need of an overhaul so as to restore its first principles. But I am quite satisfied that such is not the state of equity today.'…*

40 Lord Devlin also disapproved Associated Distributors in its application to the first (and thus necessarily the second, which is a fortiori) class of case…

41 In respect of the first and second classes of case, the remaining member of the House, Lord Radcliffe, left the matter open, though suggesting that there were difficulties in the way of the position advanced by Lord Denning…

62 This line of cases reinforce the view that in a case in the second class – where termination, accompanied by a liability to pay an agreed sum, is authorised for an 'event of default' but there is no express promise that the event will not occur – nonetheless the position may be seen as, in substance, akin to termination for breach. So does the judgment of Deane J in AMEV-UDC v Austin [(1986) 162 CLR 170]*… [His Honour said] (at 197-199)…:*

> *'… Nor, in my view, did equity ever commit itself to what would, as Lord Denning pointed out in Bridge (at 629), have been the "absurd paradox" that "it [would] grant relief to a man who breaks his contract but [would] penalise the man who keeps it"… It would have been contrary to the underlying thesis of the equitable jurisdiction to prevent unconscionable advantage being taken of the harshness of the common law to have made the existence of legal fault in the plaintiff, as distinct from legal liability, a prerequisite of entitlement to relief or to have made the contumacy of the plaintiff's conduct giving rise to legal liability a ground for equitable relief against the liability. A fortiori it would have been unreasonable for the common law itself, in withdrawing its remedies to enforce what equity regarded as a penalty, to have added a limitation that common law unenforceability did not extend to any case where the person burdened by the penalty was innocent of common law fault in the form of breach of contract. It is true that one can point to judicial statements, including some recent statements of high authority, which support the contrary view that a contractual clause will not be unenforceable as a penalty unless it provides for payment upon breach of contractual duty… Such broad*

statements appear to me, however, to have generally been made in a context where the grounds for declining to hold that a penalty was involved are properly to be seen as more narrowly confined… I am not prepared to accept them as correctly stating the position either in equity or at common law. As I have indicated, the restriction of equitable relief or common law unenforceability to the case where it is possible to identify a technical breach of contract on the part of the party claiming relief or unenforceability would, in my view, be contrary to historical fact, general principle and basic common sense.'…

72… [T]he judgments of the Court of Appeal in Associated Distributors Ltd v Hall, Somervell and Hodson LJJ in Cooden, Lords Radcliffe, Denning and Devlin in Campbell Discount Co, Diplock LJ in Financings Ltd v Baldock, Gibbs CJ in O'Dea, Lord Denning MR and Salmon LJ in United Dominions Trust (Commercial) v Ennis, and Gibbs CJ, Mason and Wilson JJ and Deane J in AMEV-UDC, either leave open or positively support the view that the doctrine of penalties applies to a case in the second class, if not the first class.

73 To my mind, the reasoning of Deane J in the passage cited above from his Honour's judgment in AMEV-UDC v Austin is compelling; so too is Lord Denning's 'absurd paradox'….

74 Accordingly, I would hold that a penalty is a contractual liability to pay or forfeit or suffer the retention of a sum of money or property which is agreed in advance to be payable (or forfeited or retainable), by one party to the other, upon or in default of the occurrence of an event which can be seen, as a matter of substance, to have been treated by the parties as lying within the area of obligation of the first party, in the sense that it is his or her responsibility to see that the specified event does or does not occur, and where the stipulated payment is out of all proportion or unrelated to the damage which might be sustained by the other party by reason of the particular occurrence or default." [emphasis added]

5 Brereton J's decision in *Integral* was reversed by the Court of Appeal in *Interstar Wholesale Finance Pty Limited v Integral Home Loans Pty Limited* [2008] NSWCA 310. In that case, Allsop P (Giles and Ipp JJA agreeing), held:

"106 In my view, the expression of view by the primary judge that the doctrine of penalties (distinguished from relief against forfeiture) in the common law

of Australia (using that expression to mean, relevantly here, the general law encompassing common law and equity) was not limited to circumstances of breach of contract was not open to his Honour. The intermediate appellate authorities in Australia, the persuasive view of a unanimous House of Lords, existing High Court authority and other views expressed in the High Court constrained the primary judge (and constrain this Court) to limiting the application of the doctrine of penalties to circumstances of breach of contract. If a wider doctrine is to be enunciated in the form of that appearing in [75] of his Honour's reasons, it is for the High Court of Australia to enunciate it…

159 … [T]he primary judge's thoughtful reasons highlight the potential tension between different approaches in this field. In my view, as I have attempted to explain, the weight of existing authority (underpinned by a recognition of the need for clarity and certainty and by a respect for the bargains of parties) is to limit the doctrine of penalties within narrow and clear boundaries…

160 The consideration of the above matters, of the relationship of penalties to relief against forfeiture and of the existence (or, perhaps, renewed recognition) of equity's role in the doctrine of penalties are matters for doctrinal consideration which will inevitably involve reconsideration of High Court authority, including IAC (Leasing) and AMEV-UDC. Therefore, it is a task for the High Court, not this Court, and not a judge at first instance." [emphasis added]

6 The Court of Appeal's decision was the subject of a grant of special leave: *Integral Home Loans Pty Ltd v Interstar Wholesale Financial Pty Ltd* [2009] HCATrans 87. During the argument preceding the grant of special leave, Gummow J indicated that he did not view the statement of the High Court in *Ringrow* (at [10]) as confining the application of the doctrine of penalties to the particular situation there described. This litigation did not, however, proceed to a full hearing, as it was settled. It was not until *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205 that the High Court had an opportunity to consider the issue.

High Court innovation

7 The doctrine of penalties was extensively revised by the High Court in *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205 and *Paciocco v Australia & New Zealand Banking Group Ltd* [2016] HCA 28; (2016) 90 ALJR 835.

8 In *Andrews*, the High Court (French CJ, Gummow, Crennan, Kiefel and Bell JJ) unanimously held (at [20], [45]-[50], [56]) that a contractual requirement to pay a sum of money conditioned upon a failure to observe a particular contractual stipulation is capable of being a penalty regardless of whether or not it is payable upon breach. The plurality said:

> *"67 [A]t first instance in Interstar [122] , Brereton J properly understood the significance of what had been said by Mason and Wilson JJ [in AMEV-UDC], when he concluded: '[T]heir Honours' judgment does not decide that relief against a penalty is available only when it is conditioned upon a breach of contract; to the contrary, it suggests that relief may be granted in cases of penalties for non-performance of a condition… on the basis that despite the absence of such an express promise, a penalty conditioned on failure of a condition is for these purposes in substance equivalent to a promise that the condition will be satisfied.'*
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> *75 … [T]he critical issue… [is] whether the sum agreed was commensurate with the interest protected by the bargain.*
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> *78 The upshot is that the restrictions upon the penalty doctrine urged by the Court of Appeal in Interstar should not be accepted. 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."* [emphasis added]

9 Accordingly, in Australia, the rule against penalties is now no longer confined to cases arising out of contractual breach. Despite this, the High Court provided no specific guidance as to the limits of the expanded doctrine, and even in *Andrews* itself left the issue of whether the charges in question were *actually* penalties to the trial judge. It is notable that UK courts have viewed *Andrews* as a "*radical departure*" from established doctrine: *Cavendish Square Holding BV v Makdessi* [2016] 2 All ER 519 at

541 (UK Supreme Court, Lord Neuberger of Abbotsbury PSC and Lord Sumption JSC, Lord Carnwath JSC agreeing).

10 In considering whether a term of a contract is penal in character, the test is generally whether the payment of the sum is extravagant, unconscionable or out of all proportion to the interests of the party which it is the purpose of the provision to protect: *Paciocco* at [29], [32] (Kiefel J, French CJ agreeing). A sum stipulated for payment on default is a penalty if it bears no relation to the possible damage to or interest of the innocent party: *Paciocco* at [32] (Kiefel J, French CJ agreeing). The issue is to be determined by a construction of the contract, including by reference to its "*inherent circumstances*" (including the consequences of a particular construction and the respective positions of the parties): *Paciocco* at [31].

The interest cases

11 In *Kellas-Sharpe v Psal Ltd* [2012] QCA 371, the Queensland Court of Appeal held that the requirement for payment of interest is a penalty where the rate increases for failing to make prompt payment (as distinct from where a lower rate is offered as an inducement to make prompt payment): [2]-[3] (McMurdo P), [32]-[49] Gotterson JA (McMurdo P and Fryberg J agreeing). In that case, the Court ultimately held that the provision in question was not a penalty because it was relevantly expressed to require payment of a different (higher) rate of interest if repayment of the loan was not made by the due date, but without any reference to that constituting a default. As a result, it was said to fall into that category of case where interest was expressed to be generally payable at a discounted rate to encourage compliance, rather than constituting an improper threat to charge a higher rate upon default: at [10]-[15], [32]-[49].

12 More recently, in *PT Thiess Contractors Indonesia v PT Arutmin Indonesia* [2015] QSC 123, Jackson J explained (at [153]) that "*the cases distinguish between a retrospective increase in the interest rate and a term which only prospectively increases the rate of interest from the date of default. The latter type of term is not subject to automatic avoidance*" (emphasis added). Critically, the Court went on to say (at [154]):

> *"[W]here automatic avoidance does not apply, the questions are whether the secondary stipulation of the higher interest rate is in the nature of security for and in terrorem of the satisfaction of the primary stipulation and the secondary stipulation imposes an additional detriment that is out of all*

proportion to the loss suffered by the obligee on the failure of the primary stipulation, or that is inordinate or extravagant or oppressive".

13 The decision in *PT Thiess Contractors Indonesia v PT Arutmin Indonesia* was recently cited with approval by the Supreme Court of NSW in *Re Funds in Court; Application of Mango Credit Pty Ltd* [2016] NSWSC 199. In that case, Lindsay J held (at [89]):

> *"…absent further consideration by the High Court, a first instance judge is bound to proceed on the basis that Andrews has not displaced the conventional rule governing differential interest rates…"*

14 In *Bay Bon Investments v Selvarajah* [2008] NSWSC 1251, White J noted that the doctrine of penalties was attracted in circumstances where there was a requirement to pay interest as damages for late repayment, if, as a matter of substance, the sum payable was not a genuine pre-estimate of the loss the plaintiff might suffer: at [47]. In similar terms to the reasoning in *PT Thiess Contractors Indonesia v PT Arutmin Indonesia*, White J went on to say (at [48]):

> *"[A] provision for the payment of interest at a higher rate after default which does not operate retrospectively is not a penalty provided it can be seen as a genuine pre-estimate of compensation for loss the lender would suffer by being kept out of its money (David Securities Pty Ltd v Commonwealth Bank of Australia (1990) 23 FCR 1 at 30, 31)."* [emphasis added]

15 In *Bay Bon Investments*, the default interest rates in question (under two separate loans) were 240% and 360% per annum. There was no evidence in that case establishing the likely or possible loss that would (or might) be suffered by the plaintiff upon non-repayment of the loans. White J accepted that the onus was on the defendant to show that the provision for default interest was a penalty, but went on to say, consistently with the general approach taken by courts to questions of onus and inferences:[1]

> *"51… [O]nce some evidence is adduced which may be sufficient to satisfy that onus, there is an evidentiary onus on the plaintiff to explain the nature of its business, the rates at which it is able to lend, and how, when the contracts were entered into, it would have been anticipated that the moneys would be re-deployed on repayment of the loans. This information was entirely in the plaintiff's camp. Evidence is to be weighed according to the power of a party*

[1] See, for example, *Katsilis v Broken Hill Pty Co Ltd* (1977) 18 ALR 181, 196-198 (Barwick CJ).

to produce it. Where facts are peculiar within the knowledge of one party, comparatively slight evidence may be sufficient to discharge the onus of proof lying on the opposite party".

16 White J held that in the absence of evidence from the plaintiff establishing that the default interest rates were a genuine pre-estimate of its loss, the default rates of 240% and 360% per annum were – as a result of the exorbitant nature of the rates themselves – enough to discharge the defendant's onus to establish that they were penalties: at [55]-[56].

17 In *Wu v Ling* [2016] NSWSC 322, a decision of the Court of Appeal published on 24 November 2016, Bergin CJ in Eq (with whom Leeming and Payne JJA agreed) noted (at [118]) that *Bay Bon Investments* remained good law following the High Court's decision in *Paciocco*. There is arguably nothing to contradict this position in the other recent case decided by a differently-constituted Court of Appeal, *Arab Bank Australia Ltd v Sayde Developments Pty Ltd* [2016] NSWCA 328, despite some superficial inconsistencies: in *Arab Bank*, the default interest rate was a fraction of the rate at issue in *Bay Bon Investments*, and *Bay Bon Investments* was apparently not drawn to the attention of the Court.

Case law in flux

18 As noted above, it is well-established that a contractual term which provides for the payment of additional interest on a retrospective basis is *ipso facto* a penalty. In addition, a term which provides for the payment of *additional* interest on a prospective basis is usually said to be a penalty if the obligation arises upon default. Conversely, a term which provides for the payment of interest on a prospective basis at a higher rate, arising because of the suspension of a right to pay a discounted rate of interest otherwise subsisting as a reward for prompt payment, is usually said *not* to be penal in nature.[2]

19 These rules reveal a strong focus on form over substance. Whilst historically sound, this approach is inconsistent with the reasoning in *Andrews* and the modern approach of generally favouring substance over form.

[2] Generally, it appears (or is at least arguable) that the general penalties doctrine continues to apply wherever the 'automatic avoidance' rule does not apply.

20 Why should a distinction be drawn between breach and non-breach (i.e. late payment default payment vs prompt payment reward) and prospective/ retrospective operation? The latter distinction *may* be defensible, as it inherently indicates the presence of punishment. This may properly result in the retention of the 'automatic avoidance' rule; however, the former distinction appears indefensible in light of *Andrews*. Despite this, single instance judges (and probably intermediate appellate courts) are unwilling to act, no doubt as a result of the chilling effect of statements made by certain members of the High Court in *Farah Constructions v Say-Dee* (2007) 230 CLR 89 and other like cases. As a result, it is likely that the High Court will need to resolve these questions.

21 Until then, default interest provisions are more likely to be upheld if they are prospective, structured initially as a discount rate expressed to be a reward for prompt payment (in the absence of which a higher rate would apply), calculated so as to avoid an extravagant disparity between the normal and default rates and factually defensible by reference to expected or potential financial or business losses.

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