A RECENT NEW ZEALAND STATEMENT ON THE LAW OF PENALTIES

BY JOHN GREEN

Many legal systems worldwide will not enforce contractual provisions which are penalties. However, the courts' desire to enforce parties' commercial bargains has led to inconsistent application and tortuous interpretation of the rule against penalties.

The recent decision of the New Zealand Court of Appeal in *Wilaci PTY Limited v Torchlight Fund No 1 LP (In rec)* [2017] NZCA 152 (2 May 2017) will be of interest to those operating in the construction sector as it provides an indication as to how New Zealand courts might treat liquidated damages clauses.

Torchlight was a private equity fund which was established in 2009 to invest in distressed assets. It is no longer active having transferred those assets to a Cayman Islands' entity. One of its investments involved the purchase of a debt from Bank of Scotland International totalling AUD$185m, of which Torchlight had repaid all but AUD $37m by mid-2012. Being in a difficult liquidity position to pay off the debt, Torchlight sought bridging finance from a Mr Grill, a wealthy Australian engineer, businessman and founder of the publicly listed WorleyParsons Limited.

Torchlight and Mr Grill entered into a 60-day contract in which Mr Grill would provide AUD$37m to discharge the debt. In return Torchlight would repay the principal with interest at 5.25% callable on day 60 (a total of $320,000), and an additional $5m due 120 days from the day

of the advance. The contract then stipulated for a 'late fee' of $500,000 per week for each week past the due date in which the principal was not repaid. Torchlight failed to make repayments and in 2013 was placed into receivership. Torchlight then disputed the payment of the 'late fee'. Two issues arose, namely whether the penalty doctrine was engaged at all by the 'late fee' clause, and second, whether the clause was properly characterised as a penalty or as a genuine pre-estimate of loss.

In October 2015, the High Court ruled that a late payment fee claimed by *Wilaci* was a *penalty fee* and was unenforceable. The High Court considered the clause engaged the penalty doctrine because it was collateral to the breach and therefore an obligation arising secondary to the obligation to repay. The defendant's claim that the fee provided for flexible repayment failed because the debt was callable upon day 60 under the contract.

Whilst the Court acknowledged the freedom to contract, it ultimately imposed the doctrine and held the clause unenforceable. On interpretation, the Court considered the surrounding circumstances and the intention of the parties. Although reluctant to deem the clause a penalty, the Court considered it was inserted '*in terrorem*' for the collateral purpose of enforcing repayment of the principal sum. Furthermore, the amount stipulated was considered disproportionate to any conceivable loss flowing from a breach. The clause was deemed a penalty clause and therefore was unenforceable.

It should be noted that this decision applied the law of New South Wales which the loan contract prescribed, rather than the law of New Zealand in relation to the penalties issue.

Wilaci appealed and on 2 May 2017, the Court of Appeal delivered its judgment and overturned the High Court ruling holding that the late payment fee in the loan agreement was not a penalty and ordering Torchlight to pay AUD$31.5 million in late payment fees to Wilaci plus interest accruing from 1 August 2015, compounding monthly to the date of payment.

The Court, following the approach of the UK Supreme Court in *Cavendish v Makdessi* and *ParkingEye v Beavis* and the later decision of the high Court of Australia in *Paciocco* (putting aside the question of whether the doctrine is now confined to cases arising out of breach of contract only, the approach taken in the judgments in *Paciocco* are consistent with (and draw upon) those in *Cavendish*) departed from the traditional Dunlop approach and noted the following relevant principles:

First, the dichotomy which Lord Dunedin concerned himself with between penalty and legitimate liquidated damages is a false one — or at least not exclusive. Rather, "*there may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden*". The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both.

Second, *Cavendish* reinstates the pre-Dunlop focus on whether the substituted obligation is unconscionable or extravagant (said usually to amount to the same thing) i.e the test proposed by Lords Neuberger and Sumption (with whom Lords Carnwath and Clark agreed) in *Cavendish* was *[W]hether 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.

Third, consistent with authorities in the more modern doctrine of unconscionability, relevant considerations include whether both parties are commercially astute, have relatively similar bargaining power and are advised. Compelling reason would be needed why ordinary principles of freedom of contract should not apply to such parties and the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach.

Fourth, the fact that a clause substituting one scale of performance for another is designed to deter breach of the former does not mean it is penal. As Lord Hodge noted in Cavendish, many (legitimate) contractual provisions are coercive in nature.

Fifth, the justification for the rule against penalties lies in an amalgam of Equity and the common law rule based on public policy. Its essential justification, in the face of the usual (and commercially important) principle of freedom of contract, is that a provision that has its sole or predominant purpose is to punish a contract breaker is contrary to public policy.

Sixth, the purpose of the law of contract is to satisfy performance expectations. It follows that the test for a penalty cannot simply involve a narrow comparison between contractually stipulated and alternative court-imposed damages. Only a gross disproportion compels the inference that the substituted obligation is really "punitive". The threshold, necessarily, is high.

Seventh, the fundamental question to be addressed, as Kiefel J observed in *Piacocco* is whether the substituted obligation is "*out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation*" or as Keane J observed (drawing on Cavendish), whether the substituted obligation "*is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract*" which in combination, express the rule in the law of New South Wales which the Court was required to apply.

Just what will be considered a "legitimate interest" by the courts remains somewhat unclear, but may include protecting a public/national/central government/local authority interest as was the case in the 1903 case of *Clydebank Engineering* (the leading English authority prior to Dunlop to which the 'legitimate interest' test may be traced back), protecting the interests and reputation of a person or entity such as a bank as in *Torchlight*, or protecting the reputation/standing of an industry or business sector as in *Cavendish*.

While *Torchlight* was determined by a New Zealand court, it was decided under the law of New South Wales. There are important and significant differences between the UK and Australia in relation to penalties and while Torchlight provides helpful guidance and an indicator as to how the courts in New Zealand might apply the penalty doctrine to liquidated damages clauses, vis when a liquidated damages provision is negotiated between legally advised, commercially astute parties with similar bargaining power it will be enforceable irrespective of the relationship between the agreed additional financial burden to be borne by the contract-breaker and the compensatory interests of the innocent party, the position in New Zealand remains to be determined in light of recent oversea authority by New Zealand Courts under New Zealand law.