THE LAW ACCORDING TO HONEY BEES: NZ TAKES STANCE ON PENALTY DOCTRINE LAW

Frank Brown and Iain Stephenson

Honey Bees Preschool Limited v 127 Hobson Street Limited [2018] NZHC 32

The recent High Court case of *Honey Bees Preschool Limited v 127 Hobson Street Limited* provides insight into 'so-called' penalty clauses – an accepted minefield to draft or enforce in the construction sector. The case gives recognition to contractual provisions which, while outwardly punitive, protect legitimate commercial interests. The case also gives rise to the question – if equality of bargaining power is an important factor when assessing the legitimacy of a penalty provision – how does one overcome the perception that in the construction sector the contractor has less bargaining power?

The case shows:

- The Court in New Zealand favours the UK position on penalty doctrine – an approach which allows less interference by the Court in the contractual terms negotiated between parties.

- Liquidated damages clauses will not be penalty clauses if they protect "legitimate interests" and legitimate interests can include attracting and retaining customers, suggesting that provided the liquidated damages clause is directly linked to the business interests of the party seeking to rely on it, the Court is likely to take the view that it reflects the "legitimate interests" of that party.

- A party who wishes to rely on the liquidated damages clause ought to keep a paper trail which evidences what those "legitimate interests" are because the Court may be willing to look at pre-contract correspondence between the parties in its assessment of whether a clause is a penalty.

A Lease and a Lift

In short, Honey Bees Preschool (**Honey Bees**) had a lease with 127 Hobson Street (**127**) as well as a contract which stated that 127 Hobson was to install a lift on the premises. If 127 Hobson did not install the lift on time, it had to indemnify Honey Bees for all obligations under the Lease (**Clause**). This indemnity had the effect of allowing Honey Bees to continue to occupy the premises for free (for approximately 2 years). 127 failed to install the lift and Honey Bees relied on the Clause; 127 argued that it was a penalty clause and therefore unenforceable. The court

held the Clause was not a penalty and was enforceable. For a detailed outline of the judgment, read the update from our litigation team here.

The Law According to Honey Bees

The law of penalties (also known as the 'Penalty Doctrine') applies to contracts which specify a sum payable by a party if it breaches the contract. Such clauses are usually described as liquidated damages clauses in the contract but if the Court decides that these clauses are penal, they will be unenforceable.

The Penalty Doctrine has recently been considered by the NZ Court of Appeal in *Wilaci PTY Limited v Torchlight Fund No 1 LP (In rec)* (you can read our article on the case here). We note that this case was decided under Australian law, not New Zealand Law, so the decision did not provide a final conclusion on the law of penalties in New Zealand. Nonetheless, the High Court in *Honey Bees* chose to adopt the framework set out in *Torchlight*:

- Is the stipulated remedy for breach out of all proportion to the legitimate performance interests of the innocent party, or otherwise exorbitant or unconscionable, having regard to those interests? According to *Torchlight* the Court can look at the following factors in making this assessment:

- whether the parties were commercially astute, had similar bargaining power and were independently advised; and

- whether the predominant purpose of the impugned clause is to punish (as opposed to simply deter) non-performance.

Under the traditional law relating to Penalty Doctrine, courts would only uphold liquidated damages clauses if the amount claimed was compensatory and represented a genuine pre-estimate of the party's loss resulting from the breach. It is now clear that deterrence can be acceptable and that contractual clauses negotiated between commercial parties of equal standing are less likely to be open to assessment by the courts. In light of *Honey Bees*, parties to contracts may not need to be so conservative when drafting clauses that provide for payment upon breach of contract.

Power and Penalties in the Construction Context

It remains to be seen how the "similar bargaining power" factor will play out in a construction context. It is clear that the equality of standing between parties is an important factor in the application of the Penalty Doctrine. In *Honey Bees*, the relevant provision provided protection to the tenant. In construction, such clauses generally protect the principal. There remains ample uncertainty about how a Court or decision-maker would evaluate the power balance between principal and contractor or head contractor and sub-contractor in the construction context when applying *Honey Bees*.

Recent problems in high-profile construction projects would suggest that there is not equality of bargaining power between parties in larger projects – but it is unclear whether the same can be said for other types of projects, or some sub-trades.

Penalty Doctrine Here and Abroad

Those drafting contracts can still find some comfort from *Honey Bees* in that the High Court has announced a preference for the UK position over the Australian as to *the type of* contractual clauses the Court can apply the Penalty Doctrine to. The UK position takes a more "hands off" approach to terms that have been agreed between the parties.

In the UK there must be a breach of a contractual term, that is, a party must fail to do something it was contractually obliged to do before the Court will even look at whether the liquidated damages clause is a penalty. The Court, however will not look at or assess whether the contractual obligation itself is a penalty.

In Australia, the current legal position is that the Court *can* assess whether a contractual clause is a penalty without a breach having to occur. This has played out in cases in which banks have charged fees to customers who had either failed to pay fees or exceeded their overdraft limits. The customers had not breached their contracts with their bank because the contracts, in these cases, allowed the customers to not pay their fees and exceed their overdraft limits. Nonetheless the Court was willing to assess whether or not the clauses that *allowed* the bank to charge fees were penalty clauses.

The distinction lies in the nature of the obligation captured by the contractual clause. In *Honey Bees*, the clause stipulating that 127 install the lift is what the Courts have called a "primary obligation". The contract did not allow 127 to not install the lift. It *had to* and the obligation under the Clause allowing Honey Bees to continue to occupy the premises for free was a "secondary obligation" imposed on 127 when it failed to do so.

Meanwhile, in Australia, the clauses about fees did not impose an obligation on the bank's customers to avoid exceeding their overdraft limits – they could opt to do so. But if they did, they had to pay a fee. The Courts have called these types of obligations, "conditional primary obligations" because the party can do something under the contract, as long as is it willing to pay the price.

ABOUT THE AUTHORS

Mark Addison
Consulting Principal
Keypoint Law

MARK ADDISION: *SETTLING AT MEDIATION: BE CAREFUL WITH THE TERMS*

Mark has 30 years' experience in the areas of insolvency, commercial disputes and litigation. He has acted for many of Australia's largest organisations, including listed companies, banks, large private companies, and government bodies both at the State and Commonwealth level. Mark has also represented a wide variety of Australia's insolvency practitioners in corporate and bankruptcy insolvency matters. Prior to joining Keypoint, Mark was a senior partner at DibbsBarker.

Mark is known for providing advice for value and works hard to achieve practical and commercial outcomes for his clients.

KEYPOINT LAW

Iain Stephenson
Senior Associate
MinterEllisonRuddWatts

IAIN STEPHENSON: *THE LAW ACCORDING TO HONEY BEES*

Iain is a Senior Associate in our Construction team and advises clients on both non-contentious and contentious residential property, commercial property and construction matters, having been involved in some of the more significant infrastructure and housing projects in New Zealand in recent times. Iain has significant experience in defective and non-compliant building disputes including acting in the largest residential and commercial defective building proceedings in New Zealand.

Iain is an expert in the management and governance of apartment buildings and multi-unit developments, including for new builds, existing builds, refurbishments, remedial works and, post-project defects and governance disputes.

MinterEllisonRuddWatts