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# Convergence between Australian common law and English common law: The rule against penalties in the age of freedom of contract

Man YIP
*Singapore Management University, School of Law*, manyip@smu.edu.sg

Yihan GOH
*Singapore Management University*, yihangoh@smu.edu.sg



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# Convergence between Australian common law and English common law: The rule against penalties in the age of freedom of contract

**Man Yip[1] and Yihan Goh[1]**

**Abstract**
This note discusses the High Court of Australia decision of *Paciocco* v *Australia and New Zealand Bank Group Limited* on the rule against penalty clauses and situates its importance in light of the UK Supreme Court decision of *Cavendish Square Holding BV* v *Talal El Makdessi and Beavis* v *ParkingEye Ltd*. It compares the analytical frameworks laid down in the two cases and points out some unresolved issues in this area of law even following these cases.

**Keywords**
bank charges, contract, penalty clauses, rule against penalty clauses, freedom of contract

## Introduction

As French CJ observed in *Paciocco* v *Australia and New Zealand Bank Group Limited*,[1] '[t]here has been much activity' concerning the contractual rule against penalties (the 'penalty rule') within the common law world. The first major development occurred in *Andrews* v *Australian and New Zealand Banking Group Ltd*,[2] where the High Court of Australia extended the penalty rule to cover contractual provisions triggered other than by breach. However, the UK Supreme Court, in the subsequent joint appeals of *Cavendish Square Holding BV* v *Talal El Makdessi and Beavis* v *ParkingEye Ltd*,[3] declined to follow this Australian development.[4] It confirmed that the English penalty rule would only apply to secondary obligations (the breach limitation). But Australian law and English law did not continue on divergent paths. While the expanded ambit established in *Andrews* was retained in *Paciocco*,[5] the High Court of

[1] School of Law, Singapore Management University, Singapore

**Corresponding author:**
Yihan Goh, School of Law, Singapore Management University, Lee Kong Chian School of Business Building, 50 Stamford Road, Level 4, 178899 Singapore.
Email: gohyihan@smu.edu.sg

Australia's renewed approach in determining whether a provision is a penalty is in agreement with the UK Supreme Court's approach in *Cavendish*, that is, a clause will be struck down as a penalty if the stipulated consequences are entirely 'out of proportion' with the interests of the party seeking to rely on the clause. The highly anticipated *Paciocco* judgement therefore confirms that Australian law, converging with English law, treats the modern penalty rule as an exception to the principle of party autonomy and is to be restrictively applied. This commentary focuses on the common law penalty rule, in particular, by comparing the Australian development with the English position.

## Facts and holding

*Paciocco* concerned the enforceability of late payment fees for consumer credit card accounts. Such fees are typically charged if the required payable amount remains outstanding by a specified date. In other words, the late payment fee provisions were triggered by breach of contract, thereby falling within the traditional scope of the penalty rule. In *Paciocco*, Mr Paciocco, head of the representative proceedings, argued that such late payment fees charged by the bank were penalties. Alternatively, he argued that the charging of the late payment fees contravened various Australian legislative provisions.[6]

Gordon J, the judge at first instance, held that the late payment fees were penalties. In determining whether the fees were extravagant, she took the view that the only relevant losses suffered by the bank from late payments were the direct costs spent on recovering those payments.[7] She rejected the bank's expert evidence that the bank also incurred other losses, such as loss provision costs and regulatory capital costs. These costs in her view were part of the costs of operating a bank in Australia and thus irrelevant to an assessment of the bank's damage in the event of late payment. Accordingly, she found that the late payment fees far exceeded the damages that the bank could legitimately recover had it sued for breach of the obligation to repay by the specified date. On appeal, the Full Court of the Federal Court, taking a wider view of the losses that the bank would suffer arising from late payments, overruled Gordon J's decision on late payment fees.[8] The Full Court held that the test to determine if a stipulated sum was a penalty was whether that sum was commensurate with the interest to be protected. Applying that test, and having taken a wider view of what would count as relevant losses/costs to the bank, the Full Court concluded that the late payment fees were not extravagant and hence not penalties.[9]

The majority of the High Court (consisting of French CJ, Kiefel, Gaegler and Keane JJ) dismissed the appeal on both the common law penalty rule as well as the statutory claims. On the common law penalty rule, agreeing with the Full Court, the High Court affirmed that the bank had an interest in the timely repayment of credit and that late payments would damage it in respect of operational costs, loss provisioning and increases in regulatory capital costs. Based on the evidence of the bank's expert, which addressed these categories of losses, the High Court concluded that the late payment fees imposed were not out of all proportion to the bank's financial interests. Indeed, Keane J considered it difficult to treat the purpose behind such late payment fees as to punish customers. Instead, he considered that late payment fees could constitute a stream of revenue for the bank, similar to how it charged similar fees from other facilities available to customers.

In reaching this conclusion, the majority engaged in a lengthy discussion on the legal principles. The principles enunciated by the House of Lords in *Dunlop Pneumatic Tyre Co Ltd* v *New Garage and Motor Co Ltd*[10] and by the High Court in *Andrews* continue to be good law in Australia, although Lord Dunedin's famous 'tests'[11] in *Dunlop Pneumatic* require a reconsideration in

modern times. Consistent with the views of Lords Neuberger and Sumption (with whom Lord Carnwath agreed) in *Cavendish*,[12] Kiefel, Gageler and Keane JJ, writing separately, clarified[13] that Lord Dunedin's tests are to be treated as a guide, as opposed to rules for determining if a stipulation is a penalty. It was emphasized that Lord Dunedin's tests were developed based on the language[14] and wisdom of the time, but that the modern understanding of economic reality and financial risks borne by a bank as a result of late payments by customers is markedly different.[15] Kiefel J pointed out that the unarticulated policy underlying these tests is that a sum may not be charged upon breach if the purpose and effect of its provision is to threaten or punish the defaulting party. The pertinent question is whether the provision is 'out of all proportion'[16] to the innocent party's commercial interests, and those interests may go beyond seeking compensation for loss. In this connection, the majority stressed the importance of freedom of contract in the contemporary application of the penalty rule: that is, the courts will not lightly find a contractual provision to be unenforceable as a penalty.[17]

Dissenting, Nettle J held that the late payment fees were penalties because there was no evidence that the bank had any other interest to be protected by the timely payment of outstanding sums by its customers, save for the avoidance of costs. He was of the view[18] that the present case was a straightforward one to which Lord Dunedin's test 4(c) that: 'there is a presumption that a single lump sum is a penalty if it is payable on the occurrence of one or more of the several events of which some may occasion serious damage and others do not' could be applied. In addition, Nettle J preferred Gordon J's narrow view of the bank's losses in the determination of whether a clause is penal. He rejected the bank's expert evidence as being relevant to rebutting the presumption because it presented projections of potential costs that were not actually incurred.[19]

## The Australian penalty rule after *Paciocco*: Convergence and divergence with English law

### *Analytical framework*

Following *Paciocco*, the analytical framework of the penalty rule under Australian law is a two-stage process. At the threshold stage, the court needs to decide whether the disputed provision attracts the application of the penalty rule. Post-*Andrews*, this essentially involves the court distinguishing between a 'collateral stipulation' that imposes an additional detriment and an 'alternative stipulation' that provides for 'further accommodation'.[20] The former stipulation engages the penalty rule but not the latter. The second stage of the analysis, post-*Paciocco*, requires the court to decide whether the provision is a penalty by considering whether the stipulated consequences are out of all proportion to the legitimate commercial interests of the party seeking to rely on it. A party's commercial interests are to be determined by considering the wider background of the transaction.

The Australian framework bears some similarities to the two-stage English framework post-*Cavendish*. Under English law, the threshold stage similarly considers whether a clause falls within the scope of the penalty rule but the distinction is to be drawn between a primary obligation and a secondary obligation.[21] English law continues to apply the breach limitation to its penalty rule. On determining that a provision is a penalty, the second stage of the English framework asks whether the secondary obligation is clearly excessive in relation to the innocent party's legitimate interest. This corresponds largely to the second stage of the Australian framework. Notwithstanding the more expansive scope of the Australian rule, the

enforceability of a clause will be controlled by the second stage under both the English and Australian approaches. The difference between them is that a broader range of clauses would bring the Australian penalty rule into play, even though the Australian approach is unlikely to produce a different outcome from the English approach in many cases.

Whether the Australian or English first stage of analysis (that is, the distinction between collateral/alternative stipulations and that between primary/secondary obligations) is more appropriate is best left for detailed discussion on a different occasion. What should be noted is that neither distinction, determined by way of contractual construction, is easy to draw in practice. The difficulty of the English exercise is amply illustrated by the ambivalence of views of the various Supreme Court Justices in *Cavendish* as to whether the clause in the *Makdessi* appeal was a primary or secondary obligation. The collateral alternative distinction under the Australian framework is no less straightforward. An example of an alternative stipulation given by the High Court in *Andrews* was the disputed provision in *Metro-Goldwyn-Mayer Pty Ltd* v *Greenham*.[22] That case concerned a contract for the hiring of films to exhibitors for public showing pursuant to which the exhibitor was entitled to one showing at a particular time. The contract further prescribed a fee four times the original fee for each additional showing. Such a stipulation is to be characterized as 'alternative' and would not engage the Australian penalty rule. Nevertheless, the complexity of modern transactions matched by the complexity of contractual drafting would render this an exercise of construction, which is equally required by the Australian collateral alternative distinction, vigorous and challenging. As Peel commented, the Australian approach has simply moved 'some of the problems associated with the breach limitation to a different place' (Peel, 2013: 155).

## *Freedom of contract*

More explicitly than *Cavendish*, *Paciocco* affirmed the importance of freedom of contract. The principle of freedom of contract circumscribes the application of the penalty rule in both jurisdictions. This form of party autonomy is, however, subservient to other more important social values (Worthington, 2016) when the penalty rule is invoked, most notably, safeguarding against certain forms of inequality of bargaining power and impropriety in contracting. The alternative statutory claims in the *ParkingEye* appeal in *Cavendish* (concerning parking charges) as well as *Paciocco* are telling as to how these values are upheld in contemporary law and society. Legislation, aimed at specific forms of unacceptable conduct or terms in certain kinds of contracts, such as the Unfair Contract Terms Act has done with respect to consumer contracts, has assumed the paternalistic role and provided greater precision than the blunt common law rule which was historically developed to regulate a specific kind of transaction, the penal bond.[23] Indeed, the common law now plays a subsidiary, supporting role: chiefly, to operate where legislation has not intervened.[24] Therefore, neither English law nor Australian law has opted for the abolition of the penalty rule. Importantly, the precise interplay between statute and common law in a particular jurisdiction will determine the form that its penalty rule takes as well as future incremental development, notwithstanding the common English origin. For this reason, French CJ said in *Paciocco* that '[i]t may be that in this country statutory law reform offers more promise than debates about the true reading of English legal history'.[25]

Yet, how is one to explain the expansion of scope of the Australian penalty rule in *Andrews*, in disregard of the endorsement of 'freedom of contract' in earlier cases?[26] On this, one must not forget Gummow J (a well-known non-fusionist) had contributed to the joint judgement in *Andrew*s—an erudite lesson on English legal history—which affirmed that the penalty rule,

originating from equity, did not impose a breach precondition and that this equitable version continues to exist today.[27] *Paciocco* did not challenge this broadened scope but it did, quite rightly in our view, limit the practical reach of the penalty rule.

## *Out of all proportion: Commercial interests, losses and economic reality*

Overall, *Paciocco*, compared with *Cavendish*, offers less guidance on how the court is to determine whether the stipulated consequences are out of all proportion to the commercial interests of the party seeking to rely upon the contractual provision. What the majority in *Paciocco* has said is that the exercise involves a quantitative aspect. The late payment fee was charged either at AUD 35 or AUD 20, which was well below the figures assessed by the bank's expert having regard to the provisioning costs, regulatory capital costs and operational costs that could potentially be incurred by the bank in the event of late payment. What is unclear is whether the Australian measuring exercise is only or largely concerned with numbers and nothing else.

One matter merits some attention. Keane J briefly mentioned that Mr Paciocco in the case had 'freely risked incurring the late payment fee as a matter of his own convenience'.[28] Keane J reasoned that it could thus be inferred that the late payment fee charged in the particular commercial context was 'an acceptable cost of avoiding the expense and inconvenience of meeting his obligations as to timely payment of his account'—an inference that militated against a finding that the late payment fee was penal in effect. Nevertheless, that one customer could choose to freely risk incurring the fee is not itself indicative that the cost is objectively reasonable or acceptable, for another customer with insubstantial means might not have the luxury of choice.

In *Cavendish*, on the other hand, the Supreme Court highlighted factors such as reasonable notice of the allegedly penal term, difference in bargaining power between the parties, whether legal advice was obtained prior to the entry into the contract and whether the innocent party's legitimate interests had been made known to the other party at the time of contracting. The High Court in *Paciocco* did not explicitly discuss any of these factors. One cannot therefore assume that these factors are relevant under the Australian test. The Australian out of all proportion test emerged in a dispute that also raised multiple statutory claims which more directly address these other concerns. As discussed above, the legislative backdrop, which necessarily differs from jurisdiction to jurisdiction, has a decisive influence on the development of common law principles in this day and age. Accordingly, factors formulated in a different jurisdiction should not be transposed without question into another jurisdiction. It may also be that the quantitative measurement was more than sufficient to dispose of the appeal. Yet, it remains to be seen if the Australian penalty rule would in future developments consider qualitative factors directed at the quality of consent, such as the difference in bargaining power or coercive conduct at the time of contracting.

Practically, what *Paciocco* does usefully explain is how banks may legitimately price for lending, by reference to the categories of losses which the majority affirmed as relevant in the determination of whether the late payment fee provisions were penalties. In short, a bank is not limited to a genuine pre-estimate of its losses arising from the customer's breach when it contractually stipulates for a sum to be charged for late repayment. Indeed, Keane J explicitly acknowledged that one of the bank's legitimate interests is profitable lending on the basis of timeous repayment by its customers, which would be different from profitable lending on the basis of late repayment.[29] The bank is thus entitled to charge for more than what it could recover as damages for breach of contract. Gageler J said, in a similar vein, that the bank 'was not confined by a principle of law to adopting a pricing strategy for its credit card products which

involved cross-subsidisation'.[30] The 'business for profit' consideration also featured in Lord Mance's analysis in the *ParkingEye* appeal. He commented that one relevant consideration was that the specialist car park operator in the case, who imposed a parking charge on overstaying motorists, had to profit from its endeavour beyond recovering its costs of operation.[31]

At their core, *Paciocco* and *Cavendish* indicate judicial acknowledgement that courts are not best placed to measure the impact non-observance of contractual obligations has on businesses. The investigation into the wider commercial interests and the out of all proportion test (as opposed to requiring mere disproportionality) are avenues through which the courts can flexibly grapple with the commercial reality and effect a more practically relevant value judgement on the issue of enforceability. As a matter of law, while *Dunlop Pneumatic* remains good law in the sense of providing guiding considerations, it does not appear that there will be many simple and straightforward cases to which Lord Dunedin's tests can be directly applied. The *ParkingEye* appeals in *Cavendish* concerning parking charges imposed on motorists who overstayed the free 2-h maximum stay came the closest to being a simple and straightforward case. And yet, the Supreme Court in *Cavendish* did not apply Lord Dunedin's tests directly in reaching its conclusion. Keane J in *Paciocco* agreed with the Supreme Court's reasoning;[32] none of the other High Court Justices objected to the outcome.

### *Unresolved issues*

Finally, there are two unresolved issues of practical importance under Australian law. First, in *Cavendish*, Lords Mance and Hodge said that a contracting party's legitimate interests are not limited to commercial interests.[33] In *Paciocco*, however, the majority of the High Court had described a contracting party's legitimate interests as being of 'commercial', 'business' or 'financial' nature.[34] It has been argued elsewhere that legitimate non-commercial interests may include an interest in national security such as was found in *AG* v *Blake*,[35] a case on account of profits for breach of contract. In *Blake*, a double agent who published a book on his secret services work was sued by the Crown for the profits he had earned from the publication. The House of Lords awarded an account of profits, which is available exceptionally for breach of contract, on the basis that compensation for losses suffered by the Crown would not be sufficient in the case to protect the Crown's legitimate interest of ensuring that secret service could operate in complete confidence for national security concerns. We see no reason why such a kind of non-commercial interest cannot justify the stipulation of consequences by contract that go beyond compensation for loss. Importantly, there are many non-commercial contracts which contain stipulations designed to deter breach of contract that may be challenged as penalties.

Secondly, a point that has yet to be considered by the Australian and English courts alike is whether provisions that stipulate for consequences in respect of the same event (e.g. breach) could cumulatively be regarded as penal and unenforceable, even though each considered individually is not out of all proportion to the legitimate interests of the party seeking to rely on them. It is arguable that the court should take into account the cumulative effect of provisions, especially in a case where the provisions are being invoked together, thereby intensifying the ultimate impact. A resolution of this issue will have an important bearing on drafting practice.

## Conclusion

In closing, it might be worth noting that other common law courts have begun to deal with the implications of *Cavendish*. For example, in the recent Singapore High Court decision of

*iTronic Holdings Pte Ltd* v *Tan Swee Leon*,[36] George Wei J acknowledged the pending importance of *Cavendish* in Singapore law. Subsequently, in the Singapore High Court case of *Allplus Holdings Pte Ltd* v *Phoon Wui Nyen (Pan Weiyuan)*,[37] Foo Tuat Yien JC applied the distinction drawn in *Cavendish* between primary and secondary obligations. As such, the refinement of the penalty rule in Australia and England will impact the rest of the common law world, even as those jurisdictions also strive to formulate the penalty rule in a form consistent with their unique situations.

The development of the rule against penalties cannot escape from generalized statements that the interest should to be protected is 'legitimate' or that the financial repercussions are not out of all proportion. In the end, however, the proper test is framed, the key to understanding the penalty rule is its central purpose in balancing the parties' freedom to protect their interests contractually, and the law's residual interest in ensuring that that freedom is not exercised improperly. While there will be a degree of value judgement in assessing what is or is not proper, that perhaps is the best approach to take in an area underlined by commercial realities and pragmatism.


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## Notes

1. [2016] HCA 28 at [10] (*Paciocco*).
2. [2012] 247 CLR 205 (*Andrews*).
3. [2015] 3 WLR 1373 (*Cavendish*).
4. Cf. Peel (2013); Davies and Turner (2013).
5. Above n. 1.
6. Various statutory claims were brought against the bank: (a) for engaging in unconscionable conduct under the Australian Securities and Investments Commission Act 2001 (Cth) and the Fair Trading Act 1999 (Victoria); (b) the contracts were unjust transactions under the National Credit Code; and (c) the late payment fee provisions were unfair terms under the Australian Securities and Investments Commission Act 2001 (Cth) and the Fair Trading Act 1999 (Victoria).
7. *Paciocco* v *Australia and New Zealand Banking Group Ltd* [2014] 309 ALR 249.
8. *Paciocco* v *Australia and New Zealand Banking Group Ltd* [2015] 236 FCR 199.
9. Gordon J heard statutory claims mounted in respect of other fees charged by the bank. For completeness, it should also be mentioned that the Full Court dismissed the statutory claims, which were not brought before Gordon J.
10. [1915] AC 79 (*Dunlop Pneumatic*).
11. *Ibid.* at 86–87.
12. Above n. 3 at [22].

13. Above n. 1 at [30]–[41] (per Kiefel J, with whom French CJ agreed); at [141]–[151] (per Gageler J); at [260]–[270] (per Keane J).
14. *Ibid.* at [32] (per Kiefel J).
15. *Ibid.* at [264] (per Keane J).
16. *Ibid.* at [54] and [68] (per Kiefel J) and at [256] (per Keane J); at [173] (per Gageler J) was of the same view, although he used the language of 'grossly disproportionate'.
17. *Ibid.* at [54] (per Kiefel J); at [156] (per Gageler J); at [220]–[221] and [251] (per Keane J).
18. *Ibid.* at [322] and [348].
19. *Ibid.* at [349].
20. Above n. 2 at [10] and [79]–[80].
21. For a discussion of the chief problems with the primary–secondary obligation distinction, see Harder (2013).
22. [1966] 2 NSWLR 717.
23. Simpson (1966). Another example is the decision of the UK Supreme Court in *Office of Fair Trading v Abbey National plc* [2009] All ER (D) 271 that overdraft charges formed the basis of providing other customers with free current account facilities. Although the case was not decided by the application of the penalty rule, and turned on a technical issue regarding the Unfair Terms in Consumer Contracts Regulations, there was no doubt that the penalty rule was potentially relevant. We would like to thank Professor Keith Stanton for bringing this point to our attention.
24. Above n. 3 at [38] (per Lord Neuberger, Lord Sumption and Lord Carnwath); at [167] (per Lord Mance); at [260] (per Lord Hodge).
25. Above n. 1 at [10].
26. See, for example, *Ringrow Pty Ltd* v *BP Australia Pty Ltd* [2005] 224 CLR 645 at 669.
27. See a searing analysis of *Andrews* by Carter et al. (2013).
28. Above n. 1 at [267].
29. *Ibid.* at [278].
30. *Ibid.* at [172].
31. Above n. 1 at [198].
32. *Ibid*. at [266]–[267].
33. Above n. 3 at [162] (per Lord Mance) and at [256] (per Lord Hodge).
34. Above n. 1 at [29] and [35] (per Kiefel J); at [172]–[173] (per Gageler J); at [256] (per Keane J).
35. [2001] 1 AC 268.
36. [2016] 3 SLR 663.
37. [2016] SGHC 144.

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