

Penalties in Contract

The basic principle of Australian contract law is freedom of contract. However, like freedom in general, freedom of contract is subject to limitations.

One such limitation is that a provision in a contract that seeks to impose a penalty on a contracting party, is not enforceable.

What is a penalty?

In its basic form, a penalty is a requirement in a contract whereby one party, who breaches a certain clause in the contract, is obliged to pay a sum of money to the party who is not in breach. The courts have historically taken the view that if the amount to be paid to the innocent party bears no relationship to, or is much greater than, or is out of all proportion to, the damage or loss suffered by the innocent party, the obligation to make the payment will be regarded as a penalty and, as such, not be enforceable.

ANZ bank charges

On 26 July 2016, the High Court of Australia handed down its decision in *Paciocco v Australia and New Zealand Banking Group Limited* (ANZ)^[1]. One of the questions the court had to consider was whether credit card late payment fees charged by ANZ are penalties. If a penalty, the bank would not be allowed to charge such fees.

The court had to consider and determine what is the appropriate test to determine whether an amount required to be paid by one party to another is a penalty.

The court referred to the test expounded in 1915 in the *Dunlop Pneumatic Tyre case*^[2]. In this case, the court formulated the test of whether a payment is a penalty as being whether the payment is "extravagant" and "unconscionable" when compared to the "greatest loss that could conceivably be proved to have followed from the breach." In other words, if the amount to be paid is plainly excessive in comparison to the interest of the innocent party that is sought to be protected, the payment would be regarded as a penalty.

Also, where it is not possible or extremely difficult to predict what the amount of the loss to the innocent party would be, then so long as the amount of the payment was a "genuine pre-estimate" of the possible damage that the innocent party would suffer, the amount would not be construed as a penalty.

In the ANZ case, the late payment fee was fixed at \$35 until December 2009 and from then, at \$20. In the court of first instance, the primary judge accepted that whilst the actual losses suffered by ANZ could not be precisely determined, they were probably no more than \$3 for each event of late payment--- clearly much less than the \$20 or \$35 charged as a late payment fee.

The High Court held that the late payment charges were not penalties and dismissed the appeal with costs.

Why was the ANZ late payment fee not a penalty?

The High Court did not deviate from previous authority. It is still accepted that a payment will be a penalty if the amount is extravagant or out of all proportion to any legitimate interest of the innocent party.

However, what the High Court made clear is that when considering whether the amount is excessive or out of proportion to the damage or loss suffered by the innocent party, the question is not what the innocent party could recover in an action for breach of contract, but rather whether the costs to the innocent party and the effects upon its financial interests by the default can be taken into account in assessing whether the payment is a penalty.

In the ANZ case, the court accepted that when credit card payments are late, the added costs to the bank and also the effect late payments have on its other financial interests may be taken into account. For example, it was accepted that late payments on credit cards impacted upon ANZ's operational costs, loss provisioning and regulatory capital costs. As such, when taking into account these factors, the court was satisfied that the late payment fee was not out of proportion to the legitimate financial interests that the bank was seeking to protect.

Conclusion

The High Court has given a boost to freedom of contract, by effectively broadening the range of financial interests one may consider when determining whether a payment is out of all proportion to the financial costs of the innocent party. Certainly, the considerations are not limited to a narrow set of metrics. Instead, the entire business of the innocent party and how it could be affected by the breach, may be taken into account.

In our next issue we will consider whether some clauses that are typically included in commercial contracts, such as shareholders agreements, could be considered to be penalties even where they do not require one party to pay an amount to another.

[1] [2016] HCA 28.

[2] *Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Company Ltd* [1915] AC 79.