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CONSTRUCTION UPDATE

PENAL OR NOT PENAL?

THE PERENNIAL DEBATE CONTINUES WITH A STING IN THE TAIL

The doctrine of penalty has often been debated, yet the applicable law is still in the making. Recent decisions by Australian and UK courts are the latest in a series of cases which demonstrate the unsettled nature of the doctrine. Contracting parties should keep abreast of the applicable law including new case authorities to avoid an unwitting application of the doctrine which comes with a sting in the tail. This is particularly important for principals and contractors engaging in cross-border projects as laws vary between different countries.

WHAT IS A *"PENALTY"*?

A clause is a penalty if it imposes an obligation on the defaulting party to compensate the innocent party in a specified sum that is extravagant or unconscionable, such that, it is out of proportion or not a genuine pre-estimate of loss likely to be suffered. Such a clause is void under the penalty doctrine. Under the traditional view, the doctrine applies only if there is a breach of contract which triggers the defaulting party's obligation to compensate the innocent party.

CURRENT POSITION DOWN UNDER

In Australia, the courts have departed from the traditional view by extending the scope of the penalty doctrine to a much broader range of matters. This departure was first marked by the High Court's decision in *Andrews v ANZ* (2012) 247 CLR 205.

The case concerned certain bank terms which were the subject of a class action commenced by aggrieved bank customers. The customers contended that the terms which required payment of bank fees for a dishonoured cheque, late payment or exceeding an account limit were void as penalty provisions. The issue at point was whether the penalty doctrine could be applied despite the absence of a breach of contract. The Australian High Court held that terms such as those requiring payment of the bank fees despite not being triggered by a breach of contract could still constitute penalty provisions in equity. It was further held that a collateral stipulation requiring a payment could be characterised as a penalty if it purports to secure the performance of a primary

stipulation and imposes an additional benefit for the promisee or additional detriment for the promisor for non-performance.

The doctrine was recently revisited in *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50 which concerned another similar class action commenced by bank customers. The Full Federal Court nonetheless held that the late payment fees charged by the bank were not penalties both at common law and in equity as the fees were not extravagant, exorbitant or unconscionable. The bank customers have since been granted special leave to appeal to the High Court.

At present, Australian law on the penalty doctrine appears unsettled pending the outcome of the appeal. It is worth noting against this background that the UK Supreme Court recently referred to the Australian High Court's decision in *Andrews v ANZ* as a "*radical departure*" from the existing law.

THE RECENT UK SUPREME COURT DECISION IN *CAVENDISH SQUARE HOLDING BV V TALAL EL MAKDESSI* AND *PARKINGEYE LIMITED V BEAVIS* [2015] UKSC 67

The case in *Cavendish* concerned the sale of a share in a marketing company. The sale contract stipulated that upon the vendor's breach of certain restrictive covenants the vendor would no longer receive instalment payments and must sell its share at a specified reduced price. The case in *ParkingEye* concerned a car park contract under which a fee was charged for exceeding the maximum stay in the car park. Both arrangements were challenged under the penalty doctrine.

The UK Supreme Court disapproved the Australian High Court's position taken in *Andrews v ANZ* and held that only a term triggered by a breach of contract could be considered a penalty provision. The UK Supreme Court also considered the notion of "*genuine pre-estimate of loss*" to be unhelpful and outlined a new UK formulation of the penalty doctrine, namely that a penalty 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*."

Applying the new test, the UK Supreme Court held that the clauses concerned in Cavendish were not considered to be penalty provisions because the loss of entitlement to instalments was deemed to be a primary obligation, and not a secondary obligation. Moreover, the reduction in consideration for the vendor's share of the company for breaching the restrictive covenants was held to be an appropriate amount to protect the buyer's legitimate interests. The parking charge in *ParkingEye* was also held not to be a penalty on the basis that the car park owner's legitimate interests were adequately reflected in the amount of the charge.

The UK decision in *Cavendish* and *ParkingEye* is not binding in Australia, and the Australian High Court is unlikely to follow it as Australian law on the penalty doctrine has clearly diverged from that of the UK. The UK decision, however, may prompt clearer guidance from the High Court on the scope of the penalty doctrine which has been plagued by uncertainty following the decision in *Andrews v ANZ.*

OTHER JURISDICTIONS

It is important that contracting parties carrying out cross-border projects in other countries make themselves familiar with the applicable laws in those jurisdictions relating to the penalty doctrine. We can provide more information about the relevant laws of other jurisdictions upon request.

IMPLICATIONS FOR CONSTRUCTION CONTRACTS

The penalty doctrine has significant implications for construction contracts. Careful consideration should be given to certain terms of the contracts which may unwittingly attract the penalty doctrine. When Australian law applies as the governing law, the contracting parties should at least consider the following in the light of the recent case authorities.

- ***Liquidated damages clause:*** Liquidated damages may constitute a penalty if the amount payable does not constitute a "*genuine pre-estimate of loss*" and is extravagant or unconscionable in comparison with the loss anticipated as at the date of contract to arise from the breach. To prove that the amount payable is a genuine pre-estimate of loss, one should keep all records of the calculation for the amount at the time of entering into the contract as supporting evidence for the

calculation although the proof of actual loss is not required.

- ***Time bar clause:*** A time bar clause prevents the contractor from making a claim against the principal outside a specified time limit. Following the decision in *Andrews v ANZ*, it has often been argued that a time bar clause may constitute a penalty provision. Such an argument may be avoided by drafting the clause in such a way that the contractor's entitlement to a claim is made contingent upon the making of the claim within time. If the claim is made out of time, no entitlement accrues and therefore the penalty doctrine should not apply as no forfeiture of entitlement has ever occurred.

The penalty doctrine has often sparked controversies due to the uncertainty as to the scope of its application particularly in Australia. As the law on the penalty doctrine continues to develop further, contracting parties should stay alert to any new case authorities which may emerge and ensure that their standard form contracts are up-to-date and comply with the relevant law applicable to their contracts. In case of uncertainty, legal advice should be sought.

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MORE INFORMATION

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