Liquidated Damages and Penalties

Presented by Gavan Mackenzie

Senior Associate, DLA Piper

Aims

DLA PIPER

- To review recent developments in the penalty doctrine.
- To understand when the penalty doctrine applies.
- To understand when a penalty may exist.
- To understand the law on liquidated damages.
- To understand the difference between liquidated damages and penalties.
- To discuss some practical tips.

Outline

DLA PIPER

- Background
  - What are penalties?
  - What are liquidated damages?
  - Historical application of the penalty doctrine
- The expanded penalty doctrine
  - *Andrews v ANZ*
- Applying the *Andrews* test
  - *Paciocco v ANZ*
  - *Cedar Meats*
  - *Other recent cases*
- When are liquidated damages penalties?
- Practical considerations for liquidated damages.

Background

- **Penalty**:
  - A payment of money stipulated as *in terrorem* of the offending party (i.e. as a deterrent).
  - Extravagant and unconscionable sum.
  - Founded on equitable principles – designed to protect parties from contractual terms which are unconscionable.
- **Liquidated damages**:
  - A provision in a contract that fixes a pre-agreed sum payable as damages for a party's breach of contract.

Penalty doctrine pre *Andrews*

- A provision that is a penalty is unenforceable.
- Arises on breach of contract.
- A provision is a penalty when it acts as 'punishment'.
  - Not a genuine pre-estimate of the loss.
  - Out of all proportion.
  - Extravagant and unconscionable in amount.
- Use of "penalty" or "liquidated damages" is not conclusive.
- Question of construction to be decided upon the terms and circumstances of each particular contract, judged at the time the contract was made.

Andrews v ANZ

- Facts:
  - Class action against the ANZ Bank by thousands of group members.
  - Attempting to recoup $223 million in fees they claimed were penalties – fees included late credit card payments, honour, dishonour, non-payment, and over limit fees.
  - Argued that terms requiring payment of fees were unenforceable as penalties.
- First instance:
  - Doctrine against penalties did not apply because the fees were *not* charged upon breach of contract.
  - The fees were to 'afford or decline the provision of further accommodation to the customer'.

Penalty doctrine after *Andrews*

- The penalty doctrine may apply even if there is not a breach of contract.

> *'[A] stipulation prima facie imposes a penalty on a party ("the first party") if, as a matter of substance, it is collateral (or accessory) to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party.'*

- A penalty is enforceable to the extent of the actual loss.
- It is not a penalty if the stipulation is consideration for an additional obligation.
- It is not a penalty if the amount payable is a genuine pre-estimate of the loss suffered.

Paciocco v ANZ

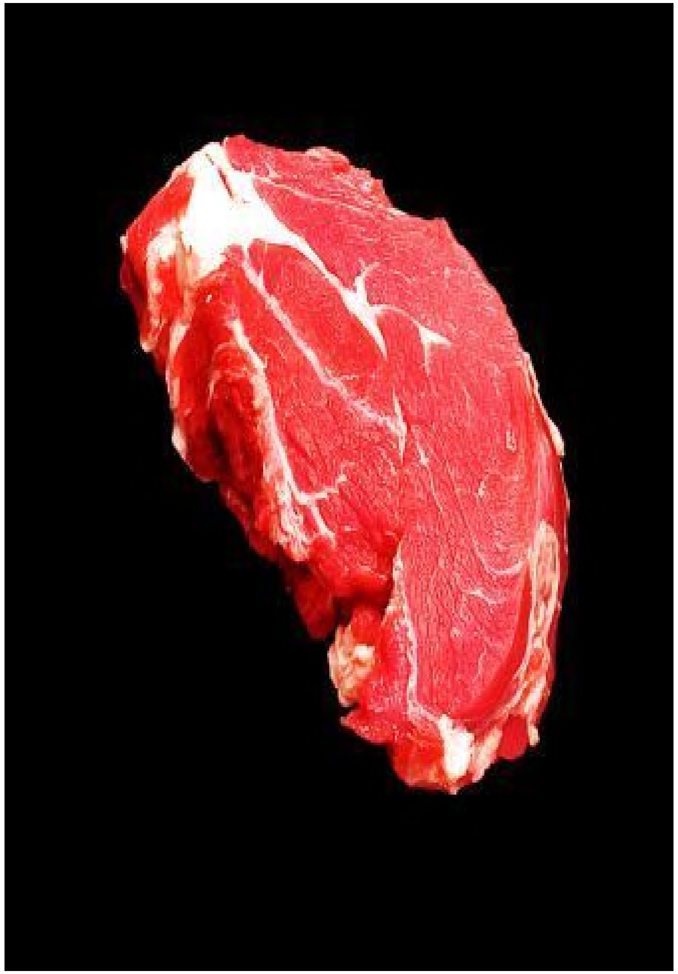
- Facts:
  - Paciocco alleged that contractual terms entitling ANZ to charge fees were penalties at common law and in equity.
  - Disputed fees were broadly categorised as 'late fees' or 'other service fees'.
  - Fees ranged between $20 - $37.50.
  - An appeal was heard by the Full Federal Court in August 2014.

Paciocco v ANZ

- The result:
  - The **credit card late payment fees were penalties** at common law and in equity.
    - Payment was conditioned on breach of contract by Mr Paciocco (i.e. failure to make a monthly minimum payment) and also *in terrorem* of a collateral stipulation.
    - Fees were not a genuine pre-estimate of the loss to ANZ.
    - The late payment fees totalled $640. Mr Paciocco was entitled to recover the difference between the late payment fees and ANZ's actual loss (adjusted for interest).
  - The **other service fees were not penalties** and therefore enforceable.
    - They were a payment to secure an additional service from the bank (i.e. provide additional credit).

Cedar Meats v Five Star

- Facts:
  - Cedar Meats provided Five Star with processing and packaging services for lamb products at the Cedar Meats' abattoir.
  - Clause 7: Cedar Meats must kill, process and pack lamb in accordance with agreed daily volumes.
  - Clause 8: If the daily volume of lambs delivered fell by more than 25% below the agreed daily volume, Five Star would pay to Cedar Meats a minimum of 75% of the agreed daily volume price.
  - Five Star did not provide the minimum daily volumes.



Cedar Meats v Five Star

- The result:
  - Did the penalty doctrine apply? Yes.
    - Clause 8 was a promise that if the conditions in clause 7 were not performed, Five Star would pay the amounts specified.
    - It was security for the satisfaction of a primary obligation.
  - Genuine pre-estimate of loss? No.
    - Cedar Meats' estimated loss for each sheep not delivered was $5.94-$8.54 per head, but clause 8 required payment of $21.50 per head.
    - This was excessive and unconscionable.
  - Clause 8 was a penalty.
  - Case remitted for determination of recoverable amount.

Penalty cases after *Andrews*

- *Sun North Investments v Dale*:
  - **Facts**: Dale lent $500,000 to Sun North. Dale was granted a call option to buy Sun North's shares (valued at $5m) for $2m. Dale sought to exercise the option. Loan was repaid 5 days later.
  - **Held**: The option to purchased was a penalty (security for obligation to repay loan). Potential windfall of $3m was excessive and out of all proportion.
- *Love v Brien*:
  - **Facts**: A special condition in a contract for sale of land required the buyer to pay an additional $500,000 if the buyer did not re-zone and transfer a specified lot of land to the seller.
  - **Held**: Special condition was not a penalty. It changed the consideration payable for the purchase (+ $500,000). Not 'out of all proportion'.

Penalty cases after *Andrews*

- *GWC Property Group v Higginson & Ors*:
  - **Facts**: GWC sought to recover $1.2m from the guarantors of Hynes Lawyers (in liquidation), who were required under a lease to repay incentives on termination of the lease.
  - **Held:** Repayment of the incentives was a penalty. They provided for significant sums to be paid over and above damages which would be payable to the landlord at common law

Summary of the penalty doctrine

- The *Andrews* test operates differently at law and in equity. Breach of a contract is a necessary element of the penalty doctrine at law but not in equity.
- A key issue in determining whether the penalties doctrine applies is whether a stipulation is security for performance of an obligation or consideration for the provision of further services.
- A stipulation will not be a penalty unless it is extravagant and unconscionable in amount.
- A party may enforce a penalty only to the extent of that party's proved loss.

Avoiding the penalty doctrine

- Principles and strategies
  - Consider at the drafting stage whether a transaction will be a payment for a further accommodation/benefit, or a payment of compensation for failure of a term.
    - Characterising a transaction as a payment for a further benefit is one way of avoiding having a provision struck down as a penalty.
    - *Paciocco* and *Andrews* give us examples.
  - If a clause seeks to recover a fixed amount from the other party on the occurrence of a specified event, then usual considerations apply (i.e. whether the payment will be a genuine pre-estimate of loss).

Liquidated damages

DLA PIPER

- Purpose and advantages of liquidated damages clauses.
  - Acts as a performance incentive.
  - Overcomes difficulty in assessing common law damages.
  - Easily and quickly enforced.
  - No proof of loss required.

- Be careful – the penalty doctrine may apply to liquidated damages clauses.

Genuine pre-estimate

- Important to ensure that liquidated damages are a genuine pre-estimate of the loss.
  - *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*
  - *Ringrow Pty Ltd v BP Australia Pty Ltd*

- Challenging to determine what a genuine pre-estimate of the loss is in the government context.
  - Major IT contracts.
  - Failure to provide critical infrastructure on time (e.g. roads).
  - Failure to provide capability (e.g. war ships).

What is a genuine pre-estimate?

Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Y Yzquierdo Y Castaneda

> "*The very reason why the parties do in fact agree to such a stipulation is that sometimes, although there is undoubtedly damage and damages ought to be recovered, the nature of the damage is such that proof of it is extremely complex, difficult, and expensive.*"

State of Tasmania v Leighton Contractors Pty Ltd

> *"Some component for loss of public utility or delay in access to infrastructure ought to have been considered, not in the evaluation of the components of the 'direct costs', but as a separate matter."*

Practical considerations

- Calculate with respect to known losses where possible
  - Maintaining current capability (including support and upgrades).
  - The resulting loss of capability compared to the new capability.
  - Costs of external providers (e.g. legal costs).
  - Obsolescence costs.
- Keep records of any calculations or considerations.
- Include statements that loss may be complex, difficult, and expensive to calculate.
- Don't specify the same amount for trivial breaches.
- Preserve the right to claim general damages.

Questions

DLA PIPER

WIN
WHAT IN-HOUSE LAWYERS NEED
SUPPORT · NETWORKING · KNOWLEDGE