**PENALTY DOCTRINE AND PACIOCCO v. AUSTRALIA AND NEW ZEALAND BANKING GROUP LIMITED**

***College of Law: The Law of Penalties***

**11 October 2016**

**Nicholas J. Simpson**[r]

## INTRODUCTION

1. The decision of *Paciocco v. Australia and New Zealand Banking Group Limited* [2016] HCA 28 heralds the end to disputes as to the validity of contractual provisions concerning the payment of late fees. It also represents a rather detailed insight into the Court's thoughts as to the penalty doctrine and when it may be invoked. *Paciocco* considered whether credit card late fees charged by the Australia and New Zealand Banking Group Limited were penalties or otherwise unconscionable and/or unfair under other legislation such as the *Australian Securities and Investments Commission Act* 2001 (Cth.) and *National Consumer Credit Protection Act* 2009 (Cth.). This paper will only discuss the challenge in respect of the penalty doctrine rather than the statutory claims made by the appellants. Further, it will discuss the impact of the decision, the concept of a penalty at common law and equity, the underlying principles of construction and what effect *Paciocco* has on the drafting of contractual clauses.

## BACKGROUND

2. Mr Lucio Paciocco, the first appellant, held credit card and deposit accounts with the ANZ, the first respondent. Mr Paciocco also controlled a company known as Speedy Development Group Pty Ltd ("**Speedy**") which also held a business deposit account with the ANZ. Both accounts held between Mr Paciocco and Speedy were charged honour and dishonour fees and non-payment fees. With respect to Mr Paciocco's credit card fees he was charged over-limit fees and late payment fees.

3. The basis of the claim was that the numerous fees were unenforceable or void as penalties and in the alternative the provisions contravened legislative instrument for being unconscionable or constituting unjust or unfair terms.[1]

4. Proceedings initially commenced in the Federal Court before Gordon J who found that the provisions for late payment fees were penalties under the common law and equity. Specifically, her Honour stated (at [373] – [374]):[2]

> *"373. The Late Payment Fees charged by ANZ … constituted a penalty at common law and a penalty in equity. The liability to pay the late payment fee was payable on breach and further and alternatively, was collateral (or accessory) to a primary stipulation (to make a payment by a particular date) in favour of ANZ. That collateral stipulation, upon failure of the primary stipulation, imposed upon the customer an*

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[1] *Paciocco v. Australia and New Zealand Banking Group Limited* [2016] HCA 28 per French CJ at [2].

[2] *Paciocco v Australia and New Zealand Banking Group Limited* [2014] FCA 35.

*additional detriment in the nature of a security for, and in terrorem of, the satisfaction of the primary stipulation which was extravagant, exorbitant and unconscionable.*

*374. The Honour, Dishonour, Non-Payment and Overlimit Fees charged by ANZ were of a different character. None of them constituted a penalty at common law or a penalty in equity. The liability to pay each of those Exception Fees was not collateral (or accessory) to a primary stipulation in favour of ANZ. The liability to pay each arose as a result of, and in exchange for, something more than and different from what had been agreed in the primary stipulation. They were not penal in nature."*

5. From the primary decision of Gordon J, Mr Paciocco and Speedy appealed in the relation to the determination of the fees referred to above at paragraph 374 of her Honour's reasoning in addition to the statutory claims. The ANZ also appealed the categorisation of the late payment fees as penalties.
6. The Full Federal Court held that the late payment fees were not penalties and were therefore enforceable against the ANZ customers. The Court also upheld Gordon J's findings in relation to the statutory causes of action and the categorisation of the other fees.
7. In respect of the penalties question, the High Court appeal was only in relation to the late payment fees. The appellants also challenged the Full Federal Court's findings in respect of the statutory claims. Both claims by the appellants were dismissed by the High Court (4 to 1) thereby upholding the Full Federal Court's decision that the late payment fees were not penalties or capable of infringing statutory provisions legislating against unconscionable, unfair and unjust terms.
8. Before descending into the reasoning of the High Court, it is useful to firstly discuss the history and understanding of the doctrine of penalties prior to the High Court appeal.

**WHAT IS A PENALTY?**

9. In 2005 the High Court in *Ringrow Pty Ltd v. BP Australia Pty Ltd* affirmed the House of Lords decision of *Dunlop Pneumatic Tyre Co Ltd v. New Garage and Motor Co Ltd* [1915] AC 79. The decision in *Dunlop* decided the "test" or guideline for deciding whether a contractual provision is a penalty and the impact of *Ringrow* was that it continued to express the law to be applied to penalties in Australia.[3]
10. *Dunlop* provided that the essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party contrasted with liquidated damages which were considered as a "genuine covenanted pre-estimate of damage".[4] This distinction as drawn by Lord Dunedin in *Dunlop* does not provide any limiting rules, but rather highlights the relevance and necessity of contractual construction.[5] To assist this process of construction, his Lordship proffered four

[3] *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71; (2005) 224 CLR 656 at 663; [2005] HCA 71 at [12].
[4] *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited* [1915] AC 79, 86.
[5] *Paciocco* per Kiefel J at [30].

"tests", which have in time become conclusive rather than being seen as guidelines when determining if a clause is a penalty[6]:

> *(a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.*
>
> *(b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid. This though one of the most ancient instances is truly a corollary to the last test. Whether it had its historical origin in the doctrine of the common law that when A promised to pay B a sum of money on a certain day and did not do so, B could only recover the sum with, in certain cases, interest, but could never recover further damages for non-timeous payment, or whether it was a survival of the time when equity reformed unconscionable bargains merely because they were unconscionable, – a subject which much exercised Jessel MR in Wallis v Smith – is probably more interesting than material.*
>
> *(c) There is a presumption (but not more) that it is penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage".*
>
> *On the other hand:*
>
> *(d) It is no obstacle to the sum stipulated being a genuine pre- estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties.*

11. The distinction between primary and collateral stipulations alluded to above is largely historical dating back to medieval times when common money bonds were in vogue. The bond would incentivise the borrower to repay the loaned amount on or before the due date so as to avoid larger sums payable and ancillary to the principal loan. Penal bonds were applied strictly at common law and also protected by equity so long as the purpose of the bond was to compensate rather than exact punishment upon the borrower.[7]

12. In *Legione v. Hateley* [1983] HCA 11; (1983) 152 CLR 406 at 549 Mason and Deane JJ stated that:

> *"A penalty, as its name suggests, is in the nature of a punishment for non-observance of a contractual stipulation; it consists of the imposition of an additional or different liability upon breach of the contractual stipulation".*

***Andrews v. ANZ – the scope of the penalty***

13. The definition in *Legione* was later accepted in *Andrews v. Australia and New Zealand Banking Group Ltd* [2012] HCA 30 which originally commenced the class action proceedings against the ANZ in the Federal Court. Gordon J also heard the matter at first instance having been asked to determine whether late payment fees could be characterised as a penalty. Her Honour found that the late payment fees were in fact penalties, however did not come to the same

[6] Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited [1915] AC 79, 86-88

[7] *Paciocco* per Kiefel J at [18] – [21].

view with respect to the remaining exception fees. Her Honour's findings in relation to those respective fees was arrived at by considering the following questions:

a. were the exception fees payable upon breach of contract?

b. was the responsibility of the customer to see that the events causing the breach did not arise?

c. If either were answered in the affirmative, was the relevant exception fee capable of being characterised as a penalty?

14. With respect to the late fee they were capable of being considered a penalty as they were triggered by a customer's failure to make a payment at a stipulated time, namely the customer's breach.[8] The balance of the exception fees were not as her Honour answered the first two questions in the negative. They were not charged as a result of breach nor by an event which the customer had an obligation to prevent.

15. That finding was challenged in the Full Federal Court and the subsequently ordered to be heard in the High Court only in respect of the penalty issue.

16. The primary issue for the High Court was whether the exception fees clauses were void as penalties and if so, whether the customer/applicants were entitled to repayments as moneys had and received by the ANZ.

17. With respect to the scope of the penalty doctrine, the High Court in *Andrews* provided that (at [10]):

> *"In general terms, 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. In that sense, the collateral or accessory stipulation is described as being in the nature of a security for and in terrorem of the satisfaction of the primary stipulation. If compensation can be made to the second party for the prejudice suffered by failure of the primary stipulation, the collateral stipulation and the penalty are enforced only to the extent of that compensation. The first party is relieved to that degree from liability to satisfy the collateral stipulation."*

18. Having propounded the general statement of penalties, the High Court considered the scope of the penalty doctrine. The issue at hand was whether the doctrine was confined to contractual breaches, as propounded by the ANZ. The Court answered in the negative making it clear that "*it does not follow … that in a simple contract the only stipulations which engage the penalty doctrine must be those which are contractual promises broken by the promisor [i.e. the customer]*".[9] The original submission from the ANZ derived from a New South Wales Court of Appeal decision *Interstar Wholesale Finance Pty Ltd v Integral Homes Pty Ltd*, which the High Court stated should not be accepted. Further, the High Court stated that Gordon J had:

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[8] *Andrews v. Australian and New Zealand Banking Group Limited* [2011] FCA 1376 per Gordon J at [243].
[9] *Andrews v. Australia and New Zealand Banking Group Ltd* [2012] HCA 30 per the Court at [45].

> *"erred in concluding, in effect, that in the absence of contractual breach or an obligation or responsibility on the customer to avoid the occurrence of an event upon which the relevant fees were charged, no question arose as to whether the fees were capable of characterisation of penalties".*[10]

19. Although not determining whether the exception fees were penalties, the High Court provided that they were capable of such taxonomy. Similarly, the High Court rejected the finding made in *Interstar* that the "*penalty doctrine [had] disappeared from equity by absorption into the common law action of assumpsit*".[11]

20. The matter was then remitted to the Federal Court for determination according to the decision in *Andrews.*

**PACIOCCO – FEDERAL COURT**

21. Upon the remittal Gordon J was tasked with the consideration of whether the exception fees were penalties at common law or equity. In more precise terms, the primary issue for her Honour was whether, as a matter of construction, the requirement in the relevant contract between the customer and the ANZ to pay a fee was to be regarded as security for performance (i.e. a penalty), or whether it was a fee charged in accordance with a pre-existing arrangement according to whether the ANZ decided to provide some more to the customer.[12]

22. In respect of the late payment fees, her Honour held that they were penal in nature by, in summary, stating the following salient points:[13]

    a. The payment, both in law and equity, was a collateral stipulation and security for or *in terrorem* of the satisfaction of the primary stipulation;

    b. The conclusion derived from the:

        i. language of the clause;

        ii. subject matter of the stipulation;

        iii. the stipulation was not a fee payable upon a further period of credit due to the overdue payment by the customer.

23. Gordon J focussed particularly on two features of the late penalties. The first was that the breach of the failed stipulation consisted of simply not paying a sum of money that gave rise to paying a fee.[14] Secondly, the amount payable was the same regardless of the time of the delay.[15] Her Honour described the second factor as triggering a presumption that the late payment clause had the character of a penalty. The determining factor was therefore the extent to which:[16]

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[10] *Andrews v. Australia and New Zealand Banking Group Ltd* [2012] HCA 30 at [78].
[11] *Andrews v. Australia and New Zealand Banking Group Ltd* [2012] HCA 30 at [51].
[12] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [38].
[13] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [116].
[14] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [121]
[15] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [119]
[16] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [48]

> *"the amount stipulated to be paid exceeded the quantum of the relevant loss or damage which can be proved to have been sustained by the breach, or the failure of the primary stipulation, upon which the stipulation was conditioned."*

24. The answer to this matter came down to the calculations and methodology of respective experts of Mr Paciocco and the ANZ. Mr Paciocco's expert, Mr Regan and ANZ's expert, Mr Inglis, proffered evidence as to the loss or damage suffered by the ANZ by virtue of the customer's non-compliance with repayment terms. The relevant principle for assessing loss, according to Gordon J, was to be undertaken on a forward-looking basis in order to determine whether the fee was extravagant when considering the greatest provable loss.[17]

25. Gordon J preferred the evidence of Mr Regan as it addressed the above determinative factor. Mr Inglis' evidence was regarded as not addressing this issue. Mr Regan considered what was the actual loss or damage suffered by the ANZ, which was calculated as being no more than $3. Although the precise amount of damages could not be determined on any view it was considerably less than $35 or $20 meaning that the late payment fees were extravagant and unconscionable and therefore penalties.[18]

26. By contrast, Mr Inglis' evidence was rejected on the basis that it reflected a theoretical accounting exercise. His approach assessed the maximum amount of costs that ANZ could conceivably have incurred as a result of the late payment. That calculation included costs of collecting the debt, the cost to the ANZ in increasing its provisions for the greater risk of late payments and the costs associated with meeting regulations concerning ANZ's capital reserves. Collated together, Gordon J regarded the bank's increased costs in loss provisions and regulatory capital as losses not suffered by late payments.[19]

27. By preferring the evidence of Mr Regan, her Honour found that the late payment fee fell within category (c) of the *Dunlop* tests or guidelines, as it was a lump sum payment triggered by a series of events.[20] The late fee may also have satisfied category (b) when qualified by category (a) so long as the loss constituted a genuine pre-estimate. In short, the fees were greater than the loss meaning they were extravagant, unconscionable, a penalty and therefore unenforceable.

**PACIOCCO – FULL FEDERAL COURT**

28. On appeal, Mr Paciocco and Speedy appealed Gordon J's determination that the balance of the exception fees were not penalties or contrary to statute. The ANZ appealed in respect of the finding that the late payment fees were penalties.

29. The reasons of the Full Federal Court were principally delivered in a judgment of Allsop CJ with whom Besanko and Middleton JJ agreed in separate judgments. The error identified in the reasoning of Gordon J was in the form of

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[17] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [45]
[18] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [155]
[19] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [133].
[20] *Paciocco v. Australia and New Zealand Banking Group Ltd* [2014] FCA 35; (2014) 309 ALR 249 at [119].

the separateness of the following two questions which her Honour had erroneously conflated:[21]

a. The anterior enquiry as to whether the provision is penal in character;

b. The subsequent enquiry as to the remedial consequence of any such characterisation.

30. According to Allsop CJ, one looks forward at the time of entry into the contract and consider to what extent the legitimate interests of the lender in the performance of the relevant provision of the contract; the other looks backwards at the damage caused in order to found some relief for such a breach.[22]

31. The correct approach to the assessment, as proffered by Allsop CJ, was to "look at the greatest possible loss on a forward looking basis."[23] Indeed, whether a stipulation is penal is:[24]

a. assessed by reference to the question of extravagance or exorbitance referrable to the bank's legitimate interests in the performance of the contract; and

b. assessed by the greatest (rather than actual) loss that could conceivably be proved following breach.

32. Rather than resorting to a contest as to the reliability of either evidence from the expert witnesses, the Full Court simply accepted Mr Inglis' evidence over Mr Regan's on the basis that Mr Regan's evidence was irrelevant to the question whether the late fees were extravagant by reference to the greatest loss provable.

33. It was accepted that the three categories identified by Mr Inglis, namely loss provision, regulatory capital and costs for collection of unpaid debts were losses conceivably incurred by the ANZ by virtue of the late payment. These categories were relevant to the legitimate interests/costs incurred and ultimately to the question of whether the costs were extravagant or exorbitant. The Full Federal Court found that they were not.

34. Allsop CJ provided that the fact that the contractual provision fell within category (b) of *Dunlop* was not decisive and would not alter the onus of proof on the applicant.[25] The Chief Justice resolved that the clause did not fall within category (b) as it was a collateral stipulation and the extravagance must be assessed by the legitimate interests of the bank according to the greatest loss provable following a breach of contract.[26]

**PACIOCCO – HIGH COURT**

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[21] *Paciocco v. Australia and New Zealand Banking Group* Limited [2015] FCAFC 50 at [114] per Allsop CJ.
[22] Ibid.
[23] Ibid, at [173].
[24] Ibid, at [137].
[25] Ibid, at [115].
[26] Ibid, at [137]

35. Despite prior High Court authority effectively resolving the issue of the test to ascertain whether a clause was a penalty, *Paciocco* provides further clarity on that point. As discussed, the *Dunlop* tests were adopted in *Ringrow* subject to the qualification of category (a) which required the extravagance to be "out of all proportion" to the potential loss.[27]

36. In characterising the late payment fee the majority observed that the relevant question was not what the ANZ could recover in an action for breach of contract, but whether the costs and effects to the ANZ's financial interests could be taken into account on the penalty issue. Although expressed in different terms, the majority effectively concluded:

    a. that the assessment was as to whether a clause was drafted to punish the defaulting party or protect the legitimate interests of the innocent party; and

    b. with respect to the legitimate interests component, the court must consider whether the fee was out of all proportion to the bank's interest in receiving prompt monthly payments.

37. More specifically, those judicial officers in the majority (Kiefel J, with whom French CJ agreed, Gageler J and Keane J) made the following paraphrased remarks:

*Kiefel J*

38. The process to be undertaken in order to determine whether an amount is unconscionable or extravagant can only be gauged against the identified or legitimate interests of the party in whose favour the stipulation is made.

39. In *Dunlop,* her Honour stated that the interests in question were regarded as substantial and the possibility of damages was real. The amount agreed in that case was not incommensurate with the relevant interests.[28]

40. Her Honour also cited, seemingly with approval, the United Kingdom Supreme Court decision of *Cavendish Square Holding BV v. Talal El Makdessi; Parking Eye Limited v. Beavis* [2015] UKSC 67 where Lord Neuberger and Lord Sumption provided that the "true test" was whether the provision is a secondary obligation which imposes a detriment on the breaching party that was out of all proportion to any legitimate interest of the innocent party to enforce the primary obligation.[29]

*Gageler J*

41. In Gageler J's opinion, the relevant indicator of punishment derives from the negative incentive to perform being out of proportion with the positive interest in performance meaning that the negative incentive amounts to deterrence by threat of punishment.[30]

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[27] *Ringrow* at [32].
[28] *Paciocco* at [52].
[29] *Paciocco* at [55].
[30] *Paciocco* at [164].

42. Further, in asking whether the stipulation is designed to principally punish the breaching party that question invites a further inquiry as to the commercial circumstances giving rise to the controversial clause or clauses. That, his Honour regarded, is a "more tailored inquiry" than what was stated in *Cavendish,* namely the assessment of the innocent party's legitimate interests.[31] His Honour did not suggest that those different inquiries would not lead to the same result. Indeed, as his Honour's reasons reveal, the legitimate interests of the ANZ significantly influenced the determination.

43. As to the surrounding circumstances the parties, his Honour referred to with approval the House of Lords decision of *Clydebank Engineering and Shipbuilding Company v. Yzquierdo y Castaneda* [1904] UKHL 3. *Clydebank* concerned a supply contract between the Spanish Government and a shipping company where ships were to be delivered within a specified time. The contract contained a clause that provided that a penalty applied for late delivery at a rate of £500 per week for each vessel. The contract was entered into at a time when the Spanish Government was attempting to suppress an insurrection in Cuba.

44. The Court at first instance of *Clyebank* determined that the shipbuilders did not successfully demonstrate that the penalties were exorbitant or unconscionable. This determination was subsequently upheld in House of Lords. In some circumstances an amount may be clearly stipulated in terrorem and not be considered a genuine pre-estimate of damage, yet the basis that amount may be justified by the surrounding context.[32]

*Keane J*

45. His Honour also considered whether the purpose of the late payment fee was to protect ANZ's legitimate interest or to punish the customers. In doing so, Keane J focused on the test in *Dunlop* decrying reliance on it as some kind of statute noting that it is simply a guide. Further, his Honour regarded category (a) as the more applicable test where breaches engage an obligation to pay a specified sum.

46. As his Honour remarked, reliance by Mr Pacicco on category (b) was incorrect. In support of that view he quoted Allsop CJ with approval who observed that the late fee "*may or may not, in fact, be greater than the sum due; [but] that does not appear on the face of the provision, or from an understanding of the facts.*"[33] Keane J also remarked that reliance on category (b) was out of step with the rationale of the penalty doctrine asserting that category (a) was the case on which Mr Pacicco must depend. Reluctance to support category (b) was due to the fact that it does not take into account the greater loss to be suffered by a debtor, which extends beyond the "mere fact of non-payment of the sum due on the due date".[34]

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[31] *Paciocco* at [166].
[32] *Paciocco* at [134] – [140].
[33] *Paciocco v. Australia and New Zealand Banking Group* Limited [2015] FCAFC 50 at [114] per Allsop CJ.
[34] *Paciocco* at [263].

47. When assessing what is extravagant and unconscionable his Honour regarded them as pointers towards the punitive purpose, which imbues the provision with the character of a punishment.[35]

48. His Honour also referred to *Cavendish* with seeming approval when considering the "real question" of whether the impugned provision "is penal, not whether it is a pre-estimate of loss".[36] Accordingly, Keane J with reference to *Andrews* and *Cavendish* regarded the distinguishing factor between a penalty and protective provision as:[37]

> *"whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the perform of the contract."*

*Nettle J – Dissent*

49. In a relatively brief overview, his Honour explored the tests for the identification of a penalty citing firstly *Dunlop* and its application in cases such as *Andrews* and *Cavendish.* The critical question his Honour stated from those decisions was "whether the sum agreed is out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."[38]

50. A point of difference however for Nettle J was the timing of the question as to whether the sum agreed is commensurate with the interest protected by the bargain. More recent cases, according to his Honour, demonstrate that that question has only been approached in more complex cases than for the straightforward damages clauses in consumer contracts.[39] What follows is that in a straightforward damages case, the legitimate interests of the innocent party will only be compensatory and thus the tests in *Dunlop* will suffice.[40]

*Findings in Pacicco*

51. In *Pacicco* the ANZ had admitted that it did not calculate the late payment fees on its credit cards in line with normal principles of damages. Instead, it conducted a calculation after the fact of costs, which included losses that would not have been available to it for breach of contract.

52. The legitimate interest of the ANZ was the performance of the contract by its customers and it was no impediment to the bank given it had no pre-estimate of costs before imposing the amount to be protected which would not be recoverable for a claim in damages.

53. According to Kiefel J the ANZ had an interest in receiving prompt payment and as such the late payment impacted on three key areas: operational costs, loss provisioning and increases in regulatory capital costs.[41]

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[35] *Paciocco* at [268].
[36] *Paciocco* at [268].
[37] *Paciocco* at [270].
[38] *Paciocco* at [320].
[39] *Paciocco* at [321].
[40] *Paciocco* at [321].
[41] *Paciocco* at [58] per Kiefel.

54. Similarly, Gageler J observed that the commercial interests of the ANZ were represented by the payment of the minimum monthly credit card fees. Provisioning costs, according to his Honour, directly affected recorded profit and the costs of regulatory capital were a real outgoing. They were clearly cost associated with running a bank.[42] As such, his Honour, like the majority preferred the evidence of Mr Inglis whose category of costs represented a commercial interest of the ANZ "in ensuring observance by its consumer credit card customers of the principal stipulation in each of their contracts for payment of the minimum monthly payment by the due date."[43]

55. As the Court accepted the commercial interests, it could not be concluded that the inclusion of the stipulation for charging had no purpose other than to punish the customer for a late payment.[44]

56. Keane J also accepted the legitimate interest of the ANZ as the ordinary business of running a bank. His Honour focussed on the economic effect of the provisioning costs calculated to secure the protection of the bank and noted that late payment clauses cannot be viewed in isolation to the other costs of the facility to borrowers.[45]

57. Drawing influence from American jurisprudence, Keane J took heed of the appreciation that "a late payment fee is part of the compensation for the risk assumed by the bank in making the facility available to the customer" where compensation is used as a term connoting "reward for risk".[46] Accordingly, maintaining that risk is part of the legitimate interest.[47]

58. His Honour expanded the notion of legitimate interest by reference to the underlying freedom of banks to timely repayments, to pursue profits via lending and to charge fees greater than what would ordinarily be recoverable in order to achieve such a profit.[48]Maintenance of a revenue stream was therefore a legitimate interest.

59. Keane J considered the evidence of Mr Regan and noted that it did not demonstrate gross disproportion required to establish the punitive character of the late payment fee.[49] His Honour rather relied on the evidence of Mr Inglis, which took into account these broader legitimate interests and therefore satisfied the Court that the clause was not punitive.

60. For the sake of completeness, his Honour Nettle J regarded the case as falling in the (a) category meaning that the applicable tests as to whether the late payment fee was exorbitant or extravagant and out of all proportion in

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[42] *Paciocco* at [172].
[43] *Paciocco* at [176].
[44] *Paciocco* at [176].
[45] *Paciocco* at [274].
[46] *Paciocco* at [277].
[47] *Paciocco* at [277].
[48] *Paciocco* at [278].
[49] *Paciocco* at [279].

comparison with the greatest loss that could conceivably be proved following the breach.[50]

61. In this case, as his Honour remarked, the subject contract was a standard form credit contract where the bargaining power was such that Mr Paciocco had not available opportunity to negotiate the terms of the contract. That relationship with the late fee payments, as described earlier, were out of all proportion to the $6.90 of costs that might be conceivably be recovered warranted the conclusion that the fee was a penalty.[51]

**CONSEQUENCES OF PACIOCCO**

*Correctness of Andrews*

62. By referring to *Andrews, Paciocco* reaffirmed the understanding propounded by *Andrews,* namely stating the correctness of the application of the penalty rule to breach of contract at law and in equity. Further, *Paciocco* reconfirmed that breach of contract is not the only cause to trigger the application of the penalty doctrine to contractual provisions.

63. Reference to the correctness of the *Andrews* in *Paciocco,* was made by French CJ and Gageler J in their respective judgments. In responding to criticism of the United Kingdom Supreme Court in *Cavendish* that *Andrews* represented a significant departure of the doctrine of penalties, Gageler J rather pointedly remarked that "the statement if wrong and appears to be based on a misunderstanding of *Andrews.*"[52] His Honour went further and emphasised the importance of *Andrews* as explaining the conception of a penalty as:[53]

    a. Punishment for non-observance of a contractual explanation;

    b. A continuation of the concept which originated in equity; and

    c. The product of centuries of equity jurisprudence.

*Impact on principles of damages*

64. An obvious conclusion from *Paciocco* is that the notion of damage for perspective of determining legitimate interest goes beyond that which is within reach under the claims for breach of contract; what is to be considered is the nature of the interest protected by the contractual clause. That means that legitimate interest is not confined to loss caused by the defaulting party's conduct or such loss within the contemplation of the contracting parties.[54]

*What can legitimate interest include?*

65. By referring to cases such as *Cavendish* and *Clydebank, Paciocco* seemingly suggests that legitimate interests will extend beyond monetary interests. That is clearly the inference from Gageler J's reasons when referring to the expanded

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[50] *Paciocco* at [338].
[51] *Paciocco* at [371].
[52] *Paciocco* at [121].
[53] *Paciocco* at [127].
[54] *Hadley v Baxendale* (1854) 9 Exch 341.

interests in *Clydebank.* As Justice McDougall has stated, writing extrajudicially that:

> *"where the "damage" or protected interests are "diffuse", it is more difficult to assess the extravagance (or otherwise) of the stipulated sum. Thus, it may be more likely that the question of penalty will arise."*[55]

66. This fear would however tend to invite the protective means of freedom of contract where parties are free to negotiate and thereby consider their own best interests. In other words, the chances of clauses such as liquidated damages being struck down as unenforceable are limited.

*Unconscionable, Extravagant and Exorbitant*

67. The significance of the concepts of unconscionable, extravagant and exorbitant was made clear in *Paciocco.* Those terms can only be determined by reference to the circumstances of each case, although to be inferred from those terms is that not every sum in excess of a compensatory amount will amount to a penalty. It is not enough that it lacks in proportion; it must be out of all proportion to any legitimate interest of the innocent party to the enforcement of the primary obligation.

**IMPACT ON DRAFTING**

68. *Paciocco* will be a welcome decision for businesses in many economic sectors such as banks, financial institutions, telecommunication and real estate companies. The increased protection of legitimate commercial interests means that there will be greater certainty in the application of the penalty doctrine. It will also mean that successful challenges to provisions as penalties will be significantly reduced.

69. Of course, it does not mean that clauses will be immune from attack so a few matters should be considered when drafting provisions that have secondary obligations attached to them.

70. **Rewarding positive conduct**: classic interest rate increases or additional sums payable for late payment may be regarded as penalty if the increase is not based on some kind of genuine pre-estimate. To off-set the sense of the provision being punitive, it is suggested that a reduced rate for early payment will more likely dispel the effect of the clause existing for the sole purpose of punishing the customer. Many of the telecommunication companies already have this in place;

71. **Grading liquidated amounts:** an issue in *Andrews* and *Paciocco* was that the late payment fee was the same for any kind of default. Despite being saved by the legitimate interests of the bank it would be wiser to outline a sliding scale based on the type of delay or default. Fixing a single amount may mean that the amount is sense as punitive for a minor breach;

72. **Explaining the liquidated amount**: if you are able to clearly outline the factors and amounts going into a liquidated sum upon the occurrence of an event it

[55] Justice Robert McDougall, 'Revisiting the penalties doctrine: Paciocco v ANZ' – The Commercial Law Association of Australia, 26.

will more likely be regarded as a genuine pre-estimate of loss and avoid the penalty regime. Such information could be included in a schedule to the contract or located within the defined terms to the contract. If the basis of the calculation is too difficult to determine at the outset explain those difficulties or at least colour matters to be expected in operational terms;

73. **Explaining the legitimate interest:** It may also serve the client well if the pre-estimate is supported by an outline of what commercial interests the amount seeks to support. A significant factor for the ANZ's success in the *Paciocco* was due to the Court's acceptance of its legitimate interest. Although Nettle J viewed such a test only applicable to complex contractual dealings, the majority did not take this view. That means that simple contractual damage claims may incorporate the innocent party's legitimate commercial interests meaning that penalty doctrine arguments will be less likely to succeed.

74. **Breach of contract**: the penalty doctrine also applies to clauses that are not caused by a breach of contract. Drafting and the principles above should not be ignored if them provision is not triggered by a breach.

**CONCLUSION**

75. Although the High Court in *Paciocco* has reminded Australian common law practitioners that the penalty doctrine has not withered on the vine, the decision's clarity does seem to reduce the likely success of invoking the doctrine to thwart contractual provisions as penal in nature. Indeed, on the basis of arguing genuine pre-estimate and legitimate interest as the backbone for any liquidated damage clause, the prospects of a successful challenge seem dismal at best.

76. A further significant point to take from *Paciocco* is the broadness of damages considered to protect the legitimate interest that extends beyond the confines of foreseeability with respect to the test in *Hadley v Baxendale.* Despite those boundaries extending that way in *Paciocco,* it would be useful for parties to ensure an understanding of the scope of protection when drafting, for example, relevant liquidated damage clauses. Similarly, if the matter is litigated, to ensure that the engaged expert considers more than just what the actual loss is but instead the greatest conceivable loss dictated by the legitimate interests to be protected.