IN THE SUPREME COURT OF NEW ZEALAND

I TE KŌTI MANA NUI

SC 40/2019
[2020] NZSC 53

BETWEEN	127 HOBSON STREET LIMITED First Appellant
	SUNIL GOVIND PARBHU Second Appellant
AND	HONEY BEES PRESCHOOL LIMITED First Respondent
	JASON JAMES Second Respondent

Hearing:	10 October 2019
Court:	Winkelmann CJ, O'Regan, Ellen France, Williams and Arnold JJ
Counsel:	R M Dillon for Appellants N S Gedye QC and C M Fisher for Respondents
Judgment:	5 June 2020

JUDGMENT OF THE COURT

A **The appeal is dismissed.**

B **The appellants must pay costs of $25,000 plus usual disbursements to the respondents.**

REASONS
(Given by Winkelmann CJ)

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Introduction

[1] Sometimes parties to a contract look ahead to the possibility that in the future, one or other of them will breach the contract. Rather than leaving the legal consequences of that breach to be determined by the courts through application of the law of damages for breach of contract, they agree in the contract what those

consequences will be. However, the courts have declined to enforce such clauses where the clause is determined to be penal, rather than compensatory, in nature. This appeal raises an issue not previously addressed by this Court – the principles to be applied in determining whether a clause in a contract is properly characterised as an unenforceable penalty.

[2] The first appellant, 127 Hobson Street Ltd (127 Hobson), leased premises for a childcare business to the first respondent, Honey Bees Preschool Ltd (Honey Bees). Mr Jason James, Honey Bees' director and the second respondent, guaranteed Honey Bees' obligations under the lease.

[3] In a separate document to the deed of lease, 127 Hobson and its director, Mr Sunil Govind (Dennis) Parbhu (the second appellant), agreed to install a second lift in the building, providing additional access for Honey Bees' business. The appellants further agreed that if that lift was not installed by a certain date, they would indemnify the respondents for their obligations under the lease until its expiry. The lift was not installed by the stipulated date, and so the respondents issued proceedings in the High Court to enforce the indemnity.

[4] The appellants defended the claim on a number of grounds, including that the obligation to indemnify was an unenforceable penalty. The High Court,[1] and then the Court of Appeal,[2] each found the indemnity lawful and enforceable. On this further appeal the sole issue is whether the indemnity is an unenforceable penalty.[3]

[5] In the Court of Appeal, Kós P, writing for the Court, said that the ultimate question on the penalty issue was whether the disputed indemnity clause imposed a detriment on 127 Hobson out of all proportion to any legitimate interest Honey Bees had in enforcement of the primary obligation to construct the second lift.[4] The Court

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1 *Honey Bees Preschool Ltd v 127 Hobson Street Ltd* [2018] NZHC 32, [2018] 3 NZLR 330 (Whata J) [HC judgment] at [99].

2 *127 Hobson Street Ltd v Honey Bees Preschool Ltd* [2019] NZCA 122, [2019] 2 NZLR 790 (Kós P, Brown and Gilbert JJ) [CA judgment] at [63].

3 *127 Hobson Street Ltd v Honey Bees Preschool Ltd* [2019] NZSC 62. The approved ground of appeal is whether the Court of Appeal was correct to dismiss the appellants' appeal to that Court and, in particular, whether the Court was correct to conclude that the indemnity clause did not offend the prohibition against penalties.

4 CA judgment, above n 2, at [4].

was satisfied that, properly construed, the indemnity clause was not out of all proportion to the legitimate interests of Honey Bees.[5] The Court made an order for specific performance of the indemnity.[6]

[6] On appeal to this Court, the appellants accept that the test to be applied in determining whether the indemnity was an unenforceable penalty is one of proportionality. But they say the Court of Appeal made errors in applying that test. First, it wrongly interpreted the extent of the obligation under the indemnity clause, because properly construed the clause imposed far more onerous obligations than found by the Court of Appeal. Secondly they say, when addressing the legitimate interests, the Court of Appeal was wrong to weigh Honey Bees' interest in the use of the premises for a preschool, and wrong not to weigh the extent to which the indemnity obligations exceeded any contractual damages that could have been payable for failure to install the second lift.

Background

The agreement to lease

[7] Honey Bees is a childcare provider run by Mr James and his wife. The couple were attracted into the childcare business when they could not find suitable childcare for their own son. A business broker sent them material in relation to the building owned by 127 Hobson, marketing an opportunity to run a childcare business from level 5 of the building. At the time, the four lower floors were leased to Quest Hotel with some street frontage leased to a coffee shop/café and a supermarket on the ground floor. There were also nine apartments in the building, with Mr Parbhu occupying the penthouse at the top. All floors were serviced by a single lift.

[8] The premises were advertised as having been constructed for a childcare facility for 40–50 children. But Mr James' evidence was that from the first time he viewed the premises he saw there was going to be a problem with access for a childcare business of that size – there was a single lift serving four floors and nine apartments,

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5 At [63].
6 At [67].

and the childcare centre would add 40–50 children who would be dropped off and picked up around the same time.

[9] Mr James and Mr Parbhu discussed the prospect for a second lift at their first meeting. Mr James claimed that Mr Parbhu told him it would be installed within a year, although Mr Parbhu denies that. However, a lift shaft was already in place for the second lift, and plans provided to Mr James showed that the second lift had been part of the original plans for the building.

[10] An agreement to lease the premises was executed on 28 August 2012. The agreement provided that the lease was to be on the standard Auckland District Law Society form, and that it would be for an initial lease term of six years with three rights of renewal each for a period of six years. Honey Bees had a continuing right under the agreement to cancel the lease if the Ministry of Education refused to license the premises, or granted a licence for fewer than 45 children. The agreement did not impose an obligation on 127 Hobson to install a second lift.

[11] The premises had been advertised as "ready to go and be open in a matter of weeks". The parties seem to have anticipated that obtaining the licence from the Ministry of Education would be a speedy exercise. But in the end it took around 16 months. The Ministry of Education required the premises to be fitted out before they would grant a licence. Therefore, as soon as the agreement to lease was signed, Honey Bees began work on the fit out.

[12] Honey Bees encountered difficulty with the fit out. It had difficulty getting New Zealand Fire Service approval for the kind of childcare centre contemplated, and with installing some of the facilities needed for the centre.[7] This, and other issues, caused tension in the relationship with the appellants. And the unhappiness was not all one way. Mr Parbhu believed Mr James was deliberately delaying the issue of the licence, and a dispute arose between them as to the meaning and effect of a rent holiday to which Mr Parbhu had agreed.

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[7] The New Zealand Fire Service has since been dissolved and incorporated into the new Fire and Emergency New Zealand.

[13] The Ministry of Education eventually granted a probationary licence for the centre in December 2013. The licence was only for 24 children, but was issued on a basis that enabled Honey Bees to progress to a licence for a higher number of children. Although the agreement to lease allowed Honey Bees to terminate if the premises were licensed for fewer than 45 children, Mr James said the commitments to staff and expenditure on the fit out convinced him to stick at the project.

[14] By December of 2013, Honey Bees had been in occupation of the premises for 16 months, and on Mr James' evidence, had spent about $500,000 in fitout alone. But the lease had not yet been formally documented.

Deed of Lease and Collateral Deed

[15] Even after the probationary licence was granted, there were difficulties concluding the formal documentation, with negotiations continuing over a number of detailed points. Mr Parbhu's evidence was that at this time he was suffering cash flow problems and was extremely physically and emotionally stressed. He threatened that if Honey Bees did not make a proper commitment, he would walk away from the deal.

[16] Mr James' evidence was that by this time he had lost confidence in Mr Parbhu. He was particularly concerned about the delay in installing the lift and with what a failure to install would mean to the childcare business. He believed he could not rely on Mr Parbhu's assurances about the installation and was resolved that any lease signed had to have a watertight commitment from 127 Hobson to install the lift.

[17] Mr Parbhu claimed he only agreed to install a second lift because he had been manipulated into a desperate financial situation through Mr James' refusal to commit to the lease without this undertaking. Although he agreed to give the undertaking, he stipulated it was to be recorded in a separate document, not in the lease. Mr James understood the requirement for a separate record of the agreement was because Mr Parbhu did not want his bank to be aware of it.

[18] On 20 December 2013, Mr Gilbert, 127 Hobson's business broker, sent a draft variation agreement he had prepared to both Mr James and Mr Parbhu. Mr Gilbert's email described the nature of the obligation to be undertaken as follows: "Dennis

personally, and as a director of 127 Hobson Street Ltd, agrees to install a second lift before August 2016". The email advised that this was to be recorded in a side agreement, which "will not go to Dennis's bank".

[19] In email correspondence, Mr Parbhu agreed to that draft, although he noted some minor matters that remained an issue. There was some further exchange on points of detail and then Honey Bees' solicitor assumed the responsibility of drafting the side agreement and the formal deed of lease.

[20] On 20 December 2013, Honey Bees and 127 Hobson entered into the formal Deed of Lease (Lease), and Mr James executed the Lease as guarantor. The same parties entered into the side agreement (the Collateral Deed) and this was executed by Mr Parbhu as guarantor. The Collateral Deed stated:

> BACKGROUND
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> A. Honey Bees is the lessee and Jason is the guarantor under a Deed of Lease dated on or about the date of this deed ("the Lease") entered into with 127 Hobson in respect of the premises located on the fifth floor of 127 Hobson Street, Auckland ("Premises") in replacement of an agreement to lease between Jason and 127 Hobson.
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> B. 127 Hobson and the Guarantor covenant as set out in this deed for the benefit of Honey Bees and Jason.
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> …
>
> 1. 127 Hobson agrees to install at its sole cost and expense a second lift in the building in which the Premises are located providing direct access to the Premises.
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> 2. 127 Hobson and the Guarantor agree that in the event that the second lift is not fully operational on or before 31 July 2016 then 127 Hobson and the Guarantor jointly and severally hereby indemnify Honey Bees and Jason jointly and severally for all obligations they may incur to 127 Hobson or any other landlord under the Lease including the payment of rent, operating expenses and other payments as provided under the Lease to the expiry of the Lease.
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> 3. This deed is collateral to the Lease.

[21] The preschool has been successful. Since August 2015 it has been fully licensed for 50 children and has operated at full capacity. But the installation of the lift did not go to plan. It proved difficult to obtain building consent for the installation and the project was more expensive than Mr Parbhu had expected. The obligation to

indemnify was triggered because the lift was not fully operational on or by the due date of 31 July 2016 . The lift was not installed and operational until 9 April 2018.

Respondents seek to enforce indemnity

[22] Honey Bees and Mr James issued proceedings claiming indemnity from 127 Hobson and Mr Parbhu for payments made for rent and outgoings in the period 1 August 2016 to 20 October 2016, a total of $41,392.65. They also sought an order for specific performance directing 127 Hobson and Mr Parbhu to indemnify Honey Bees and Mr James for all amounts that are due now and in the future under the Collateral Deed.

[23] The claim was resisted by 127 Hobson and Mr Parbhu on the grounds both that the indemnity was an unenforceable penalty and that the Collateral Deed was obtained in circumstances such that it amounted to an unconscionable bargain.

High Court judgment

[24] In the High Court, Whata J found that the Collateral Deed was not executed in circumstances that were unconscionable.[8] As to the claim that the indemnity clause in the Collateral Deed was an unenforceable penalty, the Judge applied the following test: whether the stipulated remedy for breach was out of all proportion to the legitimate performance interests of the innocent party, or otherwise exorbitant or unconscionable, having regard to those interests.[9] He saw this as an issue of construction, to be decided upon the terms and inherent circumstances of each contract, judged at the time of the making of the contract, not at the time of the breach. He said it was to be assessed by reference to what the parties intended and not to what in fact transpired.[10] He identified the following factors as relevant to this assessment:[11]

> (a) whether the parties were commercially astute, had similar bargaining power and were independently advised;

8 HC judgment, above n 1, at [104].
9 At [45].
10 At [78].
11 At [45]–[46].

(b) whether the predominant purpose of the impugned clause was to punish as opposed to simply deter non-performance; and, in appropriate cases,

(c) a comparison between likely loss and the stipulated sum, particularly if the performance interest is payment of a contract sum.

[25] Rejecting 127 Hobson's argument as to the duration of the indemnity, the Judge found that the indemnity applied only during the initial Lease, and did not continue during any period of renewal.[12] As to the scope of the indemnity during that initial term of the Lease, he acknowledged that, on a literal interpretation, the obligation to indemnify included rent payments, maintenance, breakages, painting, care of grounds, maintenance of waste and storm water, rubbish removal, notification of defects, use of premises and compliance with statutes.[13] He said "it defies common sense to suggest a landlord would, in indemnifying a lessees' obligations under the lease for late installation of a lift, include breaches of covenants relating to the use, maintenance and repair of damage".[14] He therefore confined the scope of the indemnity to Honey Bees to performance obligations to pay rent and outgoings.

[26] As to whether such a clause amounted to a penalty, the Judge was satisfied that Honey Bees had sought to protect two related legitimate performance interests: the installation of a second lift by a specified time; and leasehold premises that were fit for a fully licensed preschool facility for the full leasehold period, including renewals.[15] The likely losses arising from non-performance were not readily quantifiable at the time of execution. It followed that the link between the absence of a second lift and financial losses was indirect only, meaning that a comparison between the contracted for sum, and likely loss, was inapposite.[16]

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12 At [72].
13 At [70].
14 At [70].
15 At [79].
16 At [83].

[27] The Judge was satisfied that the purpose of the clause was not punitive as Honey Bees had good reason to doubt the reliability of 127 Hobson's commitment to install the lift on time and equally good reason to deter non-performance in strong terms. Although the provision of a trigger date after which all adverse consequences accrued was harsh, that was ameliorated by the length of time allowed to meet the obligation.[17]

[28] Both parties were commercially astute, and while Mr Parbhu did not take legal advice on the clause, that was his choice. The Judge said "[i]n this context there is no reason to depart from the axiom the parties can be presumed to be the best judges of their interests".[18] Although the financial cost to Mr Parbhu and 127 Hobson was significant, depriving them of all of their performance interest from the date of the breach to the end of the first lease term, the Judge observed it was not the function of the law of penalties to protect parties from their commercial decisions.[19] He was satisfied that the obligation to indemnify was not out of all proportion to the legitimate performance interests of the plaintiffs, or otherwise exorbitant or unconscionable, having regard to these interests.[20]

Court of Appeal judgment

[29] The finding that the Collateral Deed was not an unconscionable bargain was not challenged on appeal. In the Court of Appeal, the issues were the proper interpretation of the Collateral Deed and the application of the penalties rule.

[30] The Court agreed with the High Court Judge that the primary test for a penalty is the disproportionality test.[21] The essential question is whether the secondary obligation challenged as a penalty imposes a detriment on a promisor out of all proportion to the promisee's legitimate interests in performance of the primary obligation.[22] The Court said that damages are not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary

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17 At [80].
18 At [86].
19 At [96].
20 At [99].
21 CA judgment, above n 2, at [31].
22 At [31].

obligations. There were other legitimate interests a promisee might be concerned to protect, commercial or non-commercial, which could justify imposition of a super-compensatory burden.[23]

[31] As to the relevance of bargaining power and unconscientious conduct, the Court observed that the prohibition against penalties retains a philosophical connection with equity and the distinct prohibition against unconscionable bargains. Therefore, an imbalance in bargaining power and the evidence of unconscientious conduct is relevant to assessing the proportionality test.[24]

[32] The Court said that the proportionality test may also be cross-checked using an associated test: the punitive purpose test.[25] That is, whether the predominant purpose of the secondary obligation is to punish the promisor rather than protect the legitimate interest of the promisee in performance of the primary obligation. The Court saw those tests as two sides of the same coin.[26] However, it said that the punitive purpose test is concerned with the predominant rather than sole purpose, rejecting the sole purpose test postulated by Gageler J in *Paciocco v Australia & New Zealand Banking Group Ltd*.[27]

[33] The Court took the same view as the High Court Judge as to the proper interpretation of the indemnity clause. It was satisfied that the clause did not impose a penalty on 127 Hobson. The second lift was plainly a matter of considerable importance to Honey Bees and Mr James,[28] and the indemnity clause protected their legitimate interest in having a second lift installed to ensure ease of access to its premises. The Court said:[29]

> … by the point of entry into the collateral deed Honey Bees had expended some $500,000 on hard fit-out costs in order to secure Ministry of Education licensing. As it entered operation, and developed goodwill, it lacked assurance as to the completion of what it reasonably regarded as an essential attribute of the premises: a second lift. As a result of Mr Parbhu's conduct between entry

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23 At [33]–[34].
24 At [35].
25 At [36].
26 At [36].
27 At [38], referring to *Paciocco v Australia & New Zealand Banking Group Ltd* [2016] HCA 28, (2016) 258 CLR 525 at [158] and [165]–[166].
28 At [57].
29 At [58].

> into the agreement to lease and the lease itself, it also had good reason to distrust due performance on the part of 127 Hobson. It might reasonably be thought that the tenant was in a difficult position. It might well be thought that, in these circumstances, strong measures were justified — if they could be negotiated.

Issues on appeal

[34] The appeal raises the following issues:

(a) What is the content of the penalty rule in New Zealand and in particular:

(i) Must the court take into account the damages that would have been awarded for breach of the primary obligation?

(ii) What is the significance of parties' conduct and equality of bargaining power to the application of the rule?

(b) Is the indemnity clause an unenforceable penalty? This issue involves consideration of:

(i) the duration and subject matter of the indemnity contained in the Collateral Deed; and

(ii) the nature of the respondents' interests in installation of the second lift by the stipulated date, including consideration of the appellants' claims of inequality of bargaining power.

First issue: What is the content of the penalty rule in New Zealand?

Appellants' argument

[35] The appellants say that they accept the Court of Appeal's general articulation of the test set out above.[30] However, they argue the Court of Appeal got the application of the test wrong by failing to use the damages a court could award for breach of the

[30] Above at [30].

obligation as the standard against which the respondents' legitimate interests are to be weighed when assessing disproportionality. This is the best measure, they say, of proportionality and is a mandatory consideration for any court when addressing the issue of penalty.

[36] Mr Gedye QC for the respondents supports the reasoning of the High Court and Court of Appeal.

[37] Notwithstanding the appellants' purported acceptance of the Court of Appeal's formulation of the test, their arguments go to the heart of what that test is. They challenge the proposition, accepted in both the High Court and Court of Appeal, that the interests parties may legitimately protect through such clauses may be more extensive than the performance interest as measured by the damages which would have been awarded by the courts.

[38] We therefore begin our assessment of the appeal with consideration of the test to be applied in determining whether an impugned clause is an unenforceable penalty.

What is an unenforceable penalty clause?

[39] Until 2017, the leading authority in this country on the law of penalties was *Amaltal Corp Ltd v Maruha (NZ) Corp Ltd*, a decision of the Court of Appeal.[31] In that case, the issue of whether the impugned clause was a penalty was not determinative of the appeal, however the Court discussed the doctrinal basis of the law against penalties.[32] In doing so it referred to the judgment of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* (*Dunlop*) as the classic statement of the law relating to penalties.[33]

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31 *Amaltal Corp Ltd v Maruha (NZ) Corp Ltd* [2004] 2 NZLR 614 (CA).

32 The issue before the Court was whether it had jurisdiction to set aside an arbitrator's award as contrary to public policy if it wrongly upheld a clause which was a penalty. The Court found that although the doctrine of penalties had been developed in the public interest, it was not a fundamental principle of law and justice of the "higher sense" referred to in art 34 of sch 1 to the Arbitration Act 1996.

33 *Amaltal*, above n 31, at [58], citing *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 (HL).

[40] In *Dunlop*, Lord Dunedin had described a dichotomy between a penalty, "a payment of money stipulated as in terrorem of the offending party", and liquidated damages – "a genuine covenanted pre-estimate of damage" by the parties.[34] The former was unenforceable, the latter enforceable. He set out four tests that might, if applicable to the case under consideration, "prove helpful, or even conclusive" in determining whether the clause is a penalty:[35]

> (a) It will be held to be [a] 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.
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> (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. …
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> (c) There is a presumption (but no more) that it is a 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".
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> On the other hand:
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> (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.

[41] In recent years this test has been revisited in a series of decisions of the Supreme Court of the United Kingdom, the High Court of Australia, and in this country, in the case of *Wilaci Pty Ltd v Torchlight Fund No 1 LP (in rec)*.[36] Two areas of controversy have been addressed. The first is whether breach is an essential prerequisite to engaging the rule against penalties.[37] The second is the extent to which

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34 *Dunlop*, above n 33, at 86.

35 At 87–88 (citations omitted).

36 *Wilaci Pty Ltd v Torchlight Fund No 1 LP (in rec)* [2017] NZCA 152, [2017] 3 NZLR 293.

37 In *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205, the High Court of Australia extended the rule to cover situations falling short of breach. In that case, it was held that bank charges, which were imposed on customers on the occurrence of events which were not breaches of contract, could be characterised as penalties and thus be unenforceable. That approach was not followed by the United Kingdom in *Cavendish Square Holding BV v Makdessi; ParkingEye Ltd v Beavis* [2015] UKSC 67, [2016] AC 1172 at [41]–[42] per Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed), [130] per Lord Mance (with whom Lord Toulson agreed: at [292]), [241] per Lord Hodge (with whom Lord Toulson agreed: at [292]) and [291] per Lord Clarke (agreeing with the reasons of the other Judges). The *Cavendish* case involved two conjoined appeals. We refer to it as *Cavendish* throughout, except where we specifically address the facts of *ParkingEye*.

a clause may allow the innocent party to recover more than a pre-estimate of the damages a court would award on breach and still be enforceable.

[42] This appeal concerns only the second issue. The appellants argue that notwithstanding these developments, in each of these jurisdictions, the dichotomy described by Lord Dunedin in *Dunlop* holds true. We therefore review this case law.

Developments in the United Kingdom

[43] In *Cavendish Square Holding BV v Makdessi*, the Supreme Court of the United Kingdom revisited Lord Dunedin's test in *Dunlop*. The Court found that the dichotomy Lord Dunedin described between a genuine pre-estimate of loss and penalty was too narrow because the legitimate interests of the innocent party might extend beyond compensation for loss.[38]

[44] In *Cavendish*, two appeals were heard together. The first (the *Cavendish* appeal) concerned the enforceability of a clause providing for the consequences of breach of a non-compete obligation on sale of an advertising and marketing company. The second appeal (*ParkingEye*) concerned the enforceability of an £85 fee for parking longer than two hours in a privately-owned shopping centre carpark.

[45] Two sets of reasons in *Cavendish* review the origins of the penalties doctrine in equity,[39] tracing the development of the doctrine through the decisions in *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda*,[40] a case which predated *Dunlop*, and *Dunlop* itself, up until the present day. Lord Mance in particular describes how the development of case law in the United Kingdom and elsewhere since *Dunlop* reveals that the dichotomy between the compensatory and the penal is not exclusive, and cannot be maintained if legitimate interests in the performance of the contract are to be allowed proper recognition by the courts.[41]

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38 *Cavendish*, above n 37, at [31]–[32] per Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed).

39 At [4] and following per Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) and [160] and following per Lord Mance.

40 *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6 (HL).

41 *Cavendish*, above n 37, at [152].

[46] In a joint judgment, Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) reviewed the history of the penalties doctrine and also addressed how the doctrine fits within the field of contract law. They said it would be inconsistent to apply a test based only on a dichotomy between liquidated damages clauses and penalties when the courts have long vindicated performance interests which extend beyond those compensable in damages, as illustrated in the principle that specific performance of contractual obligations should ordinarily be refused where damages would be an adequate remedy.[42] They noted also that Lord Dunedin was explicit that the four "tests" were no more than guidance and, so it followed, they were not to be applied as a rigid rule in every case.[43]

[47] They commented that the focus upon Lord Dunedin's judgment had obscured the judgments of the other three Law Lords, none of whom had expressly agreed with Lord Dunedin, and in particular that of Lord Atkinson.[44] Lord Atkinson had held that the impugned clause properly protected the innocent party's performance interest, an interest which could be, and was in that case, wider than that which could be measured by "direct loss in a monetary point of view".[45] And even Lord Dunedin, they observed, had framed the essential question as whether the impugned clause was "extravagant and unconscionable".[46]

[48] They said of *Dunlop*:

> [31] In our opinion, the law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions: between a penalty and genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent. These distinctions originate in an over-literal reading of Lord Dunedin's four tests and a tendency to treat them as almost immutable rules of general application which exhaust the field.

[49] Their Lordships said the test was not whether the clause was a genuine pre-estimate of loss. Rather, they said the true test was whether:[47]

> … the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate

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42 At [30].
43 At [22].
44 At [22].
45 At [23], citing *Dunlop*, above n 33, at 92–93.
46 At [21], citing *Dunlop*, above n 33, at 87.
47 At [32].

> interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance.

A clause which provides for consequences out of all proportion to any of the innocent party's legitimate interests in performance will be penal and therefore unenforceable.

[50] Lord Hodge put the test differently as follows:[48]

> … 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 performance of the contract.

[51] Lord Mance proposed the following test:[49]

> What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable.

[52] Although differences in expression are apparent, these three tests have the same essential element: they require an assessment of proportionality between the innocent party's interest in performance of the primary obligation and the consequences provided in the impugned clause. Each make clear that the threshold for unenforceability is very high: "out of all proportion"; "extravagant, exorbitant or unconscionable".

Developments in Australia

[53] The High Court of Australia has confirmed a similar approach to that described in *Cavendish*. Although there are differences between the reasons given by the members of the Court in *Paciocco*, all Judges, with the exception of Gageler J, endorsed a test which focused on the proportionality between the effects of the impugned clause and the legitimate interest of the innocent party in performance.[50]

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48 At [255] per Lord Hodge (with whom Lord Clarke (at [291]) and Lord Toulson (at [293]) agreed).

49 At [152].

50 *Paciocco*, above n 27, at [29] per Kiefel J (with whom French CJ agreed: at [2]), [256] and [270] per Keane J (but note his Honour focused more on the test of exorbitance and unconscionability) and [319]–[321] per Nettle J (who dissented in the result); but compare Gageler J at [158] and [164]–[166].

Gageler J proposed that the test should be whether the exclusive purpose of the clause is to punish.[51] But as Kós P observed in *Wilaci*, that position is not so removed from the majority,[52] considering that Gageler J saw the relevant indicator of punishment as lying:[53]

> … in the negative incentive to perform being so far out of proportion with the positive interest in performance that the negative incentive amounts to deterrence by threat of punishment.

[54] The Judges in *Paciocco* also rejected a test that enforced a strict dichotomy between liquidated damages and penalty as too restrictive. Such an approach was considered too narrow because it did not allow for cases where there were complex performance interests protected by the penalty clause, and where damages as proved through the courts might not be an adequate remedy.[54]

Developments in New Zealand

[55] In *Wilaci*, the New Zealand Court of Appeal had to apply the law of New South Wales, the governing law of the contract at issue, in deciding whether the impugned clause was an unenforceable penalty.[55] But in doing so the Court reviewed the development of the law through the cases set out above, concluding that the test should focus on whether the impugned obligation is out of all proportion (to the extent that it is extravagant or unconscionable) to any legitimate interest of the innocent party in the enforcement of the primary obligation.[56]

The test in New Zealand

[56] We are satisfied that the Court of Appeal was correct in the essential question it posed for itself in this case, drawing as it did on the decisions of the Supreme Court of the United Kingdom and the High Court of Australia. The test to be applied is as follows. A clause stipulating a consequence for breach of a term of the contract will be an unenforceable penalty if the consequence is out of all proportion to the legitimate

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51 At [166].
52 *Wilaci*, above n 36, at [88].
53 *Paciocco*, above n 27, at [164].
54 At [48]–[50] per Kiefel J and [222] per Keane J.
55 *Wilaci*, above n 36, at [5].
56 At [88] and [95].

interests of the innocent party in performance of the primary obligation. When we refer in this judgment to legitimate interests in performance, that includes an interest in enforcing performance or some appropriate alternative to performance. A consequence will be out of all proportion if the consequence can fairly be described as exorbitant when compared with those legitimate interests.

[57] The reasoning in *Cavendish* and in *Paciocco* is persuasive as to the need to move beyond an analysis or test for penalties based upon a dichotomy between liquidated damages and penalties. The proportionality test instead allows for interests beyond an innocent party's interest in compensation for direct losses to be reflected in such clauses. It is a more flexible and permissive test than the *Dunlop* test as applied, and appropriately so. One of the organising principles of the law of obligations is freedom of contract – that parties are free to contract as they please and the courts will enforce that bargain. Although that freedom is frequently impinged upon by statute (often for the purposes of consumer protection), the common law refrains from interfering in contractual bargains unless there is good reason to do so, such as where the contract is vitiated in some way or if the contract is contrary to public policy. The penalty doctrine is an example of where the law interferes in the parties' freedom to contract on public policy grounds.[57] If the impugned clause provides a consequence for breach of a primary obligation in proportion to the legitimate interests of the innocent party in performance of that obligation, we see no good policy reason why it should not be enforced.

[58] We note in this regard that the Court of Appeal formulated as a cross-check on the proportionality test an inquiry as to whether the predominant purpose of the impugned clause is to punish the promisor rather than protect the legitimate interests of the promisee in performance of the primary obligation.[58] We do not see such a cross-check as necessary or desirable. By introducing the notion of the purpose of the clause it invites a separate inquiry into the state of mind of the parties – what was the predominant purpose of the clause? That is a fresh inquiry which may lead to a different result to that achieved by applying the proportionality test set out above. And

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57 *Cavendish*, above n 37, at [243] and [250] per Lord Hodge (with whom Lord Clarke (at [291]) and Lord Toulson (at [292]) agreed).

58 CA judgment, above n 2, at [36].

if evidence of punitive purpose is only to be looked for in the disproportion between the contracted for consequence and the innocent party's legitimate interests, then the cross-check adds nothing to the test as we have formulated it. Rather, it is another way of expressing the proportionality test, as a clause which provides for consequences which are exorbitant will be punitive.

What is a legitimate interest?

[59] A legitimate interest is an interest in performance of the primary obligation. A party to a contract may therefore impose consequences for breach which protect its interest in performance of the contract. The first inquiry is as to the nature of the innocent party's performance interest to which the clause responds or relates. This assessment is to be made at the point of formation of the contract because the question of whether an impugned clause is a penalty is a matter of construction. It therefore falls to be decided as at the time the clause was agreed between the parties and by reference to both the terms and the circumstances of the contract.[59]

[60] It is clear that the legitimate interests so described may extend beyond the harm caused by the breach as measured by a conventional assessment of contractual damages. Those interests cannot be measured simply by reference to the loss caused by the particular breach – the parties may agree to consequences for breach which recognise the broader impact of non-performance on the commercial interests the parties seek to achieve through the contract.

[61] While legitimate interests will not include objectives unrelated to the performance interest, such as punishment, what is also plain is that deterring breach can be a legitimate objective of a clause.[60] Deterring breach is simply the flip side of securing performance.[61]

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59 See *Commissioner of Public Works v Hills* [1906] AC 368 (PC). See also *Cavendish*, above n 37, at [9] per Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed (and with whom Lord Clarke agreed: at [291])) and [221] and [243] per Lord Hodge (with whom Lord Toulson agreed: at [292]); *Dunlop*, above n 33, at 86–87 per Lord Dunedin, 95 per Lord Atkinson and 100–101 per Lord Parmoor; and *Paciocco*, above n 27, at [62] per Kiefel J (with whom French CJ agreed: at [2]), [146] and [162] per Gageler J and [331] per Nettle J.

60 See *Cavendish*, above n 37, at [82] and [99] per Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed).

61 But it must also follow that if there is no legitimate interest in securing performance, there can be no legitimate interest in deterring breach.

[62] The facts in both *Dunlop* and *ParkingEye* are good illustrations of the sorts of legitimate interests which are properly weighed on this side of the balance. In *Dunlop*, the issue arose in the context of a contract for the sale of tyres between Dunlop Pneumatic Tyre Co Ltd and trade buyers. The contract contained a resale price maintenance clause, which established a minimum price for resale by those trade buyers, with a penalty stipulated for breach to be calculated on a per tyre basis. Although the other Law Lords rested their decision to affirm the enforceability of the clause on the impossibility of pre-estimating loss,[62] Lord Atkinson made the point that *Dunlop* suffered no direct or immediate loss from the resale in breach of the agreement:[63]

> The object of the appellants in making this agreement, if the substance and reality of the thing and the real nature of the transaction be looked at, would appear to be a single one, namely, to prevent the disorganization of their trading system and the consequent injury to their trade in many directions.

[63] Lord Atkinson acknowledged that interests beyond the loss caused by the breach could be protected, namely protection of the system of business, and that Dunlop had a legitimate interest in incentivising performance to support that interest.[64] As is apparent from this analysis, the commercial interests a party seeks to protect, although connected to the contract at issue, may extend beyond the four corners of the transaction regulated by that contract. They may, for example, extend to protecting a way or system of conducting business of which the contract forms a part.

[64] In *ParkingEye*, the Supreme Court upheld an £85 charge on any motorist who overstayed the two hours' parking permitted, even though it was conceded not to be a pre-estimate of damages. ParkingEye did not own the carpark, but rather managed it for the benefit of the retail centre it served. It received its income from the impugned fee. Drawing on an agreed statement of facts, Lord Neuberger and Lord Sumption said the clause had two main purposes. First, to manage the efficient use of parking space in the interests of the retail outlets, and of the users of those outlets who wish to find car parking by incentivising performance.[65] Secondly, to provide an income stream to

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62 *Dunlop*, above n 33, at 88 per Lord Dunedin, 97 per Lord Parker and 102 and 105 per Lord Parmoor.

63 At 92.

64 At 92 and 96.

65 *Cavendish*, above at n 37, at [98].

enable ParkingEye to meet the costs of operating the parking scheme and to make a profit from its services.[66] These were reasonable objectives, which could not be achieved without the fee. That did not, they said, justify the charging of a fee out of all proportion to those interests. But the charge was not viewed as exorbitant or unconscionable.[67]

[65] Counsel for the intervener in *ParkingEye* submitted that only the legitimate interests of ParkingEye could be taken into account – and not those of the retail outlets, their customers or the public at large – because only ParkingEye was party to the contract. However, their Lordships, in rejecting this argument, said:[68]

> The scheme in operation here (and in many similar car parks) is that the landowner authorises ParkingEye to control access to the car park and to impose the agreed charges, with a view to managing the car park in the interests of the retail outlets, their customers and the public at large. That is an interest of the landowners because (i) they receive a fee from ParkingEye for the right to operate the scheme, and (ii) they lease sites on the retail park to various retailers, for whom the availability of customer parking was a valuable facility. It is an interest of ParkingEye, because it sells its services as the managers of such schemes and meets the costs of doing so from charges for breach of the terms (and if the scheme was run directly by the landowners, the analysis would be no different). … The penal character of this scheme cannot depend on whether the landowner operates it himself or employs a contractor like ParkingEye to operate it. The motorist would not know or care what if any interest the operator has in the land, or what relationship it has with the landowner if it has no interest.

[66] It has been suggested that their Lordships thereby included within the legitimate interests those of third parties.[69] But it seems to us that their Lordships were rather taking into account the broader commercial objectives of ParkingEye in securing the performance of the principal obligation. ParkingEye was contracted to run the carpark in a manner which served the interests of the landowner which necessarily, since the landowner ran a retail centre, encompassed the interests of the retailers. Again, as in *Dunlop*, the imposition of the fee protected commercial objectives which extended beyond the four corners of the particular parking contract.

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66 *Cavendish*, above at n 37, at [98].

67 At [100].

68 At [99].

69 See James C Fisher "Rearticulating the Rule Against Penalty Clauses" [2016] LMCLQ 169 at 173–174; and Andrew Summers "Unresolved issues in the law on penalties" [2017] LMCLQ 95 at 112–113.

Must the court assess the damages that would have been awarded for the breach in undertaking the proportionality assessment?

[67] We now address 127 Hobson's arguments as to the content of the rule.

[68] Mr Dillon for 127 Hobson maintains that, notwithstanding the analysis we have set out, the dichotomy between liquidated damages and penalty remains, so that a clause must be one or the other. A proportionate response will always be liquidated damages, with some allowance for the difficulty of pre-estimating damages that would be recoverable on breach.

[69] On his analysis, the area of doubt the courts have addressed in recent decisions is not the continued centrality of that dichotomy but rather how damages should be assessed in cases where they are difficult to measure or prove, especially in advance of any breach. While it is true that the courts have been explicit that their level of tolerance for impugned clauses is only confined to legitimate performance interests, he argues that, in contract law, the performance interest is, in turn, confined to rules of damages and what is recoverable under those rules.

[70] He notes that the Court in *Cavendish* was explicit that the proportion between the damages recoverable and the effect of the impugned clause remains relevant to the analysis.[70] It follows, Mr Dillon submits, that the Court of Appeal should have undertaken such a calculation.

[71] We do not accept the appellants' argument that Lord Dunedin's dichotomy continues to lie at the heart of the penalties doctrine. As set out above, the legitimate interests to be weighed can be broader than the monetary value of performance and will include the broader commercial objectives secured by performance of the principal obligation.[71]

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70 *Cavendish*, above n 37, at [32].

71 The Court in *Cavendish* also considered the continuing relevance of the *Dunlop* tests where the clause appears to be a pre-estimate of the loss: *Cavendish*, above n 37, at [32] per Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) and [255] per Lord Hodge. See below at [78].

[72] Mr Dillon relies upon Professor Palmer's argument in her article "Implications of the New Rule Against Penalties" that the limits of a legitimate interest must be set by reference to those interests courts are willing to enforce since enforceability is a key attribute of a contract.[72] We agree with that analysis, and consider that much is implicit in the test. The courts are only prepared to enforce clauses which protect legitimate interests. The test we have articulated proceeds on the basis that a legitimate interest is an interest in performance of the primary obligation, and that an interest in performance extends beyond the compensatory. This is not a new idea to the law. It is reflected in the principle that specific performance of contractual obligations should ordinarily be refused where damages would be an adequate remedy.[73]

[73] However, Professor Palmer also says in her article that the legitimate interests a court will be prepared to enforce must be those for which damages are recoverable.[74] If by this Professor Palmer means, as Mr Dillon contends, that contractual damages are the measure to be used in determining proportionality, then in our view that takes too restrictive an approach not justified by sound policy or reason. But Professor Palmer goes on to clarify her point by saying that legitimate interests are only those in relation to which a court would be likely to grant relief.[75] This is a restatement of the point addressed above and with which we agree.

[74] It follows from the analysis set out above, and contrary to Mr Dillon's submission, that the test is not based purely upon the dichotomy for which he contends between pre-estimate of damages and penalty. The test allows for performance interests beyond those which are compensated through the application of the ordinary rules of damages for breach of contract.

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72 Jessica Palmer "Implications of the New Rule Against Penalties" (2016) 47 VUWLR 305 at 306 and 323–324.

73 *Cavendish*, above n 37, at [30] per Lord Neuberger and Lord Sumption; and see *Attorney-General for England and Wales v R* [2002] 2 NZLR 91 (CA) at [94] per Tipping J.

74 Palmer, above n 72, at 324.

75 At 323–324. At 322, Professor Palmer notes the increasing recognition of the performance interest in the law of contract and that it has been explicitly recognised and incorporated in the law on contractual damages, citing *Marlborough District Council v Altimarloch Joint Venture Ltd* [2012] NZSC 11, [2012] 2 NZLR 726; and *Tabcorp Holdings Ltd v Bowen Investments Pty Ltd* [2009] HCA 8, (2009) 236 CLR 272 at [12].

Is quantum of damages nevertheless a mandatory consideration?

[75] Mr Dillon argues in the alternative, that even if other interests are to be weighed, a court should always do a calculation of the damages that would have been recoverable, as that must be relevant to the proportionality assessment. The Court of Appeal, he says, was wrong not to calculate the damages. He says that exercise is necessary even where damages are difficult to calculate. He points to the category of damages known as *Wrotham Park* damages,[76] also known as negotiating damages, where the court undertakes a notional exercise of placing itself in the shoes of the innocent party prior to breach and fixing a price it would charge to licence a breach.[77] These can be awarded in compensation for a right which the court has refused to otherwise enforce (through, for example, injunctive relief or an order for specific performance), as was the case in *Wrotham Park*. Negotiating damages were discussed by the United Kingdom Supreme Court in *One Step (Support) Ltd v Morris-Garner*,[78] and their application extended to apply where it was difficult for the plaintiff to prove the loss they had suffered.[79]

[76] We see no merit in the argument that negotiating damages could be a ruler against which to measure proportionality. This proposed approach relies on bringing a set of principles developed to address one set of legal issues (assessed at the point of breach and enforcement), to bear on a completely different set of legal issues (assessed at the point of contract formation). And it is an approach which is unlikely to add anything but unnecessary complication to the law of penalties. The basis upon which negotiating damages are available, awarded, and calculated is complex and, we think it fair to say, unsettled.[80] Moreover, in cases where they have been awarded, evidence as to the economic value of the notional licence to breach has had to be called.

[77] Having said that, and while we are satisfied that a notional calculation of damages is not invariably required, we accept there may be cases where such an

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76 Named after the case *Wrotham Park Estate Co Ltd v Parkside Homes Ltd* [1974] 1 WLR 798 (Ch).

77 At 815.

78 *One Step (Support) Ltd v Morris-Garner* [2018] UKSC 20, [2019] AC 649.

79 The issue in the proceeding was breach of a restraint of trade covenant granted by a vendor on sale of their business.

80 *One Step*, above n 78, at [1] per Lord Reed (with whom Baroness Hale, Lord Wilson and Lord Carnwath agreed) and [109] per Lord Sumption.

assessment will be helpful. It may, for example, be helpful where the clause purports to provide a pre-estimate of loss, or where the impugned clause appears in a contract where the only legitimate interest in performance is properly analysed as the monetary value of that performance or as the direct losses which will flow from breach, and which are readily calculated.

[78] In *Cavendish*, the reasons of Lord Neuberger and Lord Sumption, and Lord Hodge, each recognised the continuing relevance of the *Dunlop* tests where the impugned clause purports to be a pre-estimate of damages.[81] In such cases, the assessment of the actual damages will be relevant (if not determinative) of the issue as to whether the consequence imposed for breach by the impugned clause is out of all proportion to these interests. But where the impugned clause protects interests beyond the interest in compensation for direct loss flowing from breach, or where loss would have been difficult or impossible to forecast at the point of contract formation, a notional calculation of damages is unlikely to be of value in the application of the "legitimate interest" test.

[79] It follows that we are satisfied that the Court of Appeal was correct in its formulation of the test to be applied in determining whether an impugned clause is a penalty, subject only to our view that the cross-check the Court of Appeal suggested – whether the clause has a punitive purpose – should not be adopted as part of the rule. It also follows that we reject the appellants' argument that the dichotomy between pre-estimate of damages and penalty clause continues to lie at the heart of the penalties doctrine, and their argument that it is necessary for the court in each case to assess the damages that would have been awarded for breach of the primary obligation.

Relevance of the parties' conduct and inequality of bargaining power to inquiry

[80] 127 Hobson argues that Honey Bees took advantage of Mr Parbhu's emotional and financial distress, and obtained an additional benefit for itself notwithstanding it was already obligated to lease the premises. This, it argues, was relevant to whether the impugned clause was unconscionable. 127 Hobson argues it is therefore necessary,

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81 *Cavendish*, above n 37, at [32] per Lord Neuberger and Lord Sumption and [255] per Lord Hodge.

in assessing proportionality, to address the relevance of the parties' conduct, whether they were legally advised and the balance of bargaining power between them.

[81] Although the test in cases like *Cavendish* uses the language of unconscionability, the doctrinal basis for the court's refusal to enforce a penalty clause is not that one party has taken advantage of another;[82] rather, it is that the use of contract to punish another party has been treated by the law as against public policy. In *Dunlop*, the word unconscionable was used in the same manner – to describe the effect of the clause rather than prescribing an element of the test for categorising a contractual provision as a penalty. In the various tests formulated in *Cavendish*, the word unconscionable is used as a synonym for exorbitant.

[82] That said, however, the bargaining position of the parties has not been viewed as irrelevant by the courts, and in this sense the word unconscionability has been associated with two related but different concepts: first, the oppressiveness of the clause in the sense that the consequence it provides is out of all proportion to the innocent party's legitimate interests in performance; and, secondly, unconscionability in the sense that the impugned clause is viewed as an exploitation of an unequal bargaining position.

[83] These are both touched upon in the decision of Mason and Wilson JJ in *AMEV-UDC Finance Ltd v Austin* who observed that unconscionability in its procedural sense was relevant to the application of the penalties doctrine:[83]

> The test to be applied in drawing that distinction [between penalty and legitimate compensation] is one of degree and will depend on a number of circumstances, including (1) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to the defendant, and (2) the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in seeking to enforce the term. The courts should not, however, be too ready to find the requisite degree of disproportion lest they impinge on the parties' freedom to settle for themselves the rights and liabilities following a breach of contract. The doctrine of penalties answers, in situations of the present kind, an important aspect of the criticism often levelled against unqualified freedom of contract, namely the possible inequality of bargaining power. In this way the courts strike a balance

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82 As to this see *Cavendish*, above n 37, at [34] per Lord Neuberger and Lord Sumption.

83 *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 at 193–194 (citation omitted).

> between the competing interest of freedom of contract and protection of weak contracting parties.

[84] In *Paciocco,* Kiefel J said that "unconscionable" as a descriptor for a penalty clause describes the "plainly excessive nature of the stipulation in comparison with the interest sought to be protected by that stipulation".[84] Keane J described the terms extravagant and unconscionable "as pointers towards the punitive purpose which imbues the challenged provision with the character of a punishment".[85] The Judges did not address the relevance of unequal bargaining power to the application of the doctrine.

[85] The New Zealand Court of Appeal in *Amaltal* also used the word "unconscionable" to describe the effect of the clause.[86] It cited with approval the following passage from the decision of the Supreme Court of Canada in *Elsley v JG Collins Insurance Agencies Ltd*:[87]

> It is now evident that the power to strike down a penalty clause is a blatant interference with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression.

[86] In *Cavendish*, Lord Neuberger and Lord Sumption observed that although the penalty rule originates in the concern of the courts to prevent exploitation in an age when credit was scarce and borrowers were particularly vulnerable, the modern rule is not procedural, but rather a substantive principle of law that stands apart from the doctrine of unconscionability.[88] Therefore, its operation does not depend on a finding that advantage was taken of one party.

[87] Nevertheless, they said, the broad bargaining position of the parties is relevant – where a contract is the result of negotiation between advised parties of comparable bargaining power "the strong initial presumption must be that the parties themselves

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84 *Paciocco*, above n 27, at [34].
85 At [268].
86 *Amaltal*, above n 31, at [56].
87 At [58], citing *Elsley v JG Collins Insurance Agencies Ltd* [1978] 2 SCR 916 at 937.
88 *Cavendish*, above n 37, at [34].

are the best judges of what is legitimate in a provision dealing with the consequences of breach".[89]

[88] We agree with Lord Neuberger and Lord Sumption that the primary purpose of the penalties doctrine is not to protect against oppression that may flow from exploitation of unequal bargaining power. The rule against penalties should not mix in elements of the law of unconscionable bargains or duress. The law in those areas does the work required to protect against bargains obtained by oppression. It is also relevant that a substantial volume of legislation protects consumers against oppressive provisions in consumer contracts.[90] For these reasons we do not consider it is necessary or appropriate to shape the test to encompass an element of unconscionability.

[89] However, the bargaining power of the parties will be relevant to the courts' inquiry as to the nature and extent of the innocent party's interests in performance of the primary obligation. A court will presume that commercial parties dealing with each other on equal terms are able to assess the appropriate proportion between the legitimate interests in performance of the primary obligation and the consequence of breach agreed to. The fact that a party was legally advised as to the nature and effect of the transaction will also weigh in favour of upholding the bargain. But, even where there is equal bargaining power and the parties are legally advised, a court may find on the facts that the consequences provided by the impugned clause are disproportionate to the legitimate interests.

[90] On the other hand, where there is evidence of unequal bargaining power, or where one party is not legally advised, a court will scrutinise more closely the innocent party's claims as to the interests protected, and also the issue of proportionality. However, even where there is an imbalance of negotiating strength to the point that the breaching party had no ability to negotiate different contractual terms, the innocent party may still be able to show that the challenged provision protected a legitimate interest in the performance of the primary obligation. The inequality of bargaining

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89 At [35].

90 See, for example, the Fair Trading 1986, Commerce Act 1986, Consumer Guarantees Act 1993 and Credit Contracts and Consumer Finance Act 2003.

position simply means that the court will look closely at the claimed legitimate interest, whereas where the parties have negotiated from equal positions, the starting position is rather different, as noted above.

Conclusion as to the test to be applied

[91] We summarise the test as follows:

(a) A clause stipulating a consequence for breach of a term of the contract will be an unenforceable penalty if the consequence is out of all proportion to the legitimate interests of the innocent party in performance of the primary obligation. A consequence will be out of all proportion if the consequence can fairly be described as exorbitant when compared with the legitimate interests protected.

(b) Determining whether or not the impugned clause is an unenforceable penalty requires an objective exercise of construction, notionally undertaken at the time of contract formation, and by reference to the terms and circumstances of the contract. Those circumstances can include the broader commercial context within which the contract sits.

(c) A contractual clause which provides for consequences on breach may provide for consequences designed to protect the interests of the party in performance of the primary contractual term which has been breached. Those are the legitimate interests to be weighed when assessing the proportionality of the agreed consequence.

(d) A party's legitimate interests may extend beyond the loss caused by the breach as measured by a conventional assessment of contractual damages. They may extend to the impact of non-performance on the broader commercial interests the parties seek to achieve or protect through the contract. Those interests may extend beyond the four corners of the contract, for example if they relate to a system of business of which the contract forms a part.

(e) While legitimate interests will not include objectives unrelated to the performance interest, such as punishment, what is also plain is that deterring breach can be a legitimate objective of a clause.

(f) The bargaining power of the parties will be relevant to the courts' inquiry as to the nature and extent of the innocent party's interest in performance of the primary obligation. A court will presume that commercial parties dealing with each other on equal terms are able to assess the appropriate proportion between the legitimate interest in performance of the primary obligation and the consequence contracted for on breach. The fact that a party was legally advised as to the nature and effect of the transaction will also weigh in favour of upholding the bargain. But where there is evidence of unequal bargaining power, or where one party is not legally advised, a court will scrutinise more closely the innocent party's claims as to the interests protected, and also the issue of proportionality. However, whatever the relative bargaining positions of the parties, the issue for the court remains whether the consequences for breach are out of all proportion to the innocent party's legitimate interests in performance.

(g) It is not necessary in all cases for the court to assess the damages that would have been awarded at common law for breach, but there may be cases where such calculation is the measure of the performance interest. That is likely to be the case where the impugned clause purports to provide a pre-estimate of damage, or where the impugned clause appears in a contract where the only legitimate interest in performance is properly analysed as the monetary value of the losses which flow directly from that breach, and which are readily calculated.

Second issue: Is the indemnity clause an unenforceable penalty?

Duration of the indemnity

[92] Before it is possible to undertake the proportionality assessment in this case, the nature of the indemnity obligation has to be determined. As the Court of Appeal

observed, "the parties argued counter-intuitive constructions of extremity and moderation against interest, each calculated to either invoke or evade the effect of the penalties doctrine".[91] Mr Dillon for 127 Hobson argues that where documents are collateral, as they are expressed to be here, and are executed on the same day and form the overall bargain, the terms in the documents need to be read consistently. Mr Dillon argues that, since the Collateral Deed obliges the appellants to indemnify Honey Bees for the term of the Lease, and the Lease defines the final expiry date as 24 years from 19 December 2017, that is the term of the indemnity.

[93] We accept Mr Gedye's submission that the starting point is that the exercise of a right of renewal is normally regarded in law as the grant of a new lease and clear words are needed to displace this presumption.[92] There is nothing in the language of this Lease to displace this presumption. On the contrary, the language supports the interpretation that the term of the Lease is the initial six years. The First Schedule provides that the Term of the Lease is six years. Although the First Schedule also defines a "Final Expiry Date" of 24 years less one day from the date of the Deed, that is a final expiry date, and is not described as the expiry date of the Lease. Clause 47.1 defines "term" as including a further term but only if the context requires. Most significant, however, is cl 32.1 which obliges the Landlord to grant a new lease if the right of renewal is exercised.

[94] We also agree with the common sense point made by the High Court Judge that it is commercially absurd to suggest any of the contracting parties had in mind a 22 year indemnity period when they entered into the Collateral Deed.[93] We note Mr Dillon's caution against reading down the clause so as to deprive it of its penal intent. But this is not what we are doing. Contractual interpretation invites a common sense approach to the task of assessing what the parties intended by the words, objectively assessed.[94]

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91 CA judgment, above n 2, at [45].

92 DW McMorland and others *Hinde McMorland and Sim Land Law in New Zealand* (online ed, LexisNexis) at [11.156]; and *Sina Holdings Ltd v Westpac Banking Corporation* [1996] 1 NZLR 1 (CA) at 4–5.

93 HC judgment, above n 1, at [72]. See above at [25].

94 See, for example, *Firm PI 1 Ltd v Zurich Australian Insurance Ltd* [2014] NZSC 147, [2015] 1 NZLR 432 at [60] per McGrath, Glazebrook and Arnold JJ. See also *Green Growth No 2 Ltd v Queen Elizabeth the Second National Trust* [2018] NZSC 75, [2019] 1 NZLR 161 at [59] per William Young and O'Regan JJ (with whom Glazebrook J agreed: at [151]).

Subject matter of the indemnity

[95] Mr Dillon also argues that the effect of the indemnity is to alienate every remaining property right of the landlord, saving only reversion at the final expiry of the Lease. The indemnity extends to "all obligations … under the Lease including the payment of rent, operating expenses and other payments as provided under the Lease to the expiry of the Lease". The use of the word "including" puts beyond doubt, he says, that the subject matter of the indemnity obligation extends beyond payment of rent and outgoings, and beyond payment obligations, to include obligations arising out of breach of Honey Bees' obligations under the Lease to maintain, care for the grounds, to comply with limitations of use of the premises, and to comply with statutes, regulations and bylaws affecting the premises.

[96] Again we find nothing in the language to support the argument that the clause relieves Honey Bees of all obligations under the Lease. Such an indemnity would be expressed as an indemnity for breach of Honey Bees' obligations under the Lease. Moreover, as both the High Court Judge and the Court of Appeal found,[95] it defies common sense that the parties intended 127 Hobson to indemnify Honey Bees in respect of a breach of the obligations under the Lease.

[97] Placing the indemnity obligation within the context that applied at the time it was negotiated, it is most readily interpreted as a clause indemnifying Honey Bees against payment obligations under the Lease, whatever those are, and not as an indemnity that extends to damages claims 127 Hobson might have. In this regard, it is significant that the only obligations referred to are payment obligations.

[98] While Mr Dillon points to the use of the word "including", that simply allows that there are payment obligations other than the obligation to pay rent and outgoings. The fact that rent and outgoings seem to be the only payment obligations under the Lease does not persuade us to Mr Dillon's interpretation. In a deed negotiated and documented at speed, it does not seem to us to be of significance to the interpretation of the clause that such a catch-all drafting technique was used.

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95 HC judgment, above n 1, at [72]; and CA judgment, above n 2, at [53].

[99] Properly construed, then, the indemnity clause relieved against the obligation to pay rent and outgoings from the date of default down to the end of the initial term. For these reasons we find no error in the High Court and Court of Appeal interpretations of this clause. Expressed in economic terms, the effect of the indemnity is that Honey Bees paid full rent for 17 months of the initial term (it had a rent holiday for part of the initial term) but once the indemnity obligation was triggered, Honey Bees was indemnified for rent and outgoings for the remaining three years and five months of the first term. The indemnity did not continue once Honey Bees renewed the Lease.

What was Honey Bees' legitimate interest?

[100] The appellants argue the Court of Appeal was wrong to take into account the extent of Honey Bees' interests under the Lease when assessing proportionality because, properly construed, the Collateral Deed should have been approached as unconnected to the Deed of Lease. Honey Bees was already obliged, under the agreement to lease, to execute the Lease. The Collateral Deed dealt with something new, and additional, to those pre-existing obligations – an obligation to install a second lift. The only legitimate interest to be weighed was anything that could flow from a failure to install that lift on or before the due date.

[101] We accept Mr Gedye's submission that the approach for which the appellants argue is artificial. The obligations contained in the Collateral Deed relate to access to the leased premises, and to payment obligations under the Lease. They were included in a separate document at Mr Parbhu's request but could equally have been included in the Deed of Lease. The Collateral Deed stated in cl 3 that it was collateral to the Lease. Indeed, as the appellants have argued, it is necessary to have regard to the terms of the Lease to make sense of the obligations under the Collateral Deed.

[102] The evidence supported the finding made in both the High Court and Court of Appeal that Honey Bees wanted to secure the installation of a second lift because of the impact the limited existing access would have on the development of its new business. The business was operating on the fifth floor of a busy high rise.[96] Children

[96] See above at [7] for a description of the premises.

and parents would be arriving and leaving within concentrated blocks of time. Without the second lift they would be competing with apartment owners and hotel users for the existing single lift.

[103] At the time the parties were contracting, when Honey Bees was still a start-up business, limited access would reasonably be viewed as likely to adversely impact upon the future growth and success of the business. Lifting the number of children attending the facility was important to the commercial success of the venture. The rental for the leased premises was calculated on a per head basis and assumed at least 48 children attending the premises. To state the obvious, the more children attending the preschool, the more profitable it would be. And by December 2013 Honey Bees had spent around $500,000 on hard fit-out costs on the premises. That was a sizeable amount to recoup.

[104] The appellants argue that the second lift was not important to the business, and this is evidenced by the failure to stipulate for it in the agreement to lease. Also relevant, they argue, is the availability of dedicated carparking for the centre which would reduce the importance for parents of fast lift access.

[105] But there is evidence that the lift was seen by Mr James as important to the business. It was discussed at the very first meeting, and Mr James explained that, from those discussions, he understood the installation of the lift was imminent. When it came time to execute the Deed of Lease and the lift had still not been installed, Mr James asked for that obligation to be included in the Lease.

[106] The availability of the carparks did not meet this concern, and objectively assessed it was unlikely to do so. Five dedicated car parks for a fifty-child centre would come under pressure at drop off and pick up times. And even were they adequate, parents would still be concerned with lengthy wait times for a single lift. Mr James' conduct throughout has been consistent with Honey Bees' case that it believed the second lift to be vital to the success of its business. The Court of Appeal was therefore correct to find that Honey Bees was seeking to protect its legitimate interests in operating a business on the premises supported by two lifts, and also seeking to protect the future growth prospects of that business.

Did Honey Bees take advantage of an unequal bargaining position?

[107] Mr Dillon argued that Mr James took advantage of Mr Parbhu's vulnerability and secured a clause to which Honey Bees was not contractually entitled. He points to the fact that Mr Parbhu was not legally advised before he entered into the Collateral Deed.

[108] Mr Parbhu gave evidence as to the number of commercial properties he had developed. He said he had 12 commercial premises and since 1981 had been landlord to 150 tenants in his commercial properties. At the date of the High Court hearing, he had 107 tenants over 12 premises.

[109] As noted above, the equality of bargaining position may be relevant to the scrutiny the court applies to the proportionality between the contracted-for consequence and the legitimate interests it protects. We have no doubt that the High Court Judge was correct to conclude that Mr Parbhu was a sophisticated commercial party.[97] After so many years operating as a landlord of commercial premises Mr Parbhu would have had a good understanding of the issues in play. If he did not seek legal advice, that was very much his choice.

[110] As to the argument that this was an advantage that Mr James extorted when he was already legally obligated to enter into the Lease, this overlooks the point that Mr James had a right to terminate the agreement to lease if he did not secure a licence for 45 children. Therefore he was not already bound to go through with the deal. He could have terminated the agreement and walked away, even though that would have meant the loss of the money he had already invested.

[111] The relative bargaining positions of the parties is better analysed in this way. By December 2013 there were strong commercial incentives for Honey Bees to go through with the formal documentation – it had expended so much on the premises already. Likewise, there were strong commercial incentives for Mr Parbhu to have the respondents bind themselves to the Lease, even if achieving that required that he agree both to install a lift by a certain date, and indemnify the respondents for payment

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97 HC judgment, above n 1, at [102].

obligations under the Lease if he failed to do so. We do not therefore see evidence that, in securing the indemnity obligation, Honey Bees or Mr James took advantage of a party in a weaker bargaining position.

Were the consequences out of all proportion to Honey Bees' legitimate interests in performance?

[112] The appellants argue that there was no attempt to secure proportionality between the extent of delay and the consequence. For example, if 127 Hobson was one day late in installing the second lift, the full consequences of the indemnity clause would follow. Not only does this show, the appellants argue, that Honey Bees was taking advantage of Mr Parbhu's distress, but it shows the absence of proportionality which justifies the court's intervention.

[113] We agree that the "all or nothing" nature of the indemnity clause is relevant to the issue of proportionality. There is no attempt to scale the consequences to the length of the delay. While at first blush this may seem evidence that the consequences are exorbitant, we are not satisfied that is so. 127 Hobson was given two years and seven months to complete the lift. It had ample opportunity to comply with the obligation before 31 July 2016.

[114] We also agree with the Court of Appeal that the provision of the Collateral Deed provided lesser protection than would a covenant in the Lease itself requiring completion of the lift. If the obligation had been included in the Lease, a failure to install would have been a breach of the Lease, and allowed Honey Bees to cancel, thereby relieving it of the obligation to pay rent. That was a right it might reasonably wish to secure, given its assessment that the second lift was important to the success of the business.

[115] The rights Honey Bees obtained under the Collateral Deed did not include a right to cancel the lease. And while the indemnity may appear attractive, Honey Bees had to enforce it whilst its obligation to pay rent continued. As the Court of Appeal

observed, this exposed it to unmatched timing and credit risks.[98] This difficulty with the indemnity rights is relevant to the proportionality assessment.

[116] Having weighed the interests Honey Bees had in performance of the obligation to install the lift against the consequences of the indemnity clause being triggered, we are satisfied that these consequences were not out of all proportion to the legitimate interests Honey Bees thereby secured. They cannot be described as exorbitant in the circumstances. The indemnity clause does not offend the rule against penalties.

Result

[117] The appeal is dismissed.

[118] The appellants must pay costs of $25,000 plus usual disbursements to the respondents.

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98 CA judgment, above n 2, at [60].