

MELBOURNE LINH SON BUDDHIST SOCIETY INC v GIPPSREAL LTD: THE PENALTIES DOCTRINE AND THE LOAN ESTABLISHMENT FEE CONUNDRUM

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The payment of a loan establishment fee to a lender is an important, and common, feature of loan transactions. It is also a standard drafting technique to require a borrower to pay such a fee as an agreed remedy if she fails to settle her loan. Accordingly, it is of considerable importance for lenders to know where they stand when drafting loan transactions that contain an establishment fee and whether the payment of such a fee on a borrower's default will withstand scrutiny by way of the penalties doctrine. Whether an establishment fee is punitive was precisely the issue considered by the Court of Appeal of the Supreme Court of Victoria in Melbourne Linh Son Buddhist Society Inc v Gippsreal Ltd [2017] VSCA 161 (23 June 2017). The majority held that the payment of a loan establishment fee as a component of an agreed remedy in circumstances where a borrower, in breach of contract, failed to settle a loan constituted a penalty. This note argues that the general approach adopted by the majority towards the penalties issue ought not be followed. The majority considered whether the payment of the establishment fee as a component of an agreed remedy was punitive by considering whether the fee was legitimate in the sense of being objectively fair or reasonable. It will be demonstrated in this note that the correct approach requires the court to take into account the lender's expectation interests in the performance of the loan agreement in deciding whether the agreed remedy exacts a punishment on the borrower.

I INTRODUCTION

It is a strength of the common law¹ that it is a collective body of knowledge. The dispersive character of the common law means that this body of knowledge is subject to a continuous process of refinement or restatement through the cases decided daily throughout the common law world. Of course, refinements or restatements of the law are not the only possible outcomes when a curial order and the related reasons for decisions are given. Errors in the application and statement of legal principles can, and will, occur. The expectation is that within this system, over time, the common law can self-correct such that defects

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1 The term 'common law' is used here in the sense of general judge-made law in contradistinction to statute.

and redundancies in the law can be rectified as a ‘heap of old exploded errors’.² The reason for writing this note is simple: to correct an error in the reasoning of the Court of Appeal of the Supreme Court of Victoria in *Melbourne Linh Son Buddhist Society Inc v Gippsreal Ltd*³ concerning the application of the penalties doctrine to a loan establishment fee. It is argued that the reason why the majority of Kyrou JA and Cameron AJA fell into error in applying the penalties doctrine is as follows: their Honours failed to take into account the lender’s expectation interest in the borrower’s performance of the underlying primary contractual obligations in deciding whether an impugned clause was a penalty. As this note is only concerned with the penalties issue raised by the decision, the statement of facts and analysis will be limited accordingly.

II THE DECISION

An incorporated association (*‘B’*)⁴ that was seeking finance entered into a loan agreement (termed a ‘deed of offer of finance’)⁵ with a lender (*‘A’*).⁶ *B* initially sought to borrow the sum of up to \$1 775 000 for a period of two years from *A* and the loan documents were prepared and executed by the parties on this basis.⁷ However, the amount *A* was willing to lend to *B* was subsequently reduced to \$500 000 as the value of *B*’s security had been previously overestimated.⁸ Accordingly, *A* sent *B* an ‘amended deed of offer of finance’ on substantially and relevantly similar terms to those in the original deed but reflecting the reduction of the principal.⁹ The salient point for present purposes is that it was *A*’s standard business practice to charge borrowers a ‘loan establishment fee’ calculated at around 1.5 per cent¹⁰ of the value of the principal of the loan (which would be added to the balance of the loan at the date of settlement). However, in this case, when the sum of the principal was altered in the amended deed, the loan establishment fee had not been changed to reflect the reduction in principal. This

2 Edmund Burke, *Reflections on the Revolution in France*, ed L G Mitchell (Oxford University Press, first published 1790, 2009 ed) 95.

3 [2017] VSCA 161 (23 June 2017) (*‘Melbourne Linh Son Buddhist Society’*).

4 Ibid [21] (Kyrou JA and Cameron AJA), which exists for the purpose of bringing together members of Melbourne’s Vietnamese community.

5 Ibid [23] (Kyrou JA and Cameron AJA).

6 Ibid [22] (Kyrou JA and Cameron AJA), which operates in a market for potential borrowers who cannot get a loan from a major lending institution.

7 Ibid [35] (Kyrou JA and Cameron AJA). For completeness, the terms of the deed stated that the amount of the loan would be the lesser sum of either: (i) \$1 775 000; or (ii) 50 per cent of the loan value ratio of the proposed security property. Further, although it is immaterial for present purposes, the original amount sought by *A* was the sum of \$2.6 million: at [25] (Kyrou JA and Cameron AJA).

8 Ibid [30], [43], [46] (Kyrou JA and Cameron AJA).

9 Ibid [48] (Kyrou JA and Cameron AJA). Although the reasoning is unclear, as I understand the facts, *B* never executed the amended deed due, in part, to the high establishment fee. *A* then terminated the deed and sued for the agreed remedy, as *B* had not settled the loan within the obliged timeframe: at [54]–[56] (Kyrou JA and Cameron AJA).

10 Ibid [199] (Kyrou JA and Cameron AJA). Note that *A*’s standard practice was to set the rate of the establishment fee somewhere between 1 per cent and 2.5 per cent of the principal of the loan: see also at [67].

meant that *B* would have been obliged to pay to *A* a loan establishment fee of \$26 625 for the loan of \$500 000 should the loan proceed to settlement (being 5.3 per cent of the value of the loan).¹¹

Under the terms of the original deed, *B* was obliged to proceed to settlement of the loan within four weeks of entry into the deed.¹² However, the deed also contained an agreed remedy clause which was enlivened if *B* failed to proceed to settlement of the loan.¹³ Under the agreed remedy clause, if *B* failed to proceed with the loan then *A* would become entitled to an agreed remedy consisting of three components: (i) \$26 625 representing the loan establishment fee; (ii) \$5000 representing a mortgage preparation fee; and (iii) \$11 562.50 representing three months' interest on the proposed loan of \$500 000.¹⁴ When *B* failed to settle the loan with *A* within the prescribed period, *A* issued a default notice and subsequently terminated the deed on the basis that *B* had breached or repudiated the agreement by failing to effect the settlement of the loan.¹⁵ In turn, *A* commenced proceedings in the Supreme Court of Victoria against *B* claiming, inter alia, the \$26 625 establishment fee as a component of the agreed remedy.¹⁶

In response to *A*'s claim, *B* raised a number of arguments in order to deny its liability to pay the agreed remedy. At the outset, it ought to be noted that *B* succeeded in its argument before the Court of Appeal that *A* had not lawfully exercised its contractual power to terminate the deed. That is, the case was ultimately decided on the basis that *A* was not entitled to withdraw finance from *B* in the circumstances of the case.¹⁷ This meant that *A* had wrongfully terminated the deed and was thus not entitled to claim the agreed remedy (including the component of the agreed remedy that represented the loan establishment fee). This aspect of the Court's reasons will not be explored in any detail here. I do not quibble with them and they are not directly relevant for present purposes save for noting that the correct outcome was reached in the appeal on the central issues considered by the Court. However, and relevantly for present purposes, *B* also raised the argument that the agreed remedy clause was punitive.¹⁸ It is on this issue that the majority of the Court of Appeal (Kyrou JA and Cameron AJA) fell into error and hence why the case is worthy of comment.

B's argument that the establishment fee component of the agreed remedy clause was punitive was based on there being no apparent relationship between the fee

11 Ibid [51] (Kyrou JA and Cameron AJA).

12 Ibid [35] (Kyrou JA and Cameron AJA).

13 Ibid [37] (Kyrou JA and Cameron AJA).

14 Ibid [35], [82] (Kyrou JA and Cameron AJA).

15 Ibid [17], [56]–[57] (Kyrou JA and Cameron AJA).

16 Ibid [60], [81] (Kyrou JA and Cameron AJA).

17 Ibid [1] (Maxwell P), [110], [114], [117], [126], [135] (Kyrou JA and Cameron AJA). This was because, under the relevant contractual power, *A* could only terminate the agreement if (i) the relevant default was for reasons outside of *A*'s control; and (ii) *A* gave *B* a reasonable period in which to remedy any default: at [107]. As the Court held, neither of these conditions were satisfied as *A* had not properly amended the loan documents to reflect the sum it was now willing to lend and had given *B* an unreasonably brief window in which to remedy any default: at [1] (Maxwell P), [110], [114], [117], [126], [135] (Kyrou JA and Cameron AJA).

18 Ibid [180]–[182] (Kyrou JA and Cameron AJA).

and the subsequently reduced value of the loan.¹⁹ That is, the establishment fee was calculated by reference to the original loan amount and not the reduced loan amount and therefore could not properly constitute agreed damages for the latter. Kyrou JA and Cameron AJA accepted this attractive but, with respect, ultimately flawed argument. Their Honours held the impugned quantum of \$26 625 had nothing to do with the protection of any of *A*'s legitimate commercial interests that might be damaged if *B* failed to proceed with the loan (including the pecuniary losses that *A* may suffer from *B*'s related breach of contract). Their Honours said that:

In our opinion, the establishment fee of \$26,625 is a penalty because it bears no relation to any possible damage to or interest of [*A*] arising from the putative breach of the Deed of Offer by [*B*] and it is not commensurate with any legitimate commercial interest of [*A*] which is sought to be protected by that deed in the event of its breach.

...

We are fortified in this view by the evidence ... that establishment fees are usually set at between 1 and 2.5 per cent of the approved loan amount, and are commonly 1.5 per cent. As the amount of \$26,625 was 5.32 per cent of the loan amount of \$500,000, it was 3.54 times greater than the establishment fee that [*A*] usually charged. There was no evidence from which it could be concluded that this vast discrepancy could be attributed to any genuine estimate of the loss that might arise from [*B*'s] putative breach of the Deed of Offer. The only conclusions that are open on the evidence are: that the establishment fee is extravagant and unconscionable and out of all proportion to the likely loss that [*A*] might suffer as a result of such a breach; and that its purpose is to punish [*B*] rather than to protect a legitimate commercial interest of [*A*].

Another reason given ... for retaining the establishment fee at \$26,625 was the risk inherent in the loan. *While that risk might be relevant to setting [*A*'s] 'price' for the transaction, it has nothing to do with quantifying a loss that might arise from a breach by [*B*]. The risk of a loan defaulting has no relevance when a loan does not proceed.*²⁰

Their Honours continued that the fact that the 5.3 per cent establishment fee would nonetheless be payable to *A* as a primary obligation if the contract was properly performed was irrelevant to the analysis on the penalty issue:

Neither the fixed nature of the amount nor the fact that [*B*] agreed to pay it has any bearing on whether the establishment fee is a penalty. This is because, where a party seeks to impugn an amount payable under a contract as a penalty, that party does not allege that he or she did not agree to pay that amount, but rather that that amount is unenforceable based on the principles which we have discussed above. Further, amounts sought to be impugned as penalties are usually specified as fixed amounts and one of the indicia that such an amount is a penalty is that it remains the same irrespective of the likely loss that might be suffered from breaches of different types of contractual obligations.²¹

19 Ibid [180]. The penalties issue was argued on the basis that the loan would be for the sum of \$500 000 but the establishment fee was calculated with reference to the sum of \$1 775 000.

20 Ibid [195], [199]–[200] (Kyrou JA and Cameron AJA) (emphasis added).

21 Ibid [202] (Kyrou JA and Cameron AJA).

In a brief separate judgment, Maxwell P did not join with Kyrou JA and Cameron AJA's conclusions on the penalties point, citing the lack of evidence adduced in order properly to consider the issue.²² It will be argued in this note that Kyrou JA and Cameron AJA erred in the application of the penalties doctrine. The reason for this conclusion is clear: their Honours failed properly to take into account *A*'s expectations under the agreement contained in the deed, including the fact that *A* had an expectation to receive the full establishment fee at 5.3 per cent of the principal if *B* complied with its obligation to settle the loan *irrespective* of how that fee was calculated.

III IN DEFENCE OF THE ESTABLISHMENT FEE AS A COMPONENT OF THE AGREED REMEDY

Before discussing the reasoning in *Melbourne Linh Son Buddhist Society* on the penalties issue, the nature of agreed remedy clauses will be discussed with reference to a simple example. Assume that a Latin tutor ('*A*') enters into an agreement with a keen student ('*B*') under which *A* is obliged to provide a tutorial this Saturday for the agreed sum of £200. Further assume that the contract includes a clause which provides that 'if *B* fails to attend the tutorial or cancels this agreement then she will be liable to pay to *A* the agreed sum of £200'. On Saturday morning, *B* calls *A* and says that the tutorial is off, as learning Latin seemed like a good idea at the time but was a passing fancy. In turn, *A* seeks to enforce her right to the agreed remedy of £200. In these circumstances, can *B* resist paying *A* the sum of £200 as specified in the agreed remedy clause on the basis that it is a penalty? The answer is clearly no. The reason is this: the sum of £200 reflects a reasonable facsimile of *A*'s expectations if the contract had been carried out. As Mason and Deane JJ observed in *Legione v Hately*, '[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 [or failure] of the contractual stipulation'.²³ The essential point is that there is no way to determine whether or not an impugned penalty imposes an 'additional' or 'different' liability without a legal baseline according to which to determine the monetised value to *A* of the performance of the underlying primary contractual rights, the failure of which triggers *A*'s right to the purportedly 'penal' agreed remedy.

Returning to our example, it could not be said that the £200 agreed remedy is punitive. After all, the sum of £200 represents the value which *A* expected to receive for her labour as a Latin tutor under the agreement. As such, given the clear proportionality between *A*'s lost expectations under the contract and the

22 Ibid [15] (Maxwell P). Note that his Honour was nonetheless in concurrence with the balance of the majority's reasoning: at [1]–[2].

23 (1983) 152 CLR 406, 445 (emphasis added), affd *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [9] (French CJ, Gummow, Crennan, Kiefel and Bell JJ); *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 545 [22], 548 [32] (Kiefel J, French CJ agreeing at 536 [2]), 567 [118] (Gageler J), 606 [255] (Keane J). See also Nicholas A Tiverios, 'A Restatement of Relief against Contractual Penalties: Underlying Principles in Equity and at Common Law' (Pt 1) (2017) 11 *Journal of Equity* 1, 16–19.

agreed sum, it could not be said that the sum of £200 is out of all proportion to *A*'s legitimate interest in the performance of the contract.²⁴ Nor could it be said that the sum of £200 was not a reasonable pre-estimate of the damage that *A* would suffer if *B* decided to withdraw from the contract.²⁵ Indeed, the sum of £200 is precisely *A*'s expectation loss if she had no alternative work on the Saturday in question.²⁶ Now assume for a moment that charging the sum of £50 is the standard rate for one of *A*'s Saturday Latin tutorials. Does the fact that £50 is the normal sum which *A* receives for her labour affect our conclusion that the agreed remedy of £200 is not a penalty? The answer is no. Given the *actual* agreed value of the primary rights²⁷ in the contract between *A* and *B*, and particularly *A*'s expectation

- 24 To use the test adopted by the High Court of Australia in *Paciocco* (2016) 258 CLR 525, 547 [29] (Kiefel J, French CJ agreeing at 536 [2]), 580 [164] (Gageler J), 612 [270] (Keane J). The 'legitimate interest' standard, adopted in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172 ('*Cavendish*'), can be seen in the judgment of Allsop CJ in the intermediate appeal in the *Paciocco* litigation: *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 234–5 [103]. See too the same approach adopted in *Cavendish* [2016] AC 1172, 1204 [32] (Lords Neuberger P and Sumption SCJ, Lord Carnwath SCJ agreeing), 1247 [152] (Lord Mance SCJ), 1278 [255] (Lord Hodge SCJ), 1285 [293] (Lord Toulson SCJ). For a comment on the significance of this test, see Nicholas A Tiverios, 'A Restatement of Relief against Contractual Penalties: A Framework for Applying the Australian and English Approaches' (Pt 2) (2017) 11 *Journal of Equity* 185, 200–10; J W Carter, Wayne Courtney and G J Tolhurst, 'Assessment of Contractual Penalties: *Dunlop Deflated*' (2017) 34 *Journal of Contract Law* 4.
- 25 To adopt the general 'genuine pre-estimate' of damage approach enunciated in *Dunlop Pneumatic Tyre Co, Ltd v New Garage and Motor Co, Ltd* [1915] AC 79, 88–9 ('*Dunlop*') (Lord Dunsedin); *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 663 [12], 668–9 [27]–[28] (Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ). However, under this approach, given that the parties are seeking to create an agreed remedy prior to any default, they cannot be required to create a perfect facsimile of a court award of damages. Rather, the court considers whether the agreed remedy is not out of all proportion with the pecuniary 'damage likely to flow from the event which triggers the operation of the clause and the imposition of a sanction or penalty': *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd* (1989) 15 NSWLR 564, 576–7 (Clarke JA, Kirby P agreeing at 566, McHugh JA agreeing at 567). For example, in applying the *Dunlop* guidelines, the 'damage' which *A* has 'suffered' when a contract has been lawfully terminated by *A*'s exercise of a contractual power includes loss of bargain damages provided that the contract was justifiably terminated for *B*'s breach of contract (loss of bargain damages can be considered irrespective of whether *B*'s underlying breach of contract amounted to a repudiation of the contract which would normally entitle *A* to such damages when applying the general principles governing recovery for breach of contract): see *Esanda Finance Corporation Ltd v Plessnig* (1989) 166 CLR 131 ('*Esanda*').
- 26 Where *B* breaches a contract the usual remedy which *A* recovers is compensatory damages. The purpose of compensatory damages for breach of contract is to put *A* in as good a position as if the contract had been properly performed (ie the law seeks to measure the difference between *A*'s position had the contract been fully performed and *A*'s position as a result of the breach of contract): *Robinson v Harman* (1848) 1 Ex 850; 154 ER 363; *Commonwealth v Amann Aviation Pty Ltd* (1991) 174 CLR 64, 80 (Mason CJ and Dawson J). This includes damages for *A*'s loss of the bargain: *Castle Constructions Pty Ltd v Fekala Pty Ltd* (2006) 65 NSWLR 648, 654 [28]–[29] (Mason P, Beazley JA agreeing at 666 [94]). Alternative remedies include injunction, specific performance, nominal damages, substitutive damages, and, more controversially in the Australian context, restitutionary and disgorgement damages.
- 27 The use of the terms 'primary' and 'secondary' right in the context of the penalties doctrine can mislead. This is because a contractual right to an agreed remedy is actually a primary right (and not a secondary right) as the right to the agreed remedy is contained within the 'four corners' of the contract. 'The causative event that creates *A*'s right to the fixed sum is the original exercise of consent by the parties in entering into the contract in question (and *A*'s right to the fixed sum is merely triggered or enlivened, but not created, by *B*'s wrongdoing)': Tiverios, 'A Restatement of Relief against Contractual Penalties' (Pt 1), above n 23, 25 (emphasis altered); see also Carmine Conte, 'The Penalty Rule Revisited' (2016) 132 *Law Quarterly Review* 382, 386; *Harrison v Wright* (1811) 13 East 343, 348; 104 ER 402, 404 (Lord Ellenborough CJ): 'The penalty therefore is auxiliary to the enforcing performance of the contract; and the party grieved may either take the penalty as his debt at law ... or he may bring his action for damages upon the breach of the contract.'

to the sum of £200 if the contract is properly performed, it is simply irrelevant that *B* ultimately agreed to pay more for *A*'s labour than the market rate and could have bargained for a better deal.²⁸

Once we return to the facts of *Melbourne Linh Son Buddhist Society*, it is now hopefully clear why Kyrou JA and Cameron AJA fell into error on the penalties issue. Their Honours effectively asked a misleading question to the following effect: did *A* have a legitimate reason for imposing a 5.3 per cent establishment fee as part of the agreed remedy? This misleading question led their Honours into the further error of providing a misleading answer: *A* had no legitimate interest in claiming a 5.3 per cent establishment fee as part of the agreed remedy because around 1.5 per cent constitutes *A*'s general market expectations. However, this approach is unprincipled because whether an impugned clause constitutes a penalty depends on whether or not it imposes an *additional* or *different* liability upon *B* for the breach or failure of the contractual stipulation. This requires the court to consider whether the impugned agreed remedy is out of all proportion with *A*'s legitimate interests in the *performance* of the contract (and not whether the impugned agreed remedy was legitimate in light of *A*'s standard business practices or objectively determined standards of fairness and reasonableness). Naturally, when considering whether the agreed remedy clause is commensurate with *A*'s interests in the performance of the contract, the court may consider the gains made by *A* due to the failure of the contract, such as the fact that *A* could potentially redeploy the capital that was to be attributed to the loan.²⁹

Once this general approach is applied to the facts of *Melbourne Linh Son Buddhist Society*, when considering *A*'s interests in the performance of the contract one cannot wholly overlook *A*'s expectation to receive the full establishment fee under the contract.³⁰ The parties had agreed to this sum as the price *B* would pay to establish the loan, and the sum was reflected in the terms of their contract. As Kyrou JA and Cameron AJA observed elsewhere in their reasoning, if the agreement in

28 If the example were altered and the contract between the Latin tutor and student was for a term of several years but the agreed remedy required *B* to pay an entire sum of tutorial fees potentially owing on default, questions regarding *A* regaining her labour and mitigation might come into play when assessing whether the clause is punitive: see below nn 29, 52.

29 See, eg, *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359, 383 (Wilson J), 387 (Brennan J) (*'O'Dea'*). In *O'Dea*, it was held that an agreed remedy in a chattel lease that enabled the lessor (*'A'*) to recover on *A*'s early termination of the lease for the lessee's (*'B'*) breach: (i) the chattel that was the subject of the lease; (ii) the costs of recovery; (iii) rental arrears; and (iv) the total rent payable if the lease had been performed, was a penalty for failing to take into account *A*'s gains owing to the use of the chattel. See also *Esanda* (1989) 166 CLR 131. In *Esanda* it was held that an agreed remedy in a chattel lease that enabled *A* to recover on *A*'s early termination of the lease for the *B* breach: (i) the chattel that was the subject of the lease; (ii) recovery costs; (iii) rental arrears; and (iv) the total rent payable if the lease had been performed (minus previous rental payments *and minus the wholesale value of the goods*), was not a penalty as it took into account *A*'s gains owing to the use of the chattel. See also *MSC Mediterranean Shipping Co SA v Cottonex Anstalt* [2015] 2 All ER (Comm) 614, 642 [113] (Leggatt J); *Active Tree Services Pty Ltd v Electrical Resource Providers Pty Ltd* [2014] WASCA 6 (9 January 2014) [18], [21] (Martin CJ, Newnes and Murphy JJA), where it appears implicit that the Court of Appeal of the Supreme Court of Western Australia is taking into account mitigation in considering whether an impugned clause is punitive; Hugh Beale, 'Damages' in Hugh Beale (ed), *Chitty on Contracts* (Sweet & Maxwell, 32nd ed, 2016) vol 1, 1923–5 [26-202]. See also below n 52.

30 See above n 25.

question had been properly performed and *B* proceeded to settlement, then ‘the establishment fee of \$26,625 was a fixed fee that was payable in accordance with the Deed of Offer’.³¹ As I understand the facts, the Court appeared to accept that *B* was obliged to pay the loan establishment fee of 5.3 per cent if the loan proceeded to settlement and should the loan not so proceed as a result of *B*’s default then the same establishment fee also constituted a component of the agreed remedy clause. No claim for rectification of the establishment fee payable by *B* if the loan proceeded to settlement was raised (ie reducing the sum from 5.3 per cent to 1.5 per cent).³² Accordingly, on the penalties issue, Kyrou JA and Cameron AJA fell into error by considering *A*’s normal business practice (and the related out-of-pocket costs and opportunities associated with that practice) and not *A*’s actual expectation to the 5.3 per cent establishment fee should the loan proceed to settlement. The reasoning deployed in *Melbourne Linh Son Buddhist Society* would undoubtedly be correct if *B* was obliged to pay an establishment fee of 1.5 per cent of the principal if the loan was properly performed but a higher fee of 5.3 per cent as an agreed remedy on default,³³ but on the facts before the Court the payment of an establishment fee calculated at 1.5 per cent of the reduced principal of \$500 000 never formed part of the parties’ primary contractual rights and obligations.

Put simply, if *B* was under a primary contractual obligation to pay the full quantum of the higher establishment fees (calculated at 5.3 per cent of the principal) if the contract was properly performed, then *A*’s interest in receiving those fees is central to determining whether an impugned agreed remedy payable where *B* fails to settle the loan was punitive.³⁴ It seems artificial in such circumstances to say that there was an ‘additional’ liability (or punishment) imposed on *B* for the benefit of *A* in having to pay the establishment fees on breach of contract. The deed of finance was simply a hard bargain under which *B* was obliged to pay to *A* a high establishment fee (5.3 per cent) if the agreement was performed and the loan proceeded to settlement. From this starting point the agreed remedy clause did no more than operate symmetrically with the hardness of that bargain. That is, while the sum payable as the establishment fee never fell due for payment as the loan did not settle, a sum reflecting the full value of the establishment fee was nonetheless a legitimate inclusion in an agreed remedy clause.³⁵ Put another way, considering *A* would be entitled to claim for the establishment fees had the

31 *Melbourne Linh Son Buddhist Society* [2017] VSCA 161 (23 June 2017) [151]–[155].

32 *Ibid.* The Court rejected *B*’s argument that the contract should be interpreted so that the 5.3 per cent establishment fee, payable if the loan proceeded to settlement, be read as constituting a 1.5 per cent establishment fee. This note has not considered the issue of whether *B* could argue for rectification of the amount of the loan establishment fee on the basis of a mistake.

33 See *ibid* [191]–[192], [196] (Kyrou JA and Cameron AJA).

34 If anything, *A*’s standard business practice illustrates that a fee of 5.3 per cent to establish a loan would be unlikely to be replicated in the market in which it operates.

35 See also *Holyoake v Candy* [2017] EWHC 3397 (Ch) (21 December 2017) [471] (Nugee J), where Nugee J noted that: ‘I see nothing extravagant in [an agreed remedy] that if [*B*] defaulted and the loan became due, [*A*] should be entitled to the same sum ... that would otherwise have been due from him; it would be surprising if by defaulting on his obligations, [*B*] could be liable for a lesser sum’. See further *Pacific Wireless Pty Ltd v Breeze Logistics Australia Pty Ltd* [2019] VSC 64 (18 February 2019) [98]–[100] (Lyons J).

contract be properly performed, those fees would have been generally recoverable as expectation damages if *A* simply sued *B* for breach of contract.³⁶

It is submitted that the impugned agreed remedy clause considered in *Melbourne Linh Son Buddhist Society* was not a penalty (or at the very least not a penalty for the reason that it did not reflect *A*'s standard business practice). For an agreed remedy to be a penalty, it has to be *out of all proportion* to *A*'s interests in the performance of the contract. Given *A*'s expectations to the full establishment fee under the contract if *B* properly performed its primary obligations and proceeded with the loan, the impugned clause does not appear to bear this characteristic. The approach adopted in this note is consistent with that adopted by the Court of Appeal of the Supreme Court of New South Wales in *R J & M Bezzina Pty Ltd v Saxby Bridge Mortgages Pty Ltd*.³⁷ In that case, a property developer ('*B*') received finance and entered into an agreement with a finance broker ('*A*'). *A* was to arrange finance for *B* for a specified sum in return for a brokerage fee of \$155 000.³⁸ The contract contained exclusivity provisions which meant that *B* was in breach of contract if it obtained finance from an alternative source. An agreed remedy clause in the agreement required *B* to pay to *A* the entire brokerage fee in the event that *B*'s breach of contract resulted in *B* obtaining finance from another source.³⁹ In breach of the exclusivity provisions, *B* obtained finance otherwise than through *A*.⁴⁰ In turn, *A* sought to claim the brokerage fee as an agreed remedy, and *B* resisted on the basis that the payment of the full fee constituted a penalty.⁴¹ The Court unanimously held that *A* was entitled fully to enforce the agreed remedy (ie claim the brokerage fee). As Giles JA (with whom Hodgson JA and Cripps AJA agreed) held, *B*'s breach of contract deprived *A* of its expectations under the contract to earn the fee.⁴² Guided by this approach, his Honour concluded that:

I do not think that payment of the amount of the Brokerage Fee was 'extravagant and unconscionable in amount in comparison with the greatest loss that could

36 See above n 25. That is, *A* would be entitled to damages for the loss of the particular bargain that it entered into with *B* (subject to a potential deduction in being able to redeploy its capital). See generally *Castle Constructions Pty Ltd v Fekala Pty Ltd* (2006) 65 NSWLR 648, 654 [28]–[29] (Mason P, Beazley JA agreeing at 666 [94]); *Gumland Property Holdings Pty Ltd v Duffy Bros Fruit Market (Campbelltown) Pty Ltd* (2008) 234 CLR 237, 258 [55]–[56] (Gleeson CJ, Kirby, Heydon, Crennan and Kiefel JJ); *Gigi Entertainment Pty Ltd v Schmidt* (2013) 17 BPR 32 611, 32 627 [83] (Ward JA).

37 [2004] NSWCA 211 (23 June 2004).

38 Being 1 per cent of the proposed principal: *ibid* [33].

39 *Ibid* [2].

40 *Ibid* [10]–[13].

41 *Ibid* [16]–[19].

42 A brokerage fee is slightly different from the loan establishment fee considered in *Melbourne Linh Son Buddhist Society* [2017] VSCA 161 (23 June 2017). This is because it cannot be absolutely certain at the time of entry into a brokerage agreement that the broker will ultimately earn its establishment fee by successfully obtaining the proper finance for a potential borrower as the establishment of the loan in question depends on the consent of a third party lender: this was an observation made in *Sydney Constructions & Development Pty Ltd v Reynolds Private Wealth Pty Ltd* (2016) 311 FLR 217, 225 [49]–[51] (Barrett AJA). On the other hand, in *Melbourne Linh Son Buddhist Society* [2017] VSCA 161 (23 June 2017), *B* was obliged in the deed to proceed to settlement which means *A* had an expectation to the fee and not merely a chance to earn it.

conceivably be proved to have followed from the breach', to use some of the words of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* (1915) AC 79 at 87, or disproportionate to the loss likely to be suffered by [A]. In my opinion, [the agreed remedy] did not impose an extravagant or unconscionable obligation such that it was a penalty.⁴³

Likewise, in *Edwards v Massey*,⁴⁴ the Full Court of the Supreme Court of Queensland upheld an agreed remedy which entitled a real estate agent ('A') to claim his commission (£33 15s) where a vendor ('B') terminated early an exclusive agency agreement under which A was to find a purchaser for B's farm.⁴⁵ B terminated the agency agreement by withdrawing A's authority to sell the property and A sought to recover his commission as an agreed remedy. The Court unanimously allowed A to recover his commission as an agreed remedy as it reflected A's expectations under the agreement. As counsel for A (Harry Gibbs, who would later become the Chief Justice of the High Court of Australia) successfully argued:

if [B's] withdrawal does constitute a breach of the agreement, then the provision is one for liquidated damages, because the stipulated sum can not be said to be so extravagant or exorbitant that it had no relation to the loss which [A] could possibly sustain by the breach; in the fact the sum was the only possible pre-estimate of damage the parties could genuinely have made.⁴⁶

Accepting these submissions, Stanley J (with whom Mansfield SPJ agreed) said:

In my opinion [A] on the existing contract can in no circumstances of fulfillment or breach get more or less than a certain sum of money. The parties obviously intended to express that sum in the contract. ... Having regard to the very limited duration of the contract, and the possible limitation of [A's] commission, I cannot say that this sum is so exorbitant that it cannot have any real relation to the loss [that A] might possibly sustain by breach, and that it should be relieved against as a penalty and not treated as liquidated damages.⁴⁷

The real point of contention in *Melbourne Linh Son Buddhist Society* on the penalties issue ought to have been whether the agreed remedy properly took into

43 *R J & M Bezzina Pty Ltd v Saxby Bridge Mortgages Pty Ltd* [2004] NSWCA 211 (23 June 2004) [33] (Giles JA, Hodgson JA agreeing at [39], Cripps AJA agreeing at [40]).

44 [1947] QSR 226.

45 Ie B was obliged to pay A's commission if B 'deprive[d] [A] of the opportunity of earning [A's] remuneration by [B's] act in withdrawing the farm from sale, or by selling it privately or through any other agent during the stipulated time of twenty-one days': *ibid* 231.

46 *Edwards v Massey* [1947] QSR 226, 229 (Gibbs) (during argument). On the contrary, counsel for B (Mr Fairleigh) unsuccessfully argued that A's expectations under the contract ought not be taken into account: 'If the undertaking to pay [the commission] does apply to a withdrawal then it is a penalty. The amount is based on the greatest gain [A] could obtain and not on loss. A genuine pre-estimate would be based on the expenses incurred and the time the agreement had been in force': at 229–30 (Fairleigh) (during argument) (citations omitted).

47 *Ibid* 232 (Stanley J, Mansfield SPJ agreeing at 230). However, there are strong hints of the intention-based approach to determining whether a clause is a penalty (which was dominant in the 19th and early 20th centuries) in the concurring judgment of Sheehy J: at 234. For more on the intention-based approach to the penalties doctrine see: Tiverios, 'A Restatement of Relief against Contractual Penalties' (Pt 1), above n 23, 13–16.

account *A*'s related gains in light of *B*'s breach of contract.⁴⁸ In this connection, it should not be overlooked that the agreed remedy clause did take into account some of the potential gains made by *A* in being able to redeploy capital if the loan did not settle. This was because, on a proper construction of the agreed remedy clause, *B* was only liable for the payment of three months' interest on the principal of the loan and not the *total* interest due under the two-year⁴⁹ loan agreement.⁵⁰ However, this is not to say that all establishment fees that are payable on default will not be punitive, as such fees can essentially function as a substitute for interest and therefore operate as a fee for the use of *A*'s capital.⁵¹ Thus full payment of fees for the use of *A*'s capital might fail to take into account the potential for that same capital to be redeployed (but this is simply not how the penalties issue was approached in *Melbourne Linh Son Buddhist Society*).⁵²

The central points for present purposes are that: (i) the impugned agreed remedy *did* take into account *A*'s gains on *B*'s default by being able to redeploy the capital by limiting the amount of interest payable on *B*'s default to three months; (ii) as *A* had an expectation to the high loan establishment fee (calculated at 5.3 per cent) if the contract was properly performed and *B* proceeded to settlement, it was not to the point to say that the payment of that same fee as a component of an agreed remedy was unreasonable compared to *A*'s standard business practice; and (iii) for an agreed remedy to be characterised as punitive it has to achieve the

48 See above n 29 and accompanying text. It may be more familiar to readers to refer to this as taking into account *A*'s 'duty to mitigate' loss. But, as David Winterton has noted,

[s]trictly speaking, the claimant has no "duty" to mitigate its loss in the aftermath of a breach since the defendant has no correlative "right" that the claimant take such mitigatory action. However, the rule does prevent the victim of a breach of contract (or a tort) from recovering compensation to make good loss that could have been avoided by taking reasonable post-breach action, meaning that its practical effect is more or less the same as if there were such a duty.

David Winterton, *Money Awards in Contract Law* (Hart Publishing, 2015) 250 (citations omitted).

49 It was the intention of the parties that the duration of the loan spanned two years, although as originally drafted the loan was to be for a term of one year: *Melbourne Linh Son Buddhist Society* [2017] VSCA 161 (23 June 2017) [35], [38].

50 Ibid [35], [81]–[82] (Kyrour JA and Cameron AJA).

51 For the importance of such fees in the context of the penalties doctrine, see *Macquarie Bank Ltd v Lin* [2005] QSC 221 (12 August 2005) [185]–[190] (McMurdo J); *Yarra Capital Group Pty Ltd v Sklash Pty Ltd* [2006] VSCA 109 (18 May 2006) [16]–[23] (Chernov JA, Warren CJ agreeing at [1]); *Quantum Asset Management Pty Ltd v Love Properties (WA) Pty Ltd* [2017] WASC 167 (20 June 2017) [82]–[91] (Banks-Smith J); *Wilaci Pty Ltd v Torchlight Fund No 1 LP (in rec)* [2017] 3 NZLR 293, 313–15 (Kós P, French and Miller JJ).

52 In this connection, see, eg, *Oresundsväret AB v Lemos; The Angelic Star* [1988] 1 Lloyd's Rep 122, 125 (Donaldson MR) (emphasis added): 'Clearly a clause which provided that in the event of any breach of contract a long term loan would immediately become repayable and *that interest thereon for the full term* would not only be still payable but would be payable at once would constitute a penalty'; *County Leasing Ltd v East* [2007] EWHC 2907 (QB) [41]–[42], [112]–[117] (Judge Seymour) ('*County Leasing*'). In *County Leasing*, a company ('*A*') that was engaged, inter alia, in the business of lending money entered into a long-term (20-year) business loan agreement with a borrower ('*B*'). A clause (cl 5) of the business loan agreement provided for an agreed remedy (triggered on *B*'s default) which obliged *B* to pay to *A*: (i) the entire principal which remained unpaid; and (ii) the entire future interest which would be due on the principal for the remaining period of the loan. That remedial clause was held to be a penalty as it exacted a punishment on *B* (ie by obliging *B* to pay for the entire time value of 20 years' worth of credit with no corresponding benefit on any default, even a default in the first month of the loan).

high hurdle of being *out of all proportion* to *A*'s interests in the performance of the contract. Given *A*'s expectation losses would include the establishment fee, it would appear that the payment of such a fee as an agreed remedy would not bear this characteristic. This conclusion may be somewhat jarring as *A* may not have had the most virtuous claim against *B* to an agreed remedy, but a lack of virtue ought not to deprive *A* of its full contractual rights.

IV CONCLUSION

It should be kept in mind that the conclusion and approach to the penalties question deployed by Kyrou JA and Cameron AJA in *Melbourne Linh Son Buddhist Society* were obiter dicta and the facts considered highly unusual. Their Honours may have considered in less detail the arguments raised on the penalties point in light of the resolution of the appeal on the breach of contract issue. Further, the reasoning deployed is only binding insofar as it is persuasive.⁵³ It is hoped, however, that the analysis above illustrates that the underlying reasoning and approach of the majority on the penalties issue is not persuasive⁵⁴ and should not be expressly adopted in future cases concerning the payment of similar fees.⁵⁵ Indeed, the central arguments made in this note (and authorities cited) do not appear to reflect the way the arguments were formulated before the Court.

The second point to note is that, when applying the penalties doctrine, properly appreciating the nature of *A*'s interests in the performance of the contract is central to the analysis. The remedy agreed may either⁵⁶ be justifiable as: (i) the clause protects the monetary value of *A*'s expectation interest in the performance of the contract (ie because *A* will always have a legitimate interest having recourse to an agreed remedy which is a genuine pre-estimate of damage);⁵⁷ or (ii) the clause protects an interest that is different from, and greater than, *A*'s interest in

53 See *Deakin v Webb* (1904) 1 CLR 585, 605 (Griffith CJ).

54 That is, applying the general injunction issued by the High Court of Australia that '[i]ntermediate appellate courts and trial judges in Australia should not depart from decisions in intermediate appellate courts in another jurisdiction' when developing the common law unless the decision is 'plainly wrong': *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* (2007) 230 CLR 89, 151–2 [135] (Gleeson CJ, Gummow, Callinan, Heydon and Crennan JJ).

55 In this connection I note that the reasoning on the penalties issue in *Melbourne Linh Son Buddhist Society* [2017] VSCA 161 (23 June 2017) has been cited positively (and applied) in *Giasoumi v Ribbera* [2017] VSC 631 (16 October 2017) [92]–[120] (Mukhtar AsJ); and cited positively in *Simcevski v Dixon* [No 2] [2017] VSC 531 (8 September 2017) [18], [31] (Riordan J).

56 The approach taken here is that a clause that is not a genuine pre-estimate of damage applying the *Dunlop* guidelines (see above n 25) may nonetheless be upheld on the legitimate interest analysis as enunciated in *Cavendish* and *Paciocco* (see above n 24). This is because *A* will always have a legitimate interest in an agreed remedy which is a genuine pre-estimate of her damage resulting from *B*'s default (ie *Dunlop* still applies as a baseline 'fallback' position). I note that the approach adopted here is consistent with that advocated by Andrew Burrows, *A Restatement of the English Law of Contract* (Oxford University Press, 2016) 136; and set out in Tiverios, 'A Restatement of Relief against Contractual Penalties' (Pt 2), above n 24. An argument to the contrary, that *Dunlop* is now dismantled, is set out in Carter, Courtney and Tolhurst, above n 24 (although the authors note that the interpretation of *Paciocco* adopted in this note is one possible reading of the decision: at 38).

57 See above n 25.

compensation for loss caused directly by *B*'s breach of contract or the failure of a non-promissory stipulation. Post-*Paciocco* the court can now consider factors which go beyond the direct punitive damage that *A* will recover against *B* when assessing whether a clause is punitive.⁵⁸

Once these points are appreciated, the central lesson to be taken from this note is that Kyrou JA and Cameron AJA erred by not properly considering *A*'s underlying interest in contractual performance when assessing whether the impugned agreed remedy was out of all proportion to those interests. *A*'s interests as evidenced in the contract included the expectation that it would be paid the high establishment fee of 5.3 per cent of the principal when *B* complied with its primary obligation to proceed with the loan. The law of penalties is not a doctrine in accordance with which the court is free to assess the reasonableness of contractual terms. The doctrine considers whether an impugned agreed remedy exacts a punishment on *B* by considering whether the remedy imposed is out of all proportion to *A*'s legitimate interests in *B*'s contractual performance. The central position taken in this note is that (i) *A*'s 'legitimate interests' for the purpose of assessing whether an agreed remedy is punitive are inclusive of the expectation that *B* will properly perform any underlying primary contractual obligations (the failure of which will trigger *A*'s right to the agreed remedy); and (ii) the harshness of principle (i) is ameliorated by the fact that when considering whether an agreed remedy clause is commensurate with *A*'s legitimate interests in the underlying performance of the contract, the court may consider the objective gains that will be made by *A* due to *B*'s default.

58 See above n 24. A good example is *ParkingEye Ltd v Beavis* [2016] AC 1172 (*'ParkingEye'*). A firm (*'A'*) was contracted by the owner of a retail park (*'C'*) to manage a car park related to *C*'s premises. During the course of *A*'s management of the car park, *A* levied a charge of £85 on motorists if they overstayed an otherwise free of charge two-hour parking limit. The defendant (*'B'*) left his vehicle in the car park for just under three hours and was accordingly issued with a notice requiring him to pay to *A* the sum of £85. *B* refused to pay the sum and so *A* commenced proceedings to claim its £85. *B* resisted *A*'s claim on the basis that, inter alia, the fee constituted a penalty. It was common ground between the parties that in making use of the car park, *B* entered into a contract with *A* under which *B* agreed to leave the car park within two hours. Failure to do so would constitute a breach of contract, in respect of which *B* agreed to pay the agreed sum of £85 to *A*. The Court held that the fee plainly engaged the penalties doctrine as it could only be regarded as existing as a charge for contravening the terms of the contract (ie the first stage of inquiry for whether the clause was a penalty was satisfied). However, the Court held in *ParkingEye* that the fee was not punitive in nature as it was not out of all proportion to *A*'s legitimate interests (notwithstanding the fact that *A* would have suffered no pecuniary damage when a consumer remains in the car park for over two hours as any new motorist who accessed the space in question would do so free of charge). The Court held that the impugned fee had the principal purposes of: (i) deterring motorists from taking advantage of the car park by staying beyond the period of free parking and thus facilitating a turnover of potential consumers for the attached retail premises (ie the agreed remedy was important to a wider scheme in order to ensure the ongoing efficacy of the retail park); and (ii) providing *A* (the parking services provider) with capital to properly administer the otherwise free parking scheme (ie the agreed remedy had the function of providing *A* with potential profits absent which it could not administer the car park).