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COMMENTARY

Late Payment Fees Not Penalties: High Court of Australia Rebuffs Bank Fees Class Action

Key Points

Australia's largest class action, in which about 43,000 customers of Australia & New Zealand Banking Group Ltd ("ANZ") sought to recover more than $50 million for alleged "excessive" bank fees, has ended with a High Court decision in favour of the bank: *Paciocco v Australia and New Zealand Banking Group Limited* [2016] HCA 28 ("*Paciocco*"). The High Court ruled that:

- A payment clause will be an illegal penalty if its purpose is to secure compliance with a primary obligation owed to party A by party B and the amount provided for is "out of all proportion" with party A's legitimate interests.
- Party A's legitimate interests are not restricted to the avoidance of damages resulting directly from non-compliance but may extend to broader commercial interests *including* the maintenance of profits.
- Whether or not the amount is "out of all proportion" to those interests is to be assessed by reference to the facts known to the parties at the time the contract is made (a forward-looking inquiry).
- However, if the payment clause is an illegal penalty, then party A will be entitled to recover only the direct losses that were *actually* suffered through party B's non-compliance (a retrospective inquiry).

Background

The class action concerned five different kinds of bank fees charged by ANZ in respect of credit card accounts maintained by Mr Paciocco, and deposit accounts maintained by a company he controlled ("SDG"): (i) non-payment fees; (ii) overlimit fees; (iii) honour fees; (iv) dishonour fees; and (v) late payment fees. Paciocco and SDG alleged that the fees were illegal penalties under the general law, and also that the bank had breached various statutory prohibitions relating to unconscionable conduct and unjust or unfair terms in consumer contracts.

At first instance and on appeal to the Full Court of the Federal Court, it was held that fees (i) to (iv) were neither penalties nor contrary to statute. The High Court's decision focused on fee (v), which was payable where the customer had failed to make a minimum payment on his or her credit card account by the due date. This was found to be a penalty by Gordon J of the Federal Court of Australia, but the Full Court disagreed and

further held that the fees were not contrary to the various statutory prohibitions.

In *Paciocco*, a majority of High Court judges approved the Full Court's analysis, providing some clarity for banks and other organisations as to what kinds of costs may be lawfully recovered under payment clauses.

The Reasoning of the Primary Judge

At first instance, Gordon J laid out six steps that could be followed when considering whether a payment clause was an illegal penalty:

1. Identify the terms and inherent circumstances of the contract, judged at the time of the making of the contract.

2. Identify the event or transaction which gives rise to the imposition of the stipulation.

3. Identify if the stipulation is payable on breach of a term of the contract (a necessary element at law but not in equity). This necessarily involves consideration of the substance of the term, including whether the term is security for, and in *terrorem* of, the satisfaction of the term.

4. Identify if the stipulation, as a matter of substance, is collateral (or accessory) to a primary stipulation in favour of one contracting party and the collateral stipulation, upon failure of the primary stipulation, imposes upon the other contracting party an additional detriment in the nature of a security for, and in *terrorem* of, the satisfaction of the primary stipulation.

5. If the answer to either question 3 or 4 is "yes," then further questions arise (at law and in equity), including:[1]

    5.1 Is the sum stipulated a genuine pre-estimate of damage?

    5.2 Is the sum stipulated extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved?

    5.3 Is the stipulation payable on the occurrence of one or more or all of several events of varying seriousness?

    These questions are necessarily interrelated.

6. If 5 has been satisfied, then the stipulation is unenforceable to the extent that the stipulation exceeded that amount. Put another way, the party harmed by the breach or the failure of the primary stipulation may enforce the stipulation only to the extent of that party's proved loss.

Steps 3 and 4 followed from the High Court's earlier decision in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 ("Andrews"), discussed below. Justice Gordon found that the late payment fees were indeed payable on breach of contract, and that they functioned as collateral, securing the customer's compliance with a primary stipulation (i.e. making the minimum credit card payment on time).

In relation to step 5, her Honour compared the amount of the late payment fees (which ranged from $20 to $35) to the actual loss suffered by the bank as a result of the late payments. Importantly, expert evidence adduced by Mr Paciocco and SDG estimated the bank's loss to be about 50c per instance of late payment. This amount reflected ANZ's increased "operational costs" and would restore the bank to the position it would have occupied had the credit card payments been made on time. Further significant factors included that:

- ANZ had failed to carry out any kind of pre-estimation of loss when determining the amount of the fees; and
- The same fee was payable irrespective of the seriousness of the breach.

Gordon J found that the actual loss suffered by the bank would have been less than $3.00. Compared to that loss, a fee of $20 to $35 was grossly disproportionate, extravagant, and illegal.

Critically, her Honour rejected the evidence of ANZ's expert, who assessed the maximum amount of costs that the bank could conceivably have incurred as a result of the late payment. As well as increased operational costs, the expert identified potential harms to the bank's wider financial interests, such as loss provisioning and the increased costs of

regulatory capital. Gordon J considered these potential losses to be too remote for the purpose of step 5, which was concerned only with "compensable damage", i.e. damages that could be recovered in litigation.

The Appeals: What Interests May Be Protected by a Payment Clause?

On appeal, the Full Court of the Federal Court of Australia (Allsop CJ, Middleton and Besanko JJ) approved the six steps laid out by Gordon J. However, the Court held that her Honour had conflated steps 5 and 6:[2]

- Step 5 asks whether the payment clause is penal in character, and this is determined by reference to the legitimate interests of the wronged party as at the time the contract was entered into; whereas
- Step 6 asks what the wronged party can recover if the payment clause is a penalty, and this is determined by reference to the actual loss suffered in the event.

According to the Full Court, Justice Gordon erred in disregarding the bank's expert evidence of its conceivable losses and in determining whether the amount was penal solely by reference to the actual loss suffered on the breach. (The Full Court's decision is discussed in more detail in a previous Jones Day *Commentary*: "Bank Fees Class Action in Australia Fails Before Full Federal Court" (May 2015).)

A majority of the High Court (French CJ, Kiefel, Keane and Gageler JJ, Nettle J dissenting) agreed with the Full Court's reasoning, and particularly the judgment of Allsop CJ. The effect of the majority judgments may be summarised as follows:

- In relation to step 5, the legitimate interests of the wronged party are not limited to the damages that can be recovered in litigation (that is, for breaches of contract, amounts necessary to restore ANZ to the position it would have been in had the late payments been made).
- Here, ANZ's legitimate interests were not limited to "the reimbursement of the expenses directly occasioned by the customer's default" but extended to ensuring that its revenues were maintained "at the level of profitability required by its shareholders".[3]
- The fact that there was an element of cross-subsidisation in the fees, which reduced the bank's overall risk in providing credit card facilities to a mass of individual customers, was neither here nor there.
- It followed that Gordon J should have had regard to ANZ's evidence relating to the costs of loss provisioning and regulatory capital—*notwithstanding* these were part of the costs of running a bank in Australia.[4]
- Having regard to that evidence, it could not be concluded that the late payment fees of $20 to $35 were "out of all proportion" to the legitimate interests of the bank.
- The fact that the bank had not attempted to calculate the actual loss it would suffer if a customer failed to make a minimum credit card payment on time was not fatal; on the other hand, if the bank had undertaken such an exercise, this would have tended to suggest the clause was not a penalty.
- Various policy factors mitigated against the Court intervening in the circumstances, including the difficulty of determining what level of interest and charges would be "reasonable", and the values of commercial certainty and freedom of contract.[5]

The Statutory Claims

The High Court upheld the Full Court's rejection of the appellants' statutory claims relating to "unconscionable conduct" (under s 12CB of the *Australian Securities and Investments Commission Act 2001* (Cth) ("ASIC Act") and s 8 of the *Fair Trading Act 1999* (Vic) ("FTA", since replaced)), "unjust transactions" (under s 76 of the *National Credit Code*, established under the *National Consumer Credit Protection Act 2009* (Cth)), and "unfair" contract terms (under ss 12BF and 12BG of the ASIC Act and Pt 2B of the FTA). The crux of the appellants' claims on this front was stated to be the disproportion between the bank's fees and the actual costs incurred by the bank and the general disparity of bargaining power between the bank and its customers.

Keane J (with whom French CJ and Kiefel J agreed) observed that such power imbalances were economy-wide and did not, of themselves, make the behaviour of market participants "unconscionable". The fees charged by ANZ were materially the same as those charged by its competitors, and there was no suggestion that the market as a whole was "unlawfully

skewed". The legislation did not require the Court to act as a price regulator, and the following factors, which may have given the Court cause to intervene, were absent:[6] any dishonesty or abuse of market power by the bank; any concealment from Mr Paciocco of the requirements of the late payment fee; any inability of Mr Paciocco to understand the effect of the contracts in that respect, or other vulnerability; or the exercise of any financial pressure causing Mr Paciocco to enter into the contracts.

The Law of Penalties: Australia Versus the United Kingdom

Prior to *Andrews*, the orthodox position in both England and Australia was that for a contractual payment to be a penalty, it had to be triggered by a breach of contract. The Andrews Court did away with that requirement, a development that has since been heavily criticised by members of the UK Supreme Court: *Cavendish Square Holding BV v Makdessi* [2015] 3 WLR 1373 at 1396; [2016] 2 All ER 519 at 541. There are now significant divergences between the two jurisdictions, although these should not be overstated. In summary:

- In both Australia and the United Kingdom, a penalty is essentially an unlawful deterrent: it is security for the party's primary obligation, in an amount that is exorbitant, extravagant or grossly disproportionate.
- In Australia but not in the United Kingdom, a payment clause can be an illegal penalty even if the obligation to pay is not triggered by a breach of contract. (This made no difference in *Paciocco*, because the late payment fee was triggered by a breach of contract).
- In Australia but not in the United Kingdom, an illegal penalty can be partially enforced to the extent of the actual loss suffered by the wronged party, instead of being wholly unenforceable.
- In Australia and the United Kingdom, the amount of the payment clause may legitimately reflect the financial, business or commercial interests of the wronged party, extending beyond its interests in recovering contractual damages.

Ramifications

The *Paciocco* decision is undoubtedly a major win for banks and other corporations charging standard fees to retail clients. The spectre of liability created by the Court's decision in *Andrews*, which broadened the scope of the penalties doctrine in Australia, has been largely put to rest. The scope of the doctrine may be broader, but the penalty test is basically the same: the amount has to be grossly disproportionate, extravagant or exorbitant when compared with the interests that the clause seeks to protect.

Practical lessons from the *Paciocco* litigation include that:

- Instructions to an expert must reflect the legal test the Court will need to apply—here, the appellants' evidence of actual loss was not relevant to whether the fees were penal in character.[7]
- It is not necessary to actually undertake a pre-estimation of loss when determining the amount of a fee or compensation clause; however, if this exercise is undertaken, then it may be helpful in proving that the clause is not penal.
- A party's estimation of its costs does not need to be precise—as the test is whether the amount is "out of all proportion" with the party's legitimate interests.[8]
- A power imbalance between contracting parties does not, on its own, mean that the insertion of a compensation clause (which may exceed the actual loss suffered) is unconscionable.
- A bank's ability to charge fees is not unlimited, with relevant outer limits imposed by laws proscribing the abuse of market power or dishonest conduct in the market.[9]

Lawyer Contacts

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Endnotes

1 These principles were drawn from the leading judgment of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 86-87.

2 *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199 at 236, [113]-[117] per Allsop CJ.

3 *Paciocco & Anor v Australia and New Zealand Banking Group Limited* [2016] HCA 28 at [216], [223] (Keane J); see also [172] (Gageler J).

4 *Paciocco & Anor v Australia and New Zealand Banking Group Limited* [2016] HCA 28 at [65] (Kiefel J) [172] (Gageler J).

5 *Paciocco & Anor v Australia and New Zealand Banking Group Limited* [2016] HCA 28 at [214], [220], [250] (Keane J).

6 *Paciocco & Anor v Australia and New Zealand Banking Group Limited* [2016] HCA 28 at [286]-[291] (Keane J); see also *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199 at 238, [347] per Allsop CJ.

7 *Paciocco v Australia & New Zealand Banking Group Ltd* [2016] HCA 28 at [59] (Kiefel J).

8 *Paciocco v Australia & New Zealand Banking Group Ltd* [2016] HCA 28 at [57] (Kiefel J).

9 *Paciocco v Australia & New Zealand Banking Group Ltd* [2016] HCA 28 at [213] (Keane J).