

New Penalty Test Confirmed

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The Supreme Court today issued a judgment upholding previous decisions of the High Court¹ and Court of Appeal² in the *Honey Bees Preschool v 127 Hobson Street* case.³

This decision confirms that New Zealand has a new test for what does (and doesn't) constitute an unenforceable penalty clause.

A clause setting out a consequence for a breach of contract will now be unenforceable if that consequence is out of all proportion to the legitimate interests of the innocent party in having the obligation performed.

That's a wider test than the previous one, which focussed on whether the consequence was a fair or genuine assessment of the financial loss being suffered by the innocent party as a result of the breach. Under the new test the Courts will now take a wider view of the situation, and be more prepared to respect and enforce the consequences agreed to by the parties.

The facts

Honey Bees was a childcare centre. It rented a building at 127 Hobson St. For the Centre to work properly it required a second lift (there was only one). A collateral deed of lease required the landlord (127 Hobson St Ltd) to install that second lift by a certain date.

When the landlord failed to provide this lift *Honey Bees* invoked a clause in collateral deed which, in effect, allowed *Honey Bees* to stay on for the remaining 3 years and 5 months of the lease without having to pay rent or outgoings.⁴

The landlord challenged that clause, saying it was an unenforceable penalty clause.

¹ *Honey Bees Preschool Limited v 127 Hobson Street Limited* [2018] NZHC 32.

² *127 Hobson Street Limited v Honey Bees Preschool Limited* [2019] NZCA 122. We wrote about the Court of Appeal decision [here](#).

³ *127 Hobson Street Limited v Honey Bees Preschool Limited* [2020] NZSC 53

⁴ Technically the clause provided that the Landlord would indemnify the tenant for the rental and outgoings payable for the remainder of the lease.

What's a penalty?

A penalty clause is a clause in a contract that's designed to punish a wrong doer. The Courts don't like them, and they won't enforce them. In this case that would mean that Honey Bees had to keep paying rent.

The Courts will allow and enforce a liquidated damages clause. That means a clause which fairly estimates the damage that would be suffered by the innocent party as a result of the breach.

The test for whether a clause was a (prohibited) penalty or a (permitted) liquidated damages clause focused on whether the amount was a genuine pre-estimate of the actual loss that the innocent party would suffer if a breach were to occur.

The new test

Now the test is simply whether the consequences of the clause are proportionate to the legitimate interests of the innocent party.

Therefore the question in *Honey Bees* was whether allowing Honey Bees to stay on without paying rent or outgoings was a proportionate consequence of the landlord's failure to install the second lift, taking into account the reasons why Honey Bees needed that lift. The Supreme Court found that it was.

The Supreme Court also said that:

- A "legitimate interest" could be wider than what is contained in the "four corners of the contract." Such an interest could include a party's desire to deter a breach of the contract; to protect a way or system of conducting business; or to ensure an income stream. However a legitimate interest won't include punishing the wrongdoer.
- Sometimes comparing the difference between the consequence imposed by the contract and what is *actually* lost by the innocent party may be relevant, for example where the clause in question claims to provide a pre-estimate of the loss that will be suffered. However this sort of calculation and comparison isn't always required, and won't be relevant where the clause aims to protect interests beyond direct monetary loss.

- Differences in bargaining power between the parties are relevant – the Court will scrutinise the situation more carefully if the bargaining positions were unequal. However you don't need to show that the bargaining power was unequal in order to demonstrate that the clause is an unenforceable penalty. The only question is whether the consequence of the clause is proportionate to the breach.

So what does this mean?

The Supreme Court's decision means that it is now easier to write a clause into a contract that imposes consequences on a party for not performing one of their obligations. Those consequences can be wider than the money lost by the innocent party as a result of the breach.

However, if you're the party trying to impose those consequences you are best to be clear (ideally in the contract) why the consequences are being imposed, so that the Court can be satisfied that the consequences are for a legitimate purpose, and aren't simply there to punish the non-performing party.

So for example, if it's crucial to you that a second lift be installed in the building you're leasing, you should set out why that lift is essential, and that you wouldn't lease the premises or invest in a fit out without this obligation being fulfilled.

Further Advice

If you have any more queries about liquidated damages or penalty clauses, please feel free to contact Jenna Riddle at jenna.riddle@gallawaycookallan.co.nz or 027 742 1032.

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