Honey bees, collateral deeds and issues as to penalties

Refinements to the penalties doctrine in the Court of Appeal

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With the recent case of *127 Hobson Street Ltd v Honey Bees Preschool Ltd* ('Honey Bees'),[1] the Court of Appeal have confirmed important refinements to the operation of the penalties doctrine. The case will be of interest to a diverse range of practitioners because of its importance to the drafting and enforcement of contracts. But property lawyers have a special interest in the case, which unfolded around a commercial lease deed.

Honey Bees — a tale of two deeds

A regular deed of lease created a lease for six years, with three rights of renewal. Honey Bees Preschool Ltd was the tenant, and 127 Hobson Street Ltd the landlord.

Executed on the same day was a collateral deed, which provided for the installation of a second lift by the landlord. If the lift was not installed within two years and seven months, the collateral deed provided that the landlord was to indemnify the tenant for all obligations under the lease until its expiry ('the collateral indemnity'). This included all rent.

This second lift was very important to the tenant, which was intending to run a preschool from the premises. The tenant wanted licensing for up to 50 children, but the premises were on the fifth floor of an inner city commercial building in Auckland. Below the premises were four floors of hotel accommodation. Above them were nine apartments. All of this was serviced by a single lift.

As it happened, the second lift was not installed in time, and the tenant tried to take advantage of the collateral indemnity. The landlord argued that it was a penalty clause, and therefore unenforceable.

The dispute went to the High Court in 2018,[2] where Whata J held that the collateral indemnity was enforceable in light of recent refinements in UK and Australian jurisprudence.[3] Kós P, giving the judgment in the Court of Appeal, upheld this new approach, and made some important comments about the scope of the refined doctrine.

Determining whether a clause is a penalty is now a question of whether the clause is disproportionate from the legitimate interests of the party seeking to apply it. But how is this different from the antecedent position?

The penalties doctrine – a little theory

The Dunlop approach

For almost a century, there was the comparative damages test best exemplified by *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* ('Dunlop').[4] The emphasis of that test was on contrasting the value of the stipulated remedy with a pre-estimate of the financial loss arising from a breach.

A weakness is immediately apparent – pre-estimation may not be possible. But the test was certainly alive to this weakness. In *Dunlop* itself, the impugned clause stipulated that, if tyres bought from the supplier were on-sold by the buyer for less than a certain value, a large fine was imposed on the buyer. It was accepted that on-selling tyres for less could create 'a system of injurious undercutting', but it was impossible to say exactly what the financial loss to the supplier would be. The Court held that exact pre-estimation was not always required, and because the fine was 'not incommensurate' with the conceivable loss, the clause was not a penalty.

Refinement of the doctrine

The perceived problem with the *Dunlop* approach is that, though prepared to be flexible, it was ultimately concerned with financial losses. Other losses, such as to reputational or public interests, could not always be considered.

Illustrative of these issues was *ParkingEye Ltd v Beavis*.[5] That case concerned a overstay charge in a parking building. Parking was free, but for two hours only. Remaining after that triggered a £85 fee. Certainly that fee is higher than any expected loss, but the carpark operator was thought to have a legitimate, though non-monetary, interest in a consistent turnover of carparks. This would help to bring business to the local shops, and make life easier for customers. The *Dunlop* approach was poorly equipped to handle these interests.

The modern approach that *Honey Bees* now aligns us with requires a sophisticated analysis of the 'legitimate interests' of the parties – particularly the party seeking to enforce the clause. Legitimate interests can represent more than the risk of direct monetary loss. They can account for obligations with other, more diffuse, commercial justifications, such as the protection of reputation, or a performance interest in a second lift being installed.

Once the legitimate interests are identified, two tests are considered:

1. *Disproportionality*: are the effects of the clause being challenged as a penalty out of all proportion to the legitimate interests of the innocent party? The bar is 'particularly high'.[6] If found to be disproportionate, the clause is cross-checked against;
2. *Punitive purpose*: is the predominant purpose of the impugned clause to punish rather than protect legitimate interests? This is an objective question.

The two tests are very similar, and proper determination of the legitimate interests is the key to both.

When can the penalties doctrine be invoked?

As stated in *Honey Bees*,[7] only a clause which stipulates what is to happen upon breach of another part of the contract is subject to the penalties doctrine. The doctrine cannot be used to review unwise bargains generally – that would impinge too greatly on the freedom of contract.

According to the Court of Appeal, the doctrine is rationalised on the basis that any clause which stipulates what is to happen upon breach is only a proxy for the remedial function of the court, which is fundamentally compensatory.[8] The courts are jurisdictionally bound to strike down remedial clauses which are bad proxies for their own approach, but only those clauses which are fundamentally remedial.

If the penalties doctrine is rationalised by reference to the courts' remedial jurisdiction, then penalties jurisprudence ought to remain in step with damages jurisprudence. In a sense, the refinements endorsed in *Honey Bees* recognise that modern contractual remedies are taking account of the 'performance interest', rather than simply the direct loss suffered.

Interpreting the deeds in *Honey Bees*

Did the penalties doctrine apply to the collateral indemnity?

It may be a trap for those who draft leases to think that, as long as a term is couched as a price adjustment, rather than as a stipulated remedy, the penalties doctrine can be avoided altogether. It seems clear however that the courts will seek to apply a substance over form approach to determining whether the penalties doctrine is engaged.[9]

It was accepted by the tenant in the Court of Appeal that the collateral indemnity came into effect upon a breach of the contract, but some argument took place around this question in the High Court.

There, Whata J had little trouble in characterising the collateral indemnity as secondary to the primary obligation to install the lift. It was there to ensure performance of that obligation. Additionally, while labels are not always determinative, the collateral indemnity certainly was an indemnity, and indemnities generally presuppose some triggering breach.[10] Clearly a remedial function was served, although Whata J did not employ such language.

This question as to the substance of the clause will be more difficult to answer in some cases. But those who might seek to disguise a penalty clause should be aware that the courts are only too happy to ask it.

What was the duration of the collateral indemnity?

In order to determine whether the collateral indemnity was penal, the duration of the indemnity had to be understood. It was expressed as ending on the 'expiry of the lease'.

Unintuitively, the landlord argued that the indemnity would last until the final expiry of the lease, including all rights of renewal. It took this position because being left without rent for 21 years and five months was likely to be disproportionate and therefore penal. The tenant argued that the indemnity only applied to the initial term. This represented three years and five months.

The lease deed defined its own final expiry, and the term of the lease, as including any renewal term. But the Court of Appeal was unconcerned. The Court felt that the collateral deed did not necessarily import the definitions of the lease deed – these were in fact a 'distraction' – and instead looked to the intentions of the parties.[11]

Perhaps circularly, though not therefore incorrectly, the Court held that the parties could not have intended the grossly disproportionate effect of the landlord's interpretation – 21 years and five months of indemnity.

There is a lesson here. The Court was happy to resolve an interpretative weakness in the two deeds, but it is certainly better not to have an argument at all. This issue was easily resolved only because the landlord's interpretation was so eminently unreasonable. *Honey Bees* should not be taken to suggest that a court will simply interpret impugned clauses in a way that ensures they are not penalties.

Was the clause a penalty? Application of the disproportionality test

First to be determined were the legitimate interests of the tenant. It was paying rent on the basis of 48 children attending, but was only licenced for 24 – partly because it shared the sole lift with four floors of hotel below, and nine apartments above. The second lift was therefore important to its educational licensing. It had already sunk $500,000 into fit out costs on the assurance that it would have another lift, and it had reason to be suspicious of the landlord's word in light of some misrepresentations it had made earlier about carparks. In these circumstances the Court of Appeal felt that the preschool could enforce its legitimate interests with 'strong measures'.[12]

A number of factors ensured that the collateral indemnity was proportionate to the interests above.

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Commercial landlord and tenant disputes

Three reasons why arbitration is so popular

CATHERINE GREEN

During the course of a commercial tenancy, disputes often arise between landlords and tenants in relation to the parties' obligations under the lease to maintain and repair premises, fixtures and fittings.

The end of a tenancy also often gives rise to disputes between landlord and tenant as to the extent of the tenant's obligations to 'make good' or 'reinstate' the premises to the same condition as they were in at the commencement of the lease, the repair and/or maintenance of the landlord's fixtures and fittings which the tenant was responsible to undertake, and claims by landlords for unpaid rent and outgoings.

These disputes may be resolved by direct negotiation, but all too often the dispute will escalate with the parties taking irreconcilable positions and unable to move forward without engaging in a formal determinative dispute resolution process.

The New Zealand Dispute Resolution Centre (NZDRC) is often approached in such circumstances to provide private dispute resolution services and invariably the initial enquiry will start with the same question: which process is best?

There is of course no one right answer and NZDRC routinely provides mediation, arbitration and expert determination services to parties for the resolution of such disputes. However, our overall experience indicates that arbitration clearly comes out on top as the process of choice for resolving landlord tenant disputes for three primary reasons: cost and time efficiencies (proportionality), choice of decision maker, and finality and enforceability.

Keeping the process proportionate

It is not unheard of to hear complaints of arbitration simply mirroring high court litigation with the additional cost of a private judge. However, and in NZDRC's view, the objective of arbitration must be to provide a flexible and efficient means of resolving disputes quickly, cost effectively, privately and confidentially without necessarily adhering to the formalised, technical procedures of litigation.

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The Court noted some detriments to the tenant when the collateral indemnity was compared to a standard covenant to complete works in the lease.[13] For example, the obligations were personal to the landlord, and did not run with the land, and the tenant had no ability to cancel the lease for breach of an essential term. The tenant's remedies were also limited to and by the collateral deed.

Given also that the landlord was a commercial entity (and one capable of attempting to disguise its onerous obligations in a collateral document, at that), the indemnity was not disproportionate to the tenant's legitimate interests. Being proportionate, there was no need to invoke the punitive purpose test.

As the landlord was unsuccessful in establishing that the collateral indemnity was disproportionate or a penalty, the appeal was dismissed.

Conclusions for practice

Where both parties are commercial, those seeking to protect their diverse interests may now draft relatively powerful remedial clauses without concern they will be struck down by the penalties doctrine. Disproportionality is a high bar. It ought to be borne in mind however, that although your client will know best what its interests are, these must be legitimate, and justifiable. *Honey Bees* is not authority to protect unusual, irrational, or ill-natured interests.

The corollary is that anyone advising a commercial party on a lease or contract should take care to ensure that the terms are commercially wise. *Honey Bees* is another signal that the courts are not interested in undertaking general reviews of freely made bargains. ■

1. 127 Hobson Street Ltd v Honey Bees Preschool Ltd [2019] NZCA 122.
2. Honey Bees Preschool Ltd v 127 Hobson Street Ltd [2018] NZHC 32, [2018] 3 NZLR 330.
3. Cavendish Square Holding BV v Makdessi [2015] UKSC 67; Paciocco v Australia and New Zealand Banking Group Ltd [2016] HCA 28; and Andrews v Australia and New Zealand Banking Group Ltd [2012] HCA 30. See also Wilaci Pty Ltd v Torchlight Fund No 1 LP (in rec) [2017] NZCA 152, which was a decision applying NSW law, and its applicability to NZ law was a debated matter.
4. Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79 (HL).
5. Companion case of Cavendish Square Holding BV v Makdessi [2015] UKSC 67.
6. 127 Hobson Street Ltd v Honey Bees Preschool Ltd [2019] NZCA 122 at [32].
7. 127 Hobson Street Ltd v Honey Bees Preschool Ltd [2019] NZCA 122 at [40]-[42].
8. 127 Hobson Street Ltd v Honey Bees Preschool Ltd [2019] NZCA 122 at [40]-[42].
9. Honey Bees Preschool Ltd v 127 Hobson Street Ltd [2018] NZHC 32, [2018] 3 NZLR 330 at [63].
10. Honey Bees Preschool Ltd v 127 Hobson Street Ltd [2018] NZHC 32, [2018] 3 NZLR 330 at [65].
11. 127 Hobson Street Ltd v Honey Bees Preschool Ltd [2019] NZCA 122 at [48].
12. 127 Hobson Street Ltd v Honey Bees Preschool Ltd [2019] NZCA 122 at [58].
13. 127 Hobson Street Ltd v Honey Bees Preschool Ltd [2019] NZCA 122 at [60].

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