IN THE COURT OF APPEAL OF NEW ZEALAND

I TE KŌTI PĪRA O AOTEAROA

CA99/2018
[2019] NZCA 122

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

Hearing:	22 November 2018
Court:	Kós P, Brown and Gilbert JJ
Counsel:	R M Dillon for Appellants N S Gedye QC and M S S Khan for Respondents
Judgment:	18 April 2019 at 11.00 am

JUDGMENT OF THE COURT

A The appeal is dismissed.

B A declaration is made in terms prescribed in [66].

C An order for specific performance is made in terms prescribed in [67].

D The respondents are entitled to costs for a standard appeal, on a band A basis, together with usual disbursements.

REASONS OF THE COURT

(Given by Kós P)

[1] A commercial lease in two parts. A regular deed of lease, and a collateral deed, both executed the same day. The collateral deed provided for installation of a second lift. It also provided that if the lift was not installed within two years seven months, the landlord would indemnify the tenant for all obligations under the lease until its expiry.

[2] The lift was not installed in time. The tenant says the collateral clause means it is in effect excused liability to make payments under the lease from breach to expiry of the lease, a period of three years five months.[1] The landlord says the clause is an unenforceable penalty and should be disregarded.

[3] Whata J held the clause lawful and enforceable.[2] The landlord appeals.

Background

[4] Before setting out the background facts relevant to this appeal, we repeat the caveat we expressed in *Wilaci Pty Ltd v Torchlight Fund No 1 LP (in receivership)*.[3] The issue of whether a contractual clause is an unenforceable penalty is primarily a question of construction. The ultimate question will be whether the disputed clause imposes a detriment on 127 Hobson out of all proportion to any legitimate interest of Honey Bees in enforcement of the primary obligation to construct the second lift. As we said in *Wilaci*, therefore:[4]

> Admissible matrix evidence must therefore concentrate on facts that shed light on the nature of the parties' legitimate commercial interests and relevant transactional risks — including risk of loss of capital, collateral and reputation. This exercise focuses on the [promisee], but takes into account also the interests of the [promisor].

---

1 The term of the lease was six years (with rights to renew).

2 *Honey Bees Preschool Ltd v 127 Hobson Street Ltd* [2018] NZHC 32, [2018] 3 NZLR 330 [HC judgment].

3 *Wilaci Pty Ltd v Torchlight Fund No 1 LP (in rec)* [2017] NZCA 152, [2017] 3 NZLR 293 at [6]-[8].

4 At [8].

[5] That point made, we now set out the essential contractual terms and facts constituting the admissible contractual context, and then touch briefly on the contractual aftermath.

Essential contractual terms

[6] On 20 December 2013, a deed of lease for commercial premises to be used as a childcare facility was executed. It was for a term of six years, with three rights of renewal. The landlord was 127 Hobson; the tenant Honey Bees. Also executed was a collateral deed, to which we will return. The co-owner of Honey Bees, Dr Jason James, executed the lease as guarantor. The co-owner of 127 Hobson, Mr Sunil (Dennis) Parbhu, executed the collateral deed as guarantor.

[7] The collateral deed states:

> BACKGROUND
>
> 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 on the fifth floor of 127 Hobson Street, Auckland ("Premises") in replacement of an agreement to lease between Jason and 127 Hobson.
>
> B. 127 Hobson and the Guarantor covenant as set out in this deed for the benefit of Honey Bees and Jason.
>
> …
>
> 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.
>
> 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.
>
> 3. This deed is collateral to the Lease.

Essential background facts

[8] The background facts are set out comprehensively in the judgment of Whata J.[5] So far as relevant and essential, they are as follows.

[9] Honey Bees is a childcare provider founded by Dr James and his wife, Natalija. They were looking for suitable premises in the Auckland inner city. Dr James saw an advertisement for premises owned by 127 Hobson. 127 Hobson is co-owned and directed by Mr Parbhu. The advertisement indicated the premises might accommodate as many as 50 children, although that was subject to regulatory approvals from the Ministry of Education, the Fire Brigade and Auckland Council.

[10] The premises for lease were in an inner city commercial building that had recently been enlarged. Four floors had been leased to a Quest hotel. The fifth floor was the one for lease. Above that were nine apartments, one of which Mr Parbhu occupied. All this was serviced by a single lift. Dr James gave evidence that Mr Parbhu told him that a second lift shaft was in place and a second lift would be installed within a year. Significantly, a plan of the leased premises provided during due diligence showed the building had two lifts.

[11] A conditional agreement to lease the premises was entered in on 28 August 2012. It provided for a six year lease term with three rights of renewal, a rental based on a rate of $56 per child per week, a minimum rental based on 48 children and a lease premium (i.e. key money) of $90,000. Honey Bees had the right to cancel if the Ministry of Education licensed the premises for less than 45 children.[6] The lease commencement date was to be 60 days after a five day due diligence period.

[12] The due diligence period was however much extended. A number of problems emerged. Fire Brigade approval proved to be limited to children aged over three years. The Jameses had planned to educate their own child there — but he was only one. The age limit restricted potential patronage. Serious distrust emerged after Mr Parbhu

---

5 HC judgment, above n 2.

6 A clause in the agreement refers to a Ministry "measure", but it is not a physical assessment, as 127 Hobson attempted at one point to suggest. Another clause refers to the Ministry issuing a license, "and the final license [sic] number not being less than 45 children".

sought to move the carparks from the basement to an area outside, and forwarded only part of a Council email which identified difficulties with the proposal.

[13] Perhaps most significantly, Ministry of Education licensing approval took 16 months. When obtained, in December 2013, it was a probationary licence for 24 children only. By that stage Honey Bees was in informal occupation — having needed fitted-out premises to obtain the licence. Some $500,000 had already been spent on hard fit-out of the premises. Lease negotiations continued to traverse matters such as a rent discount of 50 per cent for 14 months, rent being fixed for the first three years, the right to terminate if the licence could not be increased to 50 children, and the vexed question of the second lift.

[14] Dr James insisted on the second lift, particularly if the licence was to increase from just 24 children. He could see that with shared use of a single lift by the hotel, apartments and the childcare centre on the 5th floor, and with only five drop-off car parks, access could be a serious problem for parents. And thus a commercial risk for Honey Bees. Dr James sought a commitment that the second lift be installed and operating by January 2016. Mr Parbhu however demurred. He lived in the building. He indicated that it was something he wanted, given his own personal occupation. But he could not promise it. Dr James was however adamant that the lift had to be installed, although he would accept a slightly later date.

[15] On 20 December 2013, Hobson's agent, a Mr Anthony Gilbert, sent Dr James and Mr Parbhu a draft variation agreement. Mr Gilbert's email stated "Dennis personally, and as a director of 127 Hobson Street Ltd, agrees to install a second lift before August 2016". This was to be effected via a side agreement, which "will not go to Dennis's bank". In email correspondence Mr Parbhu agreed to that draft. Some minor revisions were agreed.

[16] The same day a formal deed of lease and collateral deed were drafted by Honey Bees' solicitors. Copies were sent to Mr Parbhu on the afternoon of 20 December 2013. Dr James attended Mr Parbhu's offices and executed both documents. Dr James was guarantor of the deed of lease, and Mr Parbhu guarantor of the collateral deed.

Subsequent events

[17] The relationship between Honey Bees and 127 Hobson has not been a smooth one. First, an argument over the status of a deposit paid by Honey Bees resulted in litigation. The High Court resolved that dispute in favour of Honey Bees.[7] Secondly, there were profound delays in installation of the second lift. Although it was supposed to be installed by 31 July 2016, a building permit for the work was only lodged two weeks prior, on 14 July 2016. It turned out that a structural beam had to be removed. As at the date of trial the work was still not complete. We were advised that the second lift received code compliance only on 9 April 2018.

Claim and defence

[18] On 14 November 2016, Honey Bees and Dr James issued these proceedings. They claimed indemnity from 127 Hobson and Mr Parbhu for payments made for rent and outgoings in the period 1 August to 20 October 2016. That was because the collateral deed did not expressly permit the withholding of payment by the tenant. So it had to pay and claim indemnity from the payee (127 Hobson) and its guarantor (Mr Parbhu). They claimed recovery of the sum paid ($41,392) and:

> An order for specific performance directing the … defendants to indemnify the … plaintiffs for all amounts that are due now and in the future pursuant to the Collateral Deed.

[19] The statement of defence denied liability to indemnify, alleging the indemnity clause was an unenforceable penalty and (somewhat obliquely) that unconscionable advantage had been taken of its weak financial status and absence of independent legal advice.

Judgment appealed

[20] When considering the rule against penalties, Whata J gave particular consideration to the decisions of this Court in *Wilaci* (albeit that it was a decision applying New South Wales law), of the United Kingdom Supreme Court in

---

7 *Honey Bees Preschool Ltd v 127 Hobson Street Ltd* [2014] NZHC 2942.

Cavendish Square Holding BV v Makdessi and of the High Court of Australia in *Paciocco v Australia New Zealand Banking Group Ltd*.[8] The Judge concluded *Wilaci* provided a coherent framework, for New Zealand law, to assess whether a clause is an unenforceable penalty. He said:[9]

> … The central issue is whether a stipulated remedy for breach is out of all proportion to the legitimate performance interests of the innocent party, or otherwise exorbitant or unconscionable, having regard to those interests. The following factors will be relevant to this assessment:
>
> (a) whether the parties were commercially astute, had similar bargaining power and were independently advised; and
>
> (b) whether the predominant purpose of the impugned clause is to punish (as opposed to simply deter) non-performance.
>
> In addition, in appropriate cases, a comparison between likely loss and the stipulated sum may be relevant, particularly where the performance interest is a contract sum.

[21] The Judge took the view that the rule against penalties affixes only to secondary obligations (including collateral or accessory obligations) to compensate or make good on the breach of or failure to discharge primary obligations.[10] The rule was, potentially, engaged here because 127 Hobson's obligation to indemnify secured the performance of its primary obligation to install the second lift.[11] He rejected a submission from Honey Bees that the indemnity clause was a "conditional primary obligation" because the essential character of the indemnity was a deterrent sanction for failure to install the lift on time.[12]

[22] The Judge concluded that the scope of the indemnity was confined to the extant lease, and not to any renewed periods.[13] Renewals constituted the grant of a new lease altogether.[14] The indemnity was not out of all proportion to Honey Bees' legitimate performance interest, or otherwise exorbitant or unconscionable having regard to that interest.[15] Honey Bees was seeking to secure and protect two related legitimate

---

8 *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67, [2016] AC 1172; and *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28, (2016) 258 CLR 525.
9 HC judgment, above n 2, at [45]–[46].
10 At [57].
11 At [60].
12 At [63].
13 At [71]–[73].
14 At [72], citing *Sina Holdings Ltd v Westpac Banking Corp* [1996] 1 NZLR 1 (CA).
15 At [77].

performance interests: installation of the second lift by a specified time, and the provision of leasehold premises fully fit for use as a pre-school facility for the full leasehold period (including renewals). Those interests provided a proper basis for a secondary obligation to indemnify Honey Bees' obligations under the lease in the event of non-performance of the primary obligation to install the lift.[16] The obligation to indemnify was only triggered if the lift was not installed some 31 months after the commencement of the lease. That afforded 127 Hobson ample opportunity to install the equipment. The Judge saw that as mitigating the apparent harshness of the indemnity running, potentially, to the expiry of the lease even if the lift was installed one day late.[17]

[23] The importance of the lift to Honey Bees would or should have been known to Mr Parbhu. It had expended significant resources on fitout of the premises, and was exposed to rental fixed by reference to a fully licensed facility of 50 children — regardless of the actual level of occupancy and against the background that at the time of execution of the collateral deed it had a probationary licence for 24 children only.[18] The point of that was of course that Honey Bees could be expected to increase its pre-school population as far as it could to defray that cost. As the Judge put it, these matters "justified a strong deterrent against non-performance".[19] The Judge concluded that both parties would reasonably also have contemplated that, by the time the second lift was due to be installed, Honey Bees would have committed significant resources to the establishment of a viable and fully licensed facility. The absence of the second lift could affect its ongoing ability to operate a childcare facility competitively and at full capacity. Further, alternative performance would be difficult if not impossible. Termination of the lease for non-performance by 127 Hobson would have major consequences for Honey Bees' business. Thus, it had no viable way of securing a second lift without 127 Hobson's cooperation.[20]

[24] Both parties were commercially astute. Mr Parbhu was particularly so. While he did not receive independent legal advice about the effect of the collateral

---

16 At [79].
17 At [80].
18 At [81].
19 At [82].
20 At [84(d)].

deed, that was a "self-imposed circumstance".[21] The Judge saw no reason to depart from the axiom that the parties could be presumed to be the best judges of their own interests.[22]

[25] The Judge accepted that the predominant purpose of the indemnity was not to punish non-performance. Honey Bees had good reason to doubt the reliability of 127 Hobson's ability to install the lift on time and equally good reason to seek to deter non-performance in strong terms. The Judge referred in his judgment to instances of misleading conduct by Mr Parbhu in the course of negotiation.[23]

[26] While the potential consequences of non-performance were substantial, and a relatively trifling breach of the clause could expose 127 Hobson and Mr Parbhu to forfeiture of all consideration from the date of breach to the expiry of the first lease, non-performance would also have a significant ongoing systematic impact on the functioning and viability of the Honey Bees' facility. But for the indemnity, it would be exposed to full rentals and outgoings liability even if not operating at full capacity and with or without installation of the second lift. The effect of the indemnity was to reallocate the risk to 127 Hobson, which had control of the premises and ample time to install the required lift.[24] It was not, the Judge said, "the function of the law of penalties to protect commercially sophisticated property investors from their commercial decisions".[25]

[27] The Judge rejected the alternative affirmative defence that the collateral deed was an unconscionable bargain.[26] Dr James was not aware of Mr Parbhu's financial difficulties and did not exploit them. Mr Parbhu insisted on using Dr James' solicitors to draft the agreements. Given his experience as an owner of commercial property, he did not feel the need to retain legal advice. As the Judge put it, "any vulnerability arising was therefore due to Mr Parbhu's decision making, and has nothing to do with [Dr] James".[27]

---

21 At [86].
22 At [86].
23 At [87].
24 At [92].
25 At [96].
26 At [102]–[104].
27 At [102].

[28] Finally, as to relief, the Judge declared that Honey Bees was entitled to specific performance of the obligation to indemnify down to the date of installation of the second lift.[28] He reserved for further argument, if necessary, the position in relation to specific performance beyond that date — i.e. until the end of the lease itself.[29] In a subsequent decision dated 10 April 2018 the Judge made a second order for specific performance down to that date.[30]

The law prohibiting penalties in New Zealand

[29] *Wilaci* was a decision of this Court, applying New South Wales law.[31] Its reasoning should be regarded as applicable in New Zealand — as several commentators have observed.[32] The reasons for that are fourfold. First, New Zealand law has largely followed English law prohibiting penalties. The principles expressed in the influential speech of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* long held force here.[33] Secondly, English law was then restated in 2015 in the United Kingdom Supreme Court decision in *Cavendish*.[34] Thirdly, one issue apart, there is now no material difference between Australian and English law in relation to penalties.[35] Fourthly, we consider a commensurate redirection of the penalties prohibition in New Zealand is necessary. The balance of the *common law* tilts more in favour of freedom of contract, and the enforcement of consensually selected remedies, today than it did a century ago. Ours is an age of far greater consumer legislative protection. Foremost among these statutes were the Credit Contracts Act 1981 and the Fair Trading Act 1986. Today, contractual overreach calls for assessment primarily through the lens of impaired consent, unconscionability or consumer law infringement. That means there is less for the prohibition against penalties to do. Commercial parties should generally be left to the

---

28 At [105].

29 At [114]. He had already held that the indemnity would not run past the first lease term: see [22] above.

30 *Honey Bees Preschool Ltd v 127 Hobson Street Ltd* [2018] NZHC 629.

31 *Wilaci,* above n 3, at [5] and [41].

32 Andrew Beck "Contract" (2017) 3 NZ L Rev 513 at 522; and Kelly Quinn "Liquidated damages in long-term relational contracts" [2017] NZLJ 256 at 259.

33 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 (HL). See Jeremy Finn, Stephen Todd and Matthew Barber (eds) *Burrows, Finn and Todd on the Law of Contract in New Zealand* (6th ed, LexisNexis, Wellington, 2018) at 884–886.

34 *Cavendish,* above n 8.

35 That issue is whether a prerequisite for the doctrine engaging is breach of a primary obligation: see the discussion below at [40]–[42].

certainty of the bargains they have made, including the remedies they have elected collectively, save in cases of gross overreach.

[30] It is unnecessary for us to here repeat the historical analysis undertaken in *Wilaci*.[36] The core principles for application of the prohibition against penalties in New Zealand may now be summarised.

The disproportionality test

[31] The primary test for a penalty is now the *disproportionality test*. The essential question is whether the secondary obligation challenged as a penalty imposes a detriment on a promisor out of all proportion to any legitimate interest of the promisee in the enforcement of the primary obligation.[37] The disproportionality test gives greater credence to freedom of contract, and the enforcement of bargains made by free agreement. It recognises that contracting parties, particularly those who are commercial entities, are likely to be the best judges of their own interests.[38]

[32] The bar — "out of all proportion" — is a particularly high one.[39] Lord Mance, in *Cavendish*, posited a similar test of whether the provision made to protect the promisee's legitimate interest is in all the circumstances "extravagant, exorbitant or unconscionable".[40] These are tests not easily satisfied. The casual or opportunistic complaint of disadvantage is swiftly spurned by them.

[33] The disproportionality test is a more sophisticated and demanding one than the comparative damages test which prevailed under *Dunlop*. As Lords Neuberger and Sumption observed in *Cavendish*, damages are not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations.[41] In many cases the protected interest of the innocent promisee will equate to available compensation for breach. That is particularly so where the primary

---

36 *Wilaci*, above n 3, at [68]–[89]. See now the excellent text by Professor Roger Halson *Liquidated Damages and Penalty Clauses* (Oxford University Press, Oxford, 2018), ch 1.

37 *Wilaci*, above n 3, at [81], [88] and [100]; *Cavendish,* above n 8, at [32], [152], [255], [266] and [293]; and *Paciocco*, above n 8, at [54], [57], [164] and [270].

38 See Halson, above n 36, at 93–100.

39 *Wilaci,* above n 3, at [87].

40 *Cavendish*, above n 8, at [152].

41 At [32].

obligation requiring protection is simply the payment of a sum of money.[42] In such a case, the legitimate interest of the promisee may well be entirely satisfied by payment of the sum plus interest plus costs.[43] But *Wilaci* shows that is not necessarily the case and, moreover, that circumstances (such as, in that case, profound risk) may justify the party setting a scale of secondary obligation that would in other circumstances seem usurious.[44] As Lord Hodge observed in *Cavendish*, the focus on disproportion between specified sum and damages capable of pre-estimation makes sense in the context of the damages clause, "but is an artificial concept if applied to clauses which have another commercial justification".[45]

[34] The expression "legitimate interest" itself recognises a wider array of considerations than would a substitute, such as "financial" or "economic" interests.[46] Some interests, commercial or non-commercial, will justify imposition of a super-compensatory burden.[47] *Dunlop* was such a case. As we noted in *Wilaci*, it involved a resale price maintenance provision, with a penalty that was 11 times the illicit discount allowed by the hapless defendant garage owner.[48] The sanctity of the agreed trade arrangement justified enforcement of an arguably disproportionate secondary obligation. Another example is the secondary appeal in *Cavendish*, *ParkingEye Ltd v Beavis*.[49] A shopping mall offered free parking for two hours. But a motorist overstaying his or her welcome became liable to a charge of £85. By no means could that payment be said to be a pre-estimate of loss arising from a motorist staying a few minutes over two hours. But the Supreme Court recognised the legitimate interest of the mall operator in the throughput of customers via a continuous turnover of parking spaces. As Lord Mance observed:[50]

> 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.

---

42 *Paciocco*, above n 8, at [160].
43 *Cavendish*, above n 8, at [249] per Lord Hodge.
44 *Wilaci,* above n 3, at [96]–[99].
45 *Cavendish*, above n 8, at [247].
46 Ewan McKendrick *Contract Law* (12th ed, Macmillan Education UK, London, 2017) at 406.
47 *Cavendish,* above n 8, at [152]. See also discussion in Jessica Palmer "Implications of the New Rule Against Penalties" (2016) 47 VUWLR 305 at 313–316 and 319–326.
48 *Wilaci,* above n 3, at [78]. See also *Cavendish*, above n 8, at [221] per Lord Hodge.
49 *Cavendish,* above n 8.
50 At [152].

[35] As we noted in *Wilaci*, the prohibition against penalties retains a limited philosophical connection with equity and the distinct prohibition against unconscionable bargains.[51] Imbalance in bargaining power and unconscientious conduct is relevant to assessing the proportionality test. In *Cavendish* Lords Neuberger and Sumption observed that the penalty rule originated with the concern that the courts prevent exploitation in an age when credit was scarce and borrowers were vulnerable. But "the modern rule is substantive, not procedural."[52] A finding that a secondary obligation is a penalty does not depend on a finding that advantage was taken unconscientiously. Lord Mance put the point plainly:[53]

> In judging what is extravagant, exorbitant or unconscionable, I consider (despite contrary expressions of view) that the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor.

The punitive purpose test

[36] The disproportionality test may also be cross-checked by another intimately associated test: the *punitive purpose test*. 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. These tests are two sides of the same coin. The punitive purpose test arises because, as we said in *Wilaci*, the remedial function of the common law of contract is confined to the achievement of performance expectations.[54] Enforcing punishments forms no part of that. The prohibition against penalties is a rule of contract law based on that public policy:[55]

> It is a question of construction of the parties' contract judged by reference to the circumstances at the time of contracting; the public policy is that the courts will not enforce a stipulation for punishment for breach of contract.

[37] The interconnection between the two tests is demonstrated in the judgment of Gageler J in *Paciocco*. As we observed in *Wilaci*, that judgment was more focused on whether the exclusive purpose of the clause was to punish, in order to deter breach.[56]

---

51 *Wilaci,* above n 3, at [82].
52 *Cavendish,* above n 8, at [34].
53 At [152].
54 *Wilaci,* above n 3, at [70]. See Halson, above n 36, at 132–135.
55 *Cavendish*, above n 8, at [243] per Lord Hodge.
56 *Wilaci,* above n 3, at [26] and [28].

Gageler J regarded the imposition of an *in terrorem* secondary obligation as capturing the essence of the conception to which the whole of the penalties analysis was directed.[57] But as he also observed:[58]

> The relevant indicator of punishment lies 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.

[38] The punitive purpose test is concerned with predominant rather than sole purpose.[59] We adopted the predominant purpose test in *Wilaci*.[60] In doing so, we rejected the sole purpose test postulated by Gageler J in *Paciocco*.[61] The approach in *Wilaci* is consistent with that in England, expressed in *Cavendish*. The predominant purpose test was also preferred by Keane J in *Paciocco*.[62] French CJ and Keifel J did not expressly take a position.

Prohibition equitable or legal?

[39] Mr Dillon urged upon us the proposition that the prohibition against penalties was essentially a rule of equity rather than common law. We do not accept that proposition. The equitable origins of the doctrine were acknowledged in *Cavendish* and *Wilaci*. But we think the rule must now be regarded as essentially one of common law, albeit influenced to a limited extent by its equitable origins. Certainly that was the view taken in *Cavendish*. As Lords Neuberger and Sumption noted, the effect of statute in the seventeenth century was that thereafter the equitable jurisdiction was rarely invoked "and the further development of the penalty rule was entirely the work of the courts of common law".[63] As they later noted, with three possible exceptions (which do not detain us here) the equitable jurisdiction "appears to have left no trace in the authorities since the fusion of law and equity in 1873".[64]

---

57 *Paciocco,* above n 8, at [165].
58 At [164].
59 This is an objective rather than subjective test based on a weighing of legitimate interest in the context of the contract.
60 *Wilaci*, above n 3, at [95], [97] and [102].
61 *Paciocco*, above n 8, at [158] and [165]–[166].
62 At [221].
63 *Cavendish*, above n 8, at [6].
64 At [42].

Prohibition premised on breach only?

[40] The doctrine of penalties arose because it has always been the courts' function to resolve the consequences of breach.[65] A grossly extravagant penalty with the predominant effect of punishment, rather than protection of a legitimate interest, offended the court's conscience in its remedial jurisdiction. The courts undertake no general review function to revise ill-assessed bargains, in the absence of equitable unconscionability or undue influence, common law duress, or a statutory jurisdiction to revise. It follows that the jurisdictional premise for the prohibition has been breach of contract.

[41] In *Andrews v Australia and New Zealand Banking Group Ltd*, the High Court of Australia took a broader view of the operation of the doctrine.[66] It concluded it might be operable in the case of any secondary or conditional obligation arising on failure to observe another contractual provision, whether or not that amounted to a breach.[67]

[42] That extension was condemned (it may be described no other way) by their Lordships in *Cavendish*.[68] We think their reservations were well made. We do not consider the prohibition invites review of contingent obligations other than those operating upon breach. However, formally that view is obiter dicta, as the question does not arise for our determination in this particular appeal. It is common ground that 127 Hobson was in breach of the collateral deed in not installing the second lift.

Issues

[43] This appeal gives rise to three issues:

(a) Issue 1: What is the proper construction of the indemnity clause?

(b) Issue 2: Is the indemnity clause a penalty?

---

65 Palmer, above n 47, at 313.
66 *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205.
67 At [10] and [78].
68 *Cavendish*, above n 8, at [40]–[43], [129]–[130], [239]–[241] and [292].

(c) Issue 3: What relief should be ordered?

[44] It is now common ground that the indemnity clause gives rise to a secondary obligation, responsive to contractual breach. Accordingly, the penalties doctrine is engaged. The critical questions are what the clause means and whether it is a penalty.

Issue 1: What is the proper construction of the indemnity clause?

[45] It is a curiosity of the law of contract that penalty cases provoke perverse positions. As in *Wilaci*, here 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.[69] Construction of a secondary obligation said to be a penalty must however be resolved without regard to ulterior consequences. The concern of the Court is instead with what the parties intended the obligation to be.[70]

Duration of indemnity

[46] Three choices perhaps exist. The indemnity (if triggered by default) may run until (1) the second lift is operational; (2) the end of the initial term of the lease; or (3) the very end of the lease if renewed (as surely it would be if the tenant enjoyed occupation rent-free). Counter-intuitively Honey Bees argued for (2), and 127 Hobson for (3). No party contended for meaning (1). We agree that no basis exists to construe cl 2 as having that limited effect.

[47] Mr Dillon (for 127 Hobson) argued for meaning (3). That is, that the deed provided an indemnity against the payment of rent and outgoings for as many as 22 years after default if the tenant renewed the lease (which surely it would do, if it did not have to pay rent). Clause 2 of the collateral deed provided the indemnity would run "to the expiry of the Lease". The lease defined its own final expiry date as 24 years from 19 December 2013 — i.e. 19 December 2037. The term of the lease was defined to include any renewal. The terms of the collateral deed therefore expired on the final expiry of the lease.

---

69 *Wilaci,* above n 3, at [33].
70 At [101].

[48] We do not accept that submission. As we read the collateral deed, it is intended to run to the expiry of the initial term only. The expression "Lease" does not necessarily import the same definitions as appear in the lease document itself. Those definitions are a distraction. The more relevant question here is what the parties intended by the provision. Here the prompt installation of the second lift had been represented, but by virtue of the collateral deed an effective obligation to do so was deferred for almost half the initial lease term — until 31 July 2016. That was some 31 months from entry into the lease itself. The parties might have agreed some rental rebate until the second lift was completed. Instead they opted for a secondary obligation wherein rental was paid in full up to the default date, but relieved upon default for somewhat more than half the initial term of the lease. There is no indication in the evidence that either party intended a longer period of relief, let alone a period of up to 22 years in which no rent or outgoings were paid even if the lift had been installed just one day late.

[49] Some email correspondence to that effect was pointed to by Mr Dillon. It post-dated both contract and breach. It may fairly be described as tactical positioning. It is no help to the Court in construing the collateral deed. That is because it says nothing whatever as to common intention.[71]

[50] It follows that the duration of the indemnity runs until the end of the initial term of the lease. And no further than that. Mr Gedye QC did not seek to argue otherwise for Honey Bees.

Subject matter of indemnity

[51] The indemnity provides that 127 Hobson and Mr Parbhu jointly and severally indemnify Honey Bees and Dr James "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".

---

[71] See *Wholesale Distributors Ltd v Gibbons Holdings Ltd* [2007] NZSC 37, [2008] 1 NZLR 277 at [52]–[53] and [73], but see [135]. *Burrows, Finn and Todd on the Law of Contract in New Zealand*, n 33 above, recognise that the position is somewhat open following *Gibbons* but suggest that the balance of authorities require mutuality or common intent: at 199–200.

[52] Mr Dillon argued that this went beyond simply the payment of rent and outgoings and that "the effect of the indemnity is to alienate every remaining property right of the owner, saving any reversion of the final expiry of the lease". The proposition seemed to be that the effect of the indemnity was that, upon breach, the tenants obtained a general indemnity from the landlord in respect of any tenant obligation whatsoever (save only delivery up of the premises at the final expiry of the lease and renewal terms).

[53] We do not accept the parties intended the indemnity to extend to non-economic obligations, in effect excusing all tenant obligations until final reversion. As the Judge 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.[72]

Issue 2: Is the indemnity clause a penalty?

[54] Mr Dillon submitted that the prolonged purpose of the collateral deed was to create an *in terrorem* position. It was unrelated to any potential loss; it was simply a deed calculated to ensure the installation of the second lift on the basis that the consequence of default would be so extreme that the risk of default could not be run. If the second lift was not installed by the due date, or was installed a day late, the full penalty would be invested upon 127 Hobson. Mr Dillon submitted that if Honey Bees had a commercial interest in having the second lift installed (which was not questioned by 127 Hobson) why then have a provision that provided no incentive if default in compliance by the due date arose? That was because the clause was designed to compel performance by due date, as Dr James had acknowledged. But submitted Mr Dillon, "this also means the penalty has no relationship with the commercial interests of the tenant".

[55] Mr Dillon submitted, further, that the commercial interest of Honey Bees had to reflect the fact that it was already obliged to enter the lease. The indemnity clause was therefore a penalty out of all proportion to or otherwise exorbitant or unconscionable having regard to the interests of a tenant in the performance of

---

[72] HC judgment, above n 2, at [70].

the landlord's obligation to install the second lift by 31 July 2016. The clause should be regarded as unenforceable, given the tenant could claim in damages only for any actual losses it could prove for breach of the performance obligation. Despite the delay in delivery of the lift, the business was successful, fully populated by pre-school children, and the delay resulted only in some inconvenience to customers. On that basis it was unlikely Honey Bees had actually suffered any material loss.

Analysis

[56] In this appeal, and in the trial below, the burden lay on the landlord to establish that an indemnity against the tenant's payment obligations until the end of the initial term of lease was out of all proportion to the legitimate interest it had in performance of the obligation to complete the second lift by 31 July 2016. That is, some two years and seven months into the six year lease term. We do not find the landlord has discharged that burden. We note six points. The first two concern the nature of Honey Bees' legitimate interests requiring protection. The remainder concern whether the protection obtained in the collateral deed could be said to be out of all proportion to those interests.

[57] First, the installation of a second lift had been the subject of representation prior to entry into the agreement to lease; thereafter 127 Hobson's commitment waned. Throughout it plainly was a matter of considerable importance to Honey Bees. It was paying rent based on at least 48 children attending its facility. Yet it initially was licensed for no more than 24, and (as it grew) had to share access with nine apartments and a four story hotel via a single lift only.

[58] Secondly, 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 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.

[59] Thirdly, in the ordinary course a commitment to complete works in leased premises would be found in a landlord's covenant in the lease. Time would be of the essence, and the tenant would enjoy either a right to cancel for default or a right to claim damages instead. Here, the lease contained no covenant to complete the second lift. Rather, 127 Hobson insisted that the obligation be contained in a collateral instrument. It appears that was because it did not want the potential impairment in value to be disclosed to its bank.

[60] Fourthly, that course was disadvantageous to Honey Bees in several respects. Clauses 1 and 2 of the collateral deed approximate an essential term requiring completion by a fixed date, time being of the essence, triggering an election on that date whether to cancel or affirm in the event of breach. These clauses might appear to put Honey Bees in a similar position to a tenant exercising a right of cancellation of the lease for breach of an essential term. But here Honey Bees was much worse off relying on the collateral deed. We note four points. (1) A right to cancel the lease would relieve the tenant from the obligation to pay rent. Here Honey Bees had no lawful basis to exit the lease. Despite default in installation of the second lift, it would be required to continue to pay the rent (and seek to enforce the indemnity under the collateral deed). That would expose it to unmatched timing and credit risks. (2) If Honey Bees were instead to withhold payment, it would be exposed to cancellation of the lease by 127 Hobson (including any assignee of its rights), loss of its sunk costs and liability for any consequent losses to 127 Hobson while the premises were re-let. (3) It was common ground before us that in the event of default, Honey Bees' remedies would be confined to (and by) the collateral deed. Thus, if it were to exit, that would also have the effect of precluding it from claiming wasted fit-out costs on the leased premises, relocation costs or new fit-out costs on replacement premises. (4) The obligations of 127 Hobson under the collateral deed are personal. They do not run with the land and do not pass to any assignee of Honey Bees' rights. The benefit to Honey Bees under collateral deed was, therefore, impaired in contrast to a direct obligation to complete the lift under the lease. Its legitimate interests must reflect that impairment.

[61] Fifthly, we heard no argument that an indemnity against payment obligations up to completion of the second lift would not be predictable, proportionate and permissible.[73] But that is not the deal the parties did. Honey Bees proposed a different arrangement, and 127 Hobson accepted it. The latter was given extra time to complete the second lift — two years and seven months — during 17 months of which Honey Bees paid full rent. The quid pro quo, as Mr Gedye submitted, was 127 Hobson assumed the risk of the indemnity against payment for the balance of the initial term (three years and five months). From an economic perspective, risk and reward could have been structured in a variety of ways. We are not persuaded that the structure here adopted was out of all proportion to Honey Bees' legitimate interests in performance of the primary obligation in the collateral deed to install a working second lift by 31 July 2016. Particularly when the disadvantages of a wholly collateral obligation are factored into account.

[62] Sixthly, the best point made by Mr Dillon was that the effect of the clause was that if the second lift was but one day late, the indemnity would relieve Honey Bees of further rental and outgoing obligation. The force of this argument is however much abated by the true construction of the clause, which is that it relieves only from default date down to the end of the initial term of the lease. The remaining argument is in effect a complaint that 127 Hobson failed to negotiate an indemnity for a shorter period — such as down to completion of the lift. But, again, that was not the deal the parties did. And nor did they agree to rebate the rental during the first part of the initial term to account for the impaired access while only one rather than two lifts were functioning. The indemnity ceases to have effect in the event of the exercise of renewal rights. The full rent, both reviewed to market and ratcheted, will apply then — even if the second lift still had not been installed. The parties must be taken to have appreciated these risk settings. We see no basis to revise them on the basis that they are now seen to be disproportionate to their previous perceptions of legitimate interest.

[63] It follows that 127 Hobson has failed to persuade us that the indemnity clause offends the prohibition against penalties.

---

[73] That is, construction (1) in [46] above.

Issue 3: What relief should be ordered?

[64] We will grant both declaratory relief and an order for specific performance to protect the integrity and due operation of the agreed indemnity. However, we consider the latter order requires some practical definition. Accordingly, in exercise of the Court's equitable jurisdiction to grant specific performance on terms, and pursuant to r 48(4) of the Court of Appeal (Civil) Rules 2005, we will make a further order (as part of the order for specific performance) concerning simultaneous performance of obligations under the lease and collateral deed. The parties remain free to agree an alternative procedure to the order made.

Result

[65] The appeal is dismissed.

[66] A declaration is made that cl 2 of the collateral deed obliges 127 Hobson and Mr Parbhu jointly and severally to indemnify Honey Bees and Dr James jointly and severally for all obligations in the nature of payments (including rent and operating expenses) down to expiry of the initial term of the lease (i.e. 19 December 2019).

[67] An order for specific performance in those terms is made. It is further ordered that payment by Honey Bees (and Dr James, if need be) under the lease and payment by 127 Hobson (and Mr Parbhu, if need be) under the collateral deed are to be effected by simultaneous exchange of bank cheques. The parties are free to agree an alternative procedure for payment (or non-payment in lieu).

[68] The respondents are entitled to costs for a standard appeal, on a band A basis, together with usual disbursements.

Solicitors:
Queen City Law, Auckland for Appellants
Fortune Manning, Auckland for Respondents