
Honey Bees Preschool: The Law against Penalties Confirmed

On 5 June 2020, the Supreme Court issued its decision on an appeal by 127 Hobson Street Limited (*127 Hobson*) against the Court of Appeal's finding that a requirement to indemnify lessee Honeybees Preschool Limited (*Honey Bees*), for all financial obligations incurred under a lease as a result of 127 Hobson's failure as lessor to install an elevator, was not an unenforceable penalty.

The issues on appeal involved an examination of the scope of the current rule against penalties in New Zealand and whether the clause in question constituted an unenforceable penalty.

Upholding the Court of Appeal finding, the Supreme Court has usefully re-stated the law on penalties in New Zealand.

Background

Honey Bees runs a childcare centre in central city premises leased from 127 Hobson. When the Deed of Lease was entered into, the parties also entered into a separate agreement under which 127 Hobson and its director agreed to install a second lift in the building to facilitate the arrival and departure of children at the central city high rise preschool.

This agreement included a provision whereby both 127 Hobson and its director agreed that in the event this second lift was not operational by 31 July 2016, Honey Bees would be indemnified against all rent and outgoings it incurred under the lease until its expiry.

The Supreme Court looked at the circumstances around entry into the overall transaction, examining why the separate second lift agreement was central to the lease's suitability.

What is the scope of the rule against penalties in New Zealand?

The Supreme Court summarised the rule against penalties as follows:

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A clause will be an unenforceable penalty if a consequence is out of all proportion (exorbitant) to the legitimate interests of the innocent party in performance of the primary obligations.

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Determining if the clause is an unenforceable penalty requires an objective exercise of construction, undertaken at the time of contract formation, and by reference to the terms and circumstances of the contract (including commercial context).

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A legitimate interest to be weighed includes any consequences designed to protect the interests of the party in performance of the primary contractual term.

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A party's legitimate interests may extend beyond the loss caused by the breach as would be measured by a conventional assessment of contractual damages, i.e. the four corners of the contract.

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Legitimate interests will not include objectives unrelated to the performance interest – including punishment – but deterring a breach can be a legitimate objective of the clause.

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The respective bargaining power of the parties is relevant, including whether legal advice was obtained.

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It is not always necessary for the court to assess damages – but there will be cases where such a monetary calculation will be the appropriate measure of the innocent party's interest in performance.

Was the indemnity clause an unenforceable penalty?

To answer this, the Court looked at Honey Bees' legitimate interests and found that the only relevant interests were those that flowed from a failure to install a second

lift on or before the due date. As the preschool was operating on the fifth floor of a busy high rise building, children and parents would be arriving and leaving within concentrated blocks of time. Honey Bees was looking to increase the capacity of its preschool over the forthcoming years. This was important to the commercial success of the venture.

The Court also found that there was no discrepancy in the parties' respective bargaining powers.

The Court agreed with the Court of Appeal's finding that, despite the 'all or nothing' nature of the indemnity clause, the consequences of the indemnity being triggered were not out of all proportion to the legitimate interests secured, and therefore the clause was not an unenforceable penalty.

Other issues

This Court also read the wording "all obligations" as applying to only "payment obligations", i.e. Honey Bees was indemnified against all its financial obligations under the lease but the agreement did not give Honey Bees a right to breach its own obligations under the lease.

It is worth noting that the Court confirmed the general understanding in property law that rights of renewal of leases are in fact grants of a new lease, not an extension of the existing lease. Therefore the indemnity provided under the indemnity agreement only applied to the initial term of the lease, rather than a 24 year period including all renewals.

10 July 2020
