**IN THE COURT OF APPEAL OF NEW ZEALAND**

**CA11/03**

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| | BETWEEN | AMALTAL CORPORATION LIMITED<br>Appellant |
| | AND | MARUHA (NZ) CORPORATION LIMITED<br>Respondent |

Hearing: 13 November 2003

Coram: Gault P
Blanchard J
McGrath J

Appearances: J E Hodder and N S Wood for Appellant
J G Miles QC and Z G Kennedy for Respondent

Judgment: 11 March 2004

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**JUDGMENT OF THE COURT DELIVERED BY BLANCHARD J**

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[1] This appeal is about the jurisdiction of the High Court under Article 34 of the First Schedule to the Arbitration Act 1996 (the Act), which governs the circumstances in which an arbitral award may be set aside. The appellant, Amaltal Corporation Ltd (Amaltal), is seeking to have an award set aside under that article on the ground that it is "in conflict with the public policy of New Zealand": Article 34(2)(b)(ii). The arbitrator, the Rt. Hon John Henry QC, found that Amaltal was in breach of a shareholders' agreement with the respondent, Maruha (NZ) Corporation Ltd (Maruha). That finding has not been challenged. The arbitrator then ordered Amaltal to transfer to Maruha all its shares in the company to which the agreement related, Ceebay Holdings Ltd (Ceebay), which holds valuable fishing quota. No consideration is to be payable for this transfer; it had been agreed in the shareholders' agreement that, if Amaltal breached any of its obligations, the

agreement would immediately terminate and Amaltal would forthwith transfer its shares in Ceebay at Maruha's direction to a person legally capable of holding the shares without contravention of the fisheries legislation. Amaltal argued unsuccessfully before the arbitrator that this provision was unenforceable because it constituted a penalty.

[2] The award was issued on 13 March 2002. On 5 June 2002 Amaltal made two applications to the High Court. The first sought leave to appeal the award under Article 5 of the Second Schedule to the Act, which allows leave to be granted for an appeal on "any question of law arising out of an award". The provisions of the Second Schedule apply to a domestic arbitration unless excluded by agreement of the parties – they were not excluded by Amaltal and Maruha – and to international arbitrations only if the parties so agree: s6(2). The High Court has a discretion whether to grant leave. It is established that the scope for review of an award for error of law is limited: see *Gold and Resource Developments (NZ) Ltd v Doug Hood Ltd* [2000] 3 NZLR 318.

[3] On the application for leave a number of questions of law were raised by Amaltal, including the claim that the arbitrator had erred in law in finding that the forfeiture clause was not a penalty. The application was, however, dismissed by Morris J on 7 August 2002. He held that there was no sufficiently strong indication of any error of law in the award to justify granting leave to appeal it. Amaltal has not sought to appeal against Morris J's decision.

[4] Amaltal's second application, with which it elected not to proceed at the same time as its leave application, sought the setting aside of the award under Article 34(2)(b) on the ground that it was in conflict with the public policy of New Zealand. Article 34 provides:

> **34 Application for setting aside as exclusive recourse against arbitral award—**
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> (1) Recourse to a court against an arbitral award may be made only by an application for setting aside in accordance with paragraphs (2) and (3).
>
> (2) An arbitral award may be set aside by the High Court only if—
>
> (a) The party making the application furnishes proof that—

(i) A party to the arbitration agreement was under some incapacity, or the said agreement is not valid under the law to which the parties have subjected it, or, failing any indication on that question, under the law of New Zealand; or

(ii) The party making the application was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings or was otherwise unable to present that party's case; or

(iii) The award deals with a dispute not contemplated by or not falling within the terms of the submission to arbitration, or contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, only that part of the award which contains decisions on matters not submitted to arbitration may be set aside; or

(iv) The composition of the arbitral tribunal or the arbitral procedure was not in accordance with the agreement of the parties, unless such agreement was in conflict with a provision of this Schedule from which the parties cannot derogate, or, failing such agreement, was not in accordance with this Schedule; or

(b) The High Court finds that—

(i) The subject-matter of the dispute is not capable of settlement by arbitration under the law of New Zealand, or

(ii) The award is in conflict with the public policy of New Zealand.

(3) An application for setting aside may not be made after 3 months have elapsed from the date on which the party making that application had received the award or, if a request had been made under article 33, from the date on which that request had been disposed of by the arbitral tribunal. This paragraph does not apply to an application for setting aside on the ground that the award was induced or affected by fraud or corruption.

(4) The High Court, when asked to set aside an award, may, where appropriate and so requested by a party, suspend the setting aside proceedings for a period of time determined by it in order to give the arbitral tribunal an opportunity to resume the arbitral proceedings or to take such other action as in the arbitral tribunal's opinion will eliminate the grounds for setting aside.

(5) Where an application is made to set aside an award, the High Court may order that any money made payable by the award shall be brought into Court or otherwise secured pending the determination of the application.

(6) For the avoidance of doubt, and without limiting the generality of paragraph (2)(b)(ii), it is hereby declared that an award is in conflict with the public policy of New Zealand if—

(a) The making of the award was induced or affected by fraud or corruption; or

(b) A breach of the rules of natural justice occurred—

(i) During the arbitral proceedings; or

(ii) In connection with the making of the award.

[5] Amaltal again argued in the High Court that the arbitrator had erred in finding that the forfeiture provision was not a penalty, i.e. it pursued the same argument as it had made on the leave application. It contended that the rule whereby penalty clauses will not be enforced by the courts is a rule of public policy. This second application was dismissed on 13 December 2002 by Harrison J, who at the same time granted an application by Maruha to have the award entered as a judgment. It is this decision of Harrison J, now reported at [2003] 2 NZLR 92, with which the present appeal is concerned.

[6] Before summarising the reasons for Harrison J's decision we briefly canvass the background facts.

**Facts**

[7] Amaltal is owned by Amalgamated Marketing Ltd and Talley's Fisheries Ltd, two New Zealand companies. Each holds 50% of Amaltal's shares. Maruha is the New Zealand subsidiary of Maruha Corporation of Japan (Maruha Japan).

[8] In 1985 Amaltal and Maruha Japan had incorporated a joint venture company, Amaltal Taiyo Fishery Co Ltd, for the primary purpose of acquiring New Zealand fishing quota and using it to conduct fishing operations. Amaltal held just over 75% of the shares in Amaltal Taiyo and Maruha Japan held the balance. It was supported by guarantees given by Maruha Japan which also paid to it approximately NZ$6.6 million in order to ensure that its after tax profit met the requirements of its financiers. During the course of the joint venture over the next six years Amaltal Taiyo obtained a significant quantity of fishing quota.

[9] In June 1991 Maruha Japan acquiesced in a request from Amaltal that Amaltal Taiyo be dissolved and its assets distributed to Amaltal and Maruha Japan in proportion to their respective shareholdings. That decision was formalised in an agreement of 25 September 1991 which, *inter alia*, provided that Maruha Japan's proportionate share (24.9995%) of Amaltal Taiyo's assets (mostly fishing quota) would be transferred to an entity nominated by Maruha Japan and capable of holding quota in accordance with New Zealand fisheries laws. The rest of Amaltal Taiyo's assets were transferred to Amaltal.

[10] It was necessary in relation to Maruha Japan's 25% share of the quota to comply with the Fisheries Act 1983. Maruha Japan needed a New Zealand joint venture partner to ensure that there was no breach of s28Z of the Fisheries Act 1983. Accordingly Ceebay was incorporated on 2 June 1992 with Amaltal holding 751 A Class shares and the respondent, a subsidiary of Maruha Japan, holding 249 B Class shares. The constitution of the company provided for the B Class shareholder to receive 99% of the profits with 1% going to Amaltal as the A Class shareholder. That arrangement of course reflected the fact that it was Maruha Japan which was contributing the entirety of the assets of the company from which profits would be derived. Amaltal was required to pay only the nominal sum of $751 to subscribe for its A shares.

[11] It was agreed that Ceebay would engage Amalgamated Marketing Ltd to manage its assets. A shareholders' agreement was executed by Maruha and Amaltal. After referring to the engagement of the manager, the shareholders' agreement provided (in cl 3.1) that the shareholders might by special resolution request the manager to arrange a sale of any or all of the assets of Ceebay and (in cl 3.2) that, if such a request were made, then the assets should first be offered to Amaltal at their market price. Both parties also agreed (in cl 3.3) to conduct Ceebay's business "that they carry on together in the spirit of good faith and cooperation" and that neither party would unfairly impede the other's business operations in New Zealand. That provision was, in its context, clearly referable as well to the business operations in New Zealand of Maruha Japan.

[12] In cl 4.3 Amaltal agreed not to request the manager to arrange for Ceebay to enter into any lease or transfer of any of the assets with a related company (as defined) of the manager or Amaltal except with the consent of both shareholders. In cl 4.4 Amaltal covenanted not to permit or take any action to enable Ceebay to conduct any business other than owning, leasing, selling and otherwise dealing with the assets in accordance with the agreement.

[13] It was provided that the agreement should continue for so long as Amaltal and Maruha continued to be shareholders. But there were the following provisions:

> 5.2 Termination: In the event that Amaltal breaches any of its obligations hereunder this Agreement will immediately terminate.
>
> 5.3 Transfer Shares: Upon termination of this Agreement pursuant to Clause 5.2 Amaltal shall forthwith transfer its shares in the Company at [Maruha's] direction to a person legally capable of holding the shares in the Company without contravention of the Act.
>
> 5.4 Resignation of Officers: Upon termination of this Agreement pursuant to Clause 5.2 any officer of the Company appointed pursuant to the rights attached to Amaltal's shares in the Company shall immediately tender his/her resignation to the Company.

[14] There were also these provisions:

> 6. CO-OPERATION
>
> The parties undertake to use all efforts to co-operate with each other for the purpose of giving effect to this Agreement and to ensure the conduct of the business of the Company is at all times to be in terms of this Agreement and no party or any director or shareholder of any party shall do or omit to do any act or thing which may frustrate this Agreement.
>
> 7. ARBITRATION
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> The parties shall use their best endeavours to resolve any disputes between them in relation to this Agreement by consultation in a spirit of co-operation but if that shall fail, then by mediation or conciliation and only as a last resort by arbitration under the Arbitration Act 1908. The provisions of this clause shall not affect the provisions of clause 3.2 as to the settling of a price.

[15] Each shareholder held pre-emptive rights over the other's shares in Ceebay.

[16] In 1996 a new Fisheries Act was enacted. When it came into force Ceebay would be deemed an overseas person and therefore not allowed to hold fishing quota.

But the Act was not brought into force before amending legislation was passed in 1999 enabling an overseas person which had previously been a lawful owner of quota, but was barred under the 1996 provisions, to obtain ministerial consent to hold or sell quota by application to the Overseas Investment Commission. That dispensation was however conditional upon consent being obtained from the Commission by 30 September 2000.

[17] Amaltal took the position that even before the passage of the 1996 Act the Ceebay structure had been unlawful under the 1983 Act and that accordingly, in terms of the earlier Act, the quota had already been forfeited to the Crown by operation of law. It refused to allow Ceebay to make any application to the Overseas Investment Commission under the 1999 amendment and it sought to acquire Maruha's shares in Ceebay at a significant discount, seeking to take advantage of the various difficulties being encountered by Maruha.

[18] Maruha had to go to the lengths of obtaining an injunction from the High Court requiring Amaltal to permit Ceebay to make the requisite application to the Commission for consent to hold quota. It was also successful in obtaining an injunction requiring Amaltal to permit Ceebay to continue leasing out its quota.

[19] Despite opposition from Amaltal, the Overseas Investment Commission then granted Ceebay's application to hold quota. Agreement was also reached by Maruha with the Ministry of Fisheries that, if it were indeed correct that the quota had been forfeited under the 1983 Act, it would be restored to Ceebay.

[20] Maruha considered that Amaltal's conduct in failing to co-operate in, and in fact obstructing, these applications had been in breach of its obligations of cooperation and good faith under the shareholders' agreement; that the agreement had thereby been terminated; and that Amaltal was now obliged to transfer its shares in Ceebay to Maruha pursuant to cl 5.3. The arbitrator agreed and so ordered. He found that there had been a lack of cooperation by Amaltal which was not the result of any genuine concern about forfeiture of the quota but was an attempt to secure a change in shareholding or a transfer of quota from Ceebay. The arbitrator was

satisfied that Amaltal's actions were at least in part designed to frustrate the agreement and could have had that result.

[21] The arbitrator dealt in the following way with Amaltal's argument that clause 5.3 of the shareholders' agreement was an unenforceable penalty provision:

> Penal provisions are not enforced because they are contrary to public policy. It is for that reason that for example it is likely that if a specified sum bears no relation to the actual loss the provision will be seen as penal. On the other hand genuine pre-estimates of loss will survive.
>
> This however is an unusual case, in that the provisions in question in the context of the agreement are not designed merely to compensate for loss arising from breach, and they must be construed in that light. The agreement records a joint venture, anticipating the involvement of Maruha and Amaltal. It terminates if they cease to be the shareholders (cl. 5.1). The obligations on Amaltal are limited. Essentially they are confined to matters of good faith and co-operation and to dealings with the assets. Having regard to the fact that the only asset is the quota, and that originated through Maruha, the importance of those obligations is apparent, particularly in the light of Maruha's entitlement to 99% of any profit, and its responsibility to ensure Ceebay's outgoings are funded (cl. 4.2). The importance of good faith and co-operation is also recognised in cl. 3.3(b), which confirms that Amaltal's pre-emptive right to the quota was it having undertaken those very obligations under cl. 3.3(a). In the overall commercial picture, it is therefore not surprising that Maruha required and Amaltal was prepared to accept that Maruha's interests in Ceebay continuing to operate in fulfilment of the joint venture purposes should be paramount, particularly in a situation where Amaltal held in excess of 75% of the shareholding. In return for strict compliance with its obligations to ensure Ceebay flourished, Amaltal had the benefit of the two pre-emptive rights. As to the argument that any minor breach could put the termination clauses into operation, the de minimis principle must apply. If a breach was not able to be so described, then the provisions could not operate. Having regard to all the circumstances, I have reached the clear view that in this agreement these particular provisions cannot in the context of the agreement as a whole properly be classed as penal and contrary to public policy. I make no finding as to the value of Amaltal's shareholding as there is insufficient evidence to carry out that exercise with any degree of confidence. However, I am doubtful whether a premium for the value of the pre-emptive rights vested in Amaltal is in the region of that tentatively suggested by Mr Frankham. Factors which would have to be addressed include Maruha's lack of any intention to sell its shares or to purchase Amaltal's shares, the assumption that Amaltal is a willing seller on the open market to a willing buyer, and the possible effect of termination of the shareholders' agreement following the exit of Amaltal.

**The High Court judgment**

[22] It had been put to Harrison J on behalf Amaltal that cls 5.2 and 5.3 of the shareholders' agreement were penalty provisions and unenforceable for reasons of public policy; that an award which allowed enforcement was thus itself contrary to public policy. Counsel for Amaltal had equated a rule of contract law based on an equitable notion of public policy with the term "the public policy of New Zealand" in Article 34(2)(b)(ii). In Harrison J's view this was wrong for two related reasons.

[23] First, he said, in the absence of a successful appeal in accordance with Article 5 of the Second Schedule, a party may only have recourse against an arbitral award by an application for setting aside in terms of Article 34(2) and (3). The award could be set aside, in the discretion of the Court, only if there were proof of any of the four nominated grounds in Article 34(2)(a) – irrelevant in the present case – or if the subject matter of the dispute was not capable of settlement by arbitration (Article 34(2)(b)(i)) or "the award is in conflict with the public policy of New Zealand" (Article 34(2)(b)(ii)). Amaltal's application for leave to appeal had sought the setting aside of the award on a point of law. The same remedy was available where a party challenged an award on the ground that it was contrary to the public policy of New Zealand. The consequence of a successful challenge by either of these routes would be a refusal of recognition and enforcement.

[24] But Harrison J described these two routes of challenge as "mutually exclusive". In his view, the Act reflected a difference between rights based on a substantive error of law in the award (Article 5) and on those relating to method or process (Article 34). Counsel for Amaltal's substantive argument on the penalty point had proceeded as if the application were an appeal on a question of law from the award even though Amaltal had discretely and unsuccessfully applied for leave to appeal on the very same question. That, the Judge said, could not have been the legislative intent, especially where the Act prescribed two distinct routes to the same remedy.

[25] Secondly, the Judge was not satisfied that an award enforcing a contractual provision, which for reasons of public policy emanating in equity should be

unenforceable, was the same as an award "in conflict with *the* public policy of New Zealand". He said that the broad equitable concept of public policy, applied to contractual dealings between individuals, did not appear to equate with the "weightier notion" of the public policy of New Zealand. The latter implied more in the nature of sovereign importance – that the award threatened a State's welfare or was truly injurious to the public good or its enforcement would be wholly offensive to the ordinary reasonable and fully informed member of the public on whose behalf the powers of the State were exercised, citing *Deutsche Schachtbau-und Tiefbohrgesellschaft mbH v Shell International Petroleum Co Ltd* [1990] 1 AC 295 (CA), per Lord Donaldson MR at 316. Under Article 34 the Court was primarily concerned with the arbitration process itself, not the substantive decision. In Harrison J's judgment, Article 34 (along with Article 36 dealing with the grounds for refusing recognition or enforcement) was directed towards something much more fundamental to the national interest than where the termination and forfeiture provisions in an otherwise valid contract – one whose purpose was not to achieve an unlawful object – were penal. He said the rule against penalties grew out of equity's concern that one party might use contractual rights to take advantage of another's misfortune. Its object was to grant relief against the hardship inflicted by the common law. It was not concerned with the more basic questions about the legality or otherwise of the contract itself. The Judge accordingly found that Amaltal had not satisfied the jurisdictional basis for setting aside or refusing to recognise and enforce the award.

[26] However, if he were wrong in that conclusion, and there were jurisdiction, Harrison J took the view that cl 5.3 of the agreement was not a penalty clause. He substantially agreed with the arbitrator's reasoning. The arbitrator had been unable to make a finding on the value of Amaltal's shareholding at the date the contract was entered into and had doubted whether Amaltal's pre-emptive rights had the value ascribed to them by the accounting expert called for Amaltal. Harrison J was not prepared to undertake a valuation exercise afresh on the basis of documents submitted by agreement on the application.

[27] Further, on the assumption that Amaltal's shares had some value at the relevant time, there was nothing to suggest that cls 5.2 and 5.3 were not the parties'

genuine pre-estimate of the damage that Maruha, as the beneficial owner of the quota and enjoying the sole right to profit, might suffer in the event of Amaltal's default, whatever the degree of severity, in performing any of its limited duties.

[28] The Judge also indicated that he would, even if finding for Amaltal on the issues of jurisdiction and penalty, have declined to exercise his discretion to set aside the award or refuse to enter it as a judgment. The substance of the dispute was whether or not Amaltal was in breach of its contractual obligations. The arbitrator had found affirmatively. Amaltal could not impeach the award itself by challenging the enforceability of the remedy granted by the arbitrator. The substance of his decision was not in issue. Assuming cls 5.2 and 5.3 were penalties, Harrison J said that he would have exercised his discretion to vary the award by directing termination of the agreement and forfeiture of shares, with compensation to be fixed by an independent party. As the integrity of the award itself was unassailable, he said he would not have had any grounds to set it aside.

**Submissions for Amaltal**

[29] For the appellant, Mr Hodder said that the Judge was wrong to find that there was no jurisdiction for the High Court to set aside the award as in conflict with the public policy of New Zealand. Counsel for Maruha was not attempting to support the Judge's erroneous reasoning that appeals on questions of law under Article 5 and applications under Article 34 were mutually exclusive. No such exclusivity was apparent in the Act or in relevant High Court Rules. Articles 34 and 36 set the exceptions to the limits on intervention in an award found in Article 5. They are not limited to the processes leading to the making of the award. Under Article 34(2)(a)(i) and (iii) the underlying contract can be examined to ensure that the processes of the High Court are not abused by the use of enforcement machinery in respect of an award which fails to meet "minimum standards". That was said to justify a "non-constrained" reading of "public policy" in (b)(ii). Such a reading would be consistent with indications given in the *travaux preparatoires* of the UNCITRAL Model Law on International Commercial Arbitration on which the First Schedule is based. Counsel said there is no sound reason to confine the

circumstances in which a question of public policy may be raised. It is not limited to fraud, corruption or breach of natural justice, the matters which, on the recommendation of the Law Commission - departing in this respect from the Model Law - were specifically mentioned in Articles 34(6) and 36(3).

[30] It was submitted that the Court could examine the reasons given by the arbitrator. They constituted part of the award. It would not be in the public interest that the Court's processes could be used to enforce something which the Court would not itself have ordered.

[31] Mr Hodder further submitted that the penalty rule was not an equitable gloss on contractual bargaining power but a long-established public policy rule against any system of private fines or civil punishment. In *Bridge v Campbell Discount Co Ltd* [1962] AC 600, 622, Lord Radcliffe had said that the refusal to sanction legal proceedings for penalties was "a rule of the court's own, produced and maintained for purposes of public policy".

[32] It was submitted for the appellant that the rule against penalties had application to agreements requiring transfer of property (*Jobson v Johnson* [1989] 1 WLR 1026) and that enforcement of cls 5.3 and 5.4 would deprive Amaltal of property rights of real value and would amount to imposition of a penalty. The effect of the clauses was that upon *any* breach of *any* of Amaltal's obligations under the agreement it must forfeit its shares in Ceebay. The provisions were not a genuine pre-estimate of anticipated damage from breach. In some instances the result of enforcement would be disproportionate to the breach, for example under cl 4.3 where Amaltal had covenanted that it would not request the manager to arrange for Ceebay to enter into any lease or transfer of any of the assets with any person or corporation which was a related company, shareholder or associated person of the manager or Amaltal.

[33] Mr Hodder said that there was valuation evidence that forfeiture would be a material and disproportionate penalty. The arbitrator had without good reason failed to apply the penalty rule in these circumstances. Contrary to the view taken by the Judge, the remedy ordered by the arbitrator was an essential part of the award and it

should have been set aside. It was submitted that the penalty rule did not permit an exercise of discretion concerning whether to order enforcement of the agreement: a penalty was simply not enforceable.

**Submissions for Maruha**

[34] It was submitted by Mr Miles QC that the High Court had no jurisdiction on an application under Article 34 to examine whether cls 5.3 and 5.4 were penalty clauses. In the absence of exceptional circumstances the Court was not permitted to review the arbitrator's statement of law, findings of fact or application of facts to the law. The arbitrator had found that the clauses were not penal. On an application under Article 34 (as distinct from an application under Article 5) that must be taken to be correct. In any event, Mr Miles said, the penalty rule is not a rule of public policy in terms of that Article, which is concerned only with matters of sovereign importance. Counsel did, however, accept, contrary to the view taken by Harrison J, that where a matter is truly one of public policy in this sense both substantive and procedural questions can be examined, subject to the bar on reopening the findings of fact and law. In short, Mr Miles submitted, the High Court must even in a matter of sovereign importance accept the arbitrator's award and ask merely whether on a reading of the award it is in conflict with a public policy of New Zealand. The Court is concerned with the decision, not with the reasoning. An arbitrator's decision to enforce a contract which the arbitrator has found to be illegal would be set aside, but not so where the arbitrator found that the contract was not illegal. This was said to be consistent with the history of the Model Law and of Article V of the New York Convention for the Recognition and Enforcement of Foreign Arbitral Awards 1958 which provided the basis for drafting the setting-aside grounds in the Model Law.

[35] The contended approach was also said to be consistent with case law on the Article. Mr Miles submitted that in England, following the majority decision of the Court of Appeal in *Westacre Investments Inc v Jugoimport – SPDR Holding Co Ltd* [2000] QB 288, the likely position was that the Court had no jurisdiction to go behind the award on policy grounds. The Court would not intervene on such grounds unless the award recorded that the underlying contract was illegal, as in

*Soleimany v Soleimany* [1999] QB 785, or the underlying subject matter was clearly in conflict with public policy, such as an agreement between robbers to share the proceeds of their crime. Public policy concerned fundamental principles of law where enforcement would violate basic notions of morality and justice or be clearly injurious to the public good. This was not so where there was merely an allegation concerning a penalty clause. Mr Miles argued that a rule simply based on a concern for bilateral justice between contracting parties would not normally be a matter of public policy within Article 34.

[36] It was further submitted that the penalty rule is not in fact based on public policy but on the desire to relieve against oppression or inequality of bargaining power where it would be unconscionable for a party to take advantage of a contractual provision.

[37] The respondent also submitted that the arbitrator had correctly determined that cls 5.2 and 5.3 were not a penalty. They did not operate *in terrorem*. No evidence had been adduced suggesting that the shares had more than nominal value when the shareholders' agreement was entered into. The only payment by Amaltal had been $751. The shares were effectively "gifted" to it by Maruha. Its obligation to act in good faith and to co-operate with Maruha was essential to the success of the company. It could not be said to be inequitable, unconscionable or oppressive for Amaltal to be required to return to Maruha the very property given to Amaltal in exchange for covenanting to so act. The clauses were simply an agreed procedure for cancellation of the agreement and the return of property. There was no windfall for Maruha.

**A preliminary matter**

[38] Before moving to the issues on the appeal, we should deal with a preliminary matter. We agree with counsel that the Judge's characterisation of the respective processes under Articles 5 of the Second Schedule and 34 of the First Schedule as "mutually exclusive" is not sustainable. We can see no reason why an appeal on a point of law under Article 5 cannot put in issue errors of process by the arbitrator as

well as errors of substantive law. (Both can be grounds for setting aside under Article 34: see para [43] below).

[39] Although in exercising its discretion whether to grant leave for an appeal the Court, consistently with international practice reviewed in *Gold and Resource Developments v Doug Hood*, must take a restrictive approach, there is good reason to give the words "any question of law arising out of the award" a broad interpretation. It is desirable that where Article 5 applies a party wishing to challenge an award should be able to include all grounds within a single application, rather than having to bring, as well, an application under Article 34, as Amaltal thought it necessary to do in this case.

[40] It follows that where an issue falling within Article 34, such as a question about the public policy of New Zealand, has been squarely raised by a party in reliance on Article 5 and rejected, it may well be an abuse of process for the party to seek to canvass it again by means of an Article 34 application. The determination under Article 5 may also give rise to an issue estoppel. As no argument on abuse of process or issue estoppel was pursued by the respondent we need say no more about that matter, save to express agreement with the comment made by Mr Miles that it seems unlikely that Parliament would have intended that in ordinary circumstances a party could successively argue the same error of law under both articles.

**Scope of "public policy"**

[41] Paragraphs (1) to (4) of Article 34 of the First Schedule to the Arbitration Act 1996 closely follow Article 34 of the Model Law. Upon the recommendation of the Law Commission, paras (5) and (6) were added. The first of these has no relevance in the present case. As para (6) itself indicates, it was introduced for the avoidance of doubt and without any intention of limiting the generality of para (2)(b)(ii) under which the High Court can in its discretion set aside an award if it is in conflict with the public policy of New Zealand.

[42] Paragraph (6) declares that two particular things are in conflict with that public policy: if the making of the award was induced or affected by fraud or

corruption or if a breach of the rules of natural justice has occurred during the arbitral proceedings or in connection with the making of the award. These may well be occurrences of such seriousness that they would be regarded as in conflict with public policy of a state, in this instance New Zealand, under the Model Law and also under the New York Convention from which the grounds for setting aside under the Model Law were taken.

[43] A legislative history of Article 34 of the Model Law is to be found in Holtzmann and Neuhaus, *A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary* pp911 et seq. Interestingly, the *travaux preparatoires* reflect a concern of delegates that the expression might be restricted to substantive questions only. The United Nations Commission on International Trade Law therefore expressly stated, in its Report of 21 August 1985, that the wording "the award is in conflict with the public policy of this State" was not to be interpreted as excluding instances or events relating to the manner in which an award was arrived at. The report also stated (at para 297) the Commission's understanding that the term "public policy" as used in the New York Convention and many other treaties covered "fundamental principles of law and justice in substantive as well as procedural respects".

[44] In the United States a "narrow reading" had been given to the public policy defence under the New York Convention by the Court of Appeals for the Second Circuit which said in *Parsons & Whittemore Overseas Co Inc v Sociéte Générale De L'Industrié Du Papier (RAKTA)* 508 F 2d 969 (1974) at 974 that enforcement of foreign arbitral awards might be denied on the basis of that defence only where enforcement "would violate the forum state's most basic notions of morality and justice". Likewise the English Court of Appeal, speaking through Sir John Donaldson MR in *Deutsche Schactbau* [1990] 1 AC 295 at 316, said that although considerations of public policy could never be exhaustively defined, it had to be shown that there was some element of illegality or that the enforcement of the award would be clearly injurious to the public good or, possibly, that it would be wholly offensive to the ordinary reasonable and fully informed member of the public on whose behalf the powers of the state are exercised.

[45] A narrow construction has also found favour in the courts of Ontario where the Court of Appeal said in *Boardwalk Regency Corp v Maalouf* (1999) 6 OR (3d) 737 at 743 that the common ground of all expressed reasons for imposing the doctrine of public policy was "essential morality", cautioning however that it must be "more than the morality of some persons and must run through the fabric of society to the extent that it is not consonant with our system of justice and general moral outlook to countenance the conduct, no matter how legal it may have been where it occurred" (the award in the case being a foreign award).

[46] Another way in which the matter has been expressed has been to say that the enforcement of an award will be contrary to public policy where the integrity of the court's processes and powers will thereby be abused: *Soleimany v Soleimany* at 800. An award whose confirmation can be seen to damage the integrity of the court system will not be enforced.

**The degree of scrutiny of the award**

[47] Assuming that the subject matter of an arbitration has required the arbitrator to make a determination on a matter capable of raising some fundamental principle of law and justice – a classic instance being the illegality of the subject contract – when will the court intervene on an application under Article 34 which asserts a conflict with public policy? In principle, it might be thought that unless it is obvious that what has occurred is contrary to public policy in the sense just discussed, the limited nature of judicial review of arbitral awards will require that the arbitrator's findings of fact and law be respected. (If Article 5 applies, an appeal may of course be able to be brought against a finding of law, subject to the restraints described in *Gold & Resource Developments).*

[48] There have been two recent English Court of Appeal cases, *Soleimany v Soleimany* and *Westacre Investments v Jugoimport*, concerning the way in which an allegation that enforcement of an award would be contrary to public policy should be approached. Both were concerned with illegality, actual or alleged.

[49] In *Soleimany* an arbitration before the Beth Din concerned contractual arrangements between two Jews about the export of carpets from Iran for sale in the United Kingdom. It emerged in the course of the arbitration that such export was illegal under the law of Iran. The arbitrators, who were applying Jewish law, expressly referred to the illegality under Iranian law of the parties' transaction but nevertheless made an award to the plaintiff for a sum of money as his share of the profits of the venture. The arbitrators considered the illegality to be of no relevance under Jewish law. The Court of Appeal declined to enforce the award in England. It sought to draw a distinction between, on the one hand, agreements of an immoral or illegal nature which were incapable of being the subject of arbitration, so that an arbitration provision was itself invalid, instancing an agreement between highwayman to arbitrate their differences and, on the other hand, arrangements alleged to involve illegality where an agreement to arbitrate could give an arbitrator jurisdiction to decide upon whether there had actually been any illegality. In the former type of case, where there was "palpable illegality", it might be that an English court would declare that there was no arbitrable dispute on the ground that an arbitrator could not lawfully enforce the contract.

[50] Because of the way the matter had come before the arbitrators in *Soleimany* – under an arbitration agreement referring existing disputes over proceeds of sale to arbitration, with the illegal aspect of the joint venture coming to attention only during the arbitration – the Court was of the opinion that the arbitration agreement itself was valid and that it was within the jurisdiction of the arbitrators to consider the question of illegality in so far as it might affect the rights of the parties. But, although the arbitrators had jurisdiction to make the award, the interposition of an award did not, in the opinion of the Court, isolate the successful party's claim from the illegality which gave rise to it.

[51] In the case before it the Court refused to enforce the award on the public policy ground because it had been found by the arbitrators that the contract was illegal by the law of Iran, a country in which it was to be performed. An award purporting to enforce an illegal contract was not enforceable. It was therefore unnecessary for the Court to consider what the position might be where an arbitrator had found that a contract was not illegal or had delivered an award without reasons.

The Court, however, expressed the view that, if there was what it called prima facie evidence from one side that the award was based on an illegal contract, there should be further inquiry "to some extent":

> Is there evidence on the other side to the contrary? Has the arbitrator expressly found that the underlying contract was not illegal? Or is it a fair inference that he did reach that conclusion? Is there anything to suggest that the arbitrator was incompetent to conduct such an inquiry? May there have been collusion or bad faith, so as to procure an award despite illegality? Arbitrations are, after all, conducted in a wide variety of situations; not just before high-powered tribunals in international trade but in many other circumstances. We do not for one moment suggest that the judge should conduct a full-scale trial of those matters in the first instance. That would create the mischief which the arbitration was designed to avoid. The judge has to decide whether it is proper to give full faith and credit to the arbitrator's award. Only if he decides at the preliminary stage that he should not take that course does he need to embark on a more elaborate inquiry into the issue of illegality. (p800)

[52] The Court of Appeal considered that this approach accorded well with the rule that there could be a bona fide compromise of an issue as to whether a contract was illegal.

[53] In *Soleimany* the judgment of the Court was delivered by Waller LJ. In the later case of *Westacre* he gave the principal judgment but the other members of the court, Mantell LJ and Sir David Hirst, tentatively took a different position concerning whether a court should embark upon an inquiry when there was prima facie evidence of illegality. *Westacre* concerned an award on a consultancy contract said to be contrary to public policy because it had been for procuring sales of equipment in Kuwait by fraud through bribery or other illicit conduct. The contract had provided for arbitration of disputes. The allegation of illegality had been a central issue of the arbitration, under Swiss law, and the arbitrators had found that performance of the contract would not have been illegal by the laws of Kuwait. On the facts as they appeared from the award and its reasons, the underlying contract did not infringe public policy.

[54] Waller LJ, in the minority on this point, nevertheless favoured allowing the facts to be reopened because of certain material placed before the Court by affidavit suggesting that witnesses at the arbitration had given perjured evidence. His Lordship described the Court as performing a balancing exercise between competing

policies of finality and illegality – "between the finality that should prima facie exist particularly for those that agree to have their disputes arbitrated, against the policy of ensuring that the executive power of the English court is not abused" (p314). The pertinent factors were, in his view, the nature of the illegality, the strength of the case that there was illegality and the extent to which it could be seen that it was addressed by the arbitral tribunal.

[55] Mantell LJ and Sir David Hirst took the position, however, that from the award itself it was clear that bribery had been the central issue. The allegation had been made, entertained and rejected. Without fresh evidence there could be no justification for refusing to enforce the award. They had difficulty with the concept, mentioned in *Soleimany*, of "some kind of preliminary inquiry short of a full-scale trial" to be embarked upon whenever there was prima facie evidence the award was based on an illegal contract. They had even greater concerns about its application in practice. In the present case, in their view, any such inquiry would inevitably have led to the conclusion that the attempt to reopen the facts should be rebuffed. The contract had been a straightforward commercial contract. The arbitrators had specifically found it was not illegal. There was nothing to suggest incompetence on the part of the arbitrators. There was no reason to suspect collusion or bad faith in the obtaining of the award. The seriousness of an alleged illegality was not a factor to be considered at the stage of deciding whether or not to mount a full-scale inquiry.

**The present case**

*(a) A question of public policy*

[56] The issue is whether the rule that a penalty clause in a contract is unenforceable is to be regarded as a matter of public policy for the purposes of Article 34 in the sense that that rule is a fundamental principle of law and justice. In our view, however, the rule is simply a branch of equity's relief jurisdiction, supplemented by developments in the common law courts (*Law v Local Board of Redditch* [1892] 1 QB 127 at 134), whereby oppression of a party to a contract may be prevented. When Lord Radcliffe said in *Bridge v Campbell Discount* (at 622) that the refusal to sanction legal proceedings for penalties "is in fact a rule of the court's

own, produced and maintained for purposes of public policy", he was saying nothing more than that the rule was developed by the courts with a view to limiting the use of a certain kind of contractual stipulation which had the potential for oppression. The same comment can be made about Diplock LJ's description of the rule as one of public policy in *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428 at 1446. The policy content of the rule would appear to be no greater than it is for many other rules of the law of contract, including the general predisposition of the law in favour of freedom of contract, which has itself sometimes been described as a public policy: for example, in *Printing and Numerical Registering Co v Sampson* (1875) LR 19 Eq 462 at 465.

[57] The respondent is quite correct that in none of the English and Commonwealth authorities cited for the appellant or in the other speeches in *Bridge v Campbell Discount* is there any reference to the rule being one of public policy, certainly not in the way in which the expression is used in Article 34. There is no mention of it, for example, in the joint judgment of Mason and Wilson JJ in *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 where (at 193-4) they gave an overview of the rule:

> Instead of pursuing a policy of restricting parties to the amount of damages which would be awarded under the general law or developing a new law of compensation for plaintiffs who seek to enforce a penalty clause, the courts should give the parties greater latitude to determine the terms of their contract. In the case of provisions for agreed compensation and, perhaps, provisions limiting liability, that latitude is mutually beneficial to the parties. It makes for greater certainty by allowing the parties to determine more precisely their rights and liabilities consequent upon breach or termination, and thus enables them to provide for compensation in situations where loss may be difficult or impossible to quantify or, if quantifiable, may not be recoverable at common law. And they may do so in a way that avoids costly and time-consuming litigation. But equity and the common law have long maintained a supervisory jurisdiction, not to rewrite contracts imprudently made, but to relieve against provisions which are so unconscionable or oppressive that their nature is penal rather than compensatory. The test to be applied in drawing that distinction is one of degree and will depend on a number of circumstances, including (1) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to the defendant, and (2) the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in seeking to enforce the term. The courts should not, however, be too ready to find the requisite degree of disproportion lest they impinge on the parties' freedom to settle for themselves the rights and liabilities following a breach of contract. The

> doctrine of penalties answers, in situations of the present kind, an important aspect of the criticism often levelled against unqualified freedom of contract, namely the possible inequality of bargaining power. In this way the courts strike a balance between the competing interests of freedom of contract and protection of weak contracting parties (see generally Atiyah, The Rise and Fall of Freedom of Contract (1979), esp. Ch.22).

The use of the word "policy" at the beginning of this passage is plainly not referable to "public policy" in the higher sense in which it is used in Article 34.

[58] The passage was approved by the Judicial Committee of the Privy Council in *Philips Hong Kong Ltd v Attorney-General of Hong Kong* (1993) 61 BLR 49 at 57-8. As the Privy Council noted, the approach of Mason and Wilson JJ was along the same lines as the classic statement of the principles of the law relating to penalties in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co* [1915] AC 79 at 86 per Lord Dunedin. Their Lordships also approved in *Philips* the view of Dickson J of the Supreme Court of Canada, expressed in *Elsley v J G Collins Insurance Agencies Ltd* (1978) 83 DLR (3d) 1 at 15:

> It is now evident that the power to strike down a penalty clause is a blatant interference with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression.

[59] So the rule, which certainly is one developed in the public interest, is concerned with relief against oppression or unconscionable behaviour by a contracting party. Unlike the principles governing the supervening effect of illegality, it has always been recognised as being subject to fairly narrow constraints, as was also remarked in *Philips* (at 55). It is not a rule which can properly be characterised as so fundamental as to constitute "public policy" in the sense in which those words have been used in Article 34 or the sources from which that article was drawn.

*(b) The award*

[60] The conclusion that the penalty rule is not a matter of the public policy of New Zealand disposes of the appeal but, if it had not done so, the appeal would still have failed, for two reasons. First, the arbitrator, a former Judge of this Court with considerable commercial experience, gave careful consideration to whether cls 5.3

and 5.4 were penal and reached the view that they were not. This was far from being a matter giving rise to such obvious concerns under New Zealand law that it might be thought incapable of founding the arbitrator's jurisdiction. He was entitled to rule upon it. If he erred in law, his error could be corrected on an application under Article 5. But, subject to such an application, which failed when leave was refused, the arbitrator's conclusion in this case that the clauses were not penal must be respected.

[61] Moreover, and this is our second reason, we are, for what it is worth, in respectful agreement with the arbitrator's views, which are quoted above in para [21]. It can be accepted that a contractual provision calling not for the payment of money but for the delivery or transfer of property may amount to an unenforceable penalty, as in *Jobson v Johnson* [1989] 1 WLR 1026. But, in the present case, which the arbitrator aptly described as unusual, the property had essentially been provided by Maruha and the clauses were designed merely to restore it to Maruha if Amaltal failed to observe its obligations. These could be summarised as amounting to a general commitment to behave towards Maruha, whose assets were at stake in the company, in a spirit of cooperation and good faith (which Amaltal appears signally to have failed to do). There is no appearance of actual or potential oppression in the arrangements, whether viewed at the time the contract was entered into, which is the point at which the matter is ordinarily to be tested, or at the time of termination of the agreement. As the arbitrator found and the Judge confirmed, the appellant did not show that it would suffer any significant loss by being required to hand over the shares. Harrison J was right to decline to enter upon a fresh valuation exercise.

**Result**

[62] The appeal is dismissed with costs of $6,000 to the respondent, together with its reasonable expenses, including travel and accommodation costs of counsel, to be fixed if necessary by the Registrar.

Solicitors:
Chapman Tripp, Wellington, for Appellant
Minter Ellison Rudd Watts, Auckland for Respondent