LIQUIDATED DAMAGES AND PENALTIES

ENSURING ENFORCEABILITY

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Contents

Introduction

The topic of this paper seeks to ensure that you will be cognisant of the matters necessary to draft unimpeachable liquidated damages clauses in contracts. The paper endeavours to assist you to understand the parameters of the law in this area as it has developed in more recent times. Notwithstanding its development the fundamental premise at law remains with the freedom of the parties to a contract to provide for their own regime of rights and responsibilities. This is still the basic tenant of the law and parties may draft in any way they wish to deal with their contractual obligations - provided they do not breach relevant public policy considerations and create a penalty.

As Justice Peter Vickery has wryly observed[1] liquidated damages clauses have commonly been stigmatised, usually by advocates for the payer, as being inherently unjust, having the hallmarks of usury by providing a facility for the oblige to exact unjustified monetary dues which are unsupported by reciprocal consideration; or are fundamentally evil, in that they serve no good purpose other than to terrorise the obligor into strict compliance with the contract. However, such an approach ignores the positive contribution which can be provided by a well drafted liquidated damages clause to a contractual regime established by the parties.

This view finds support in ***AMEV-UDC Finance Limited v Austin*** [2] where Mason and Wilson JJ said:

> *"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 enable 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."*

In determining this 'agreed amount', whether or not a sum for liquidated damage is a "genuine pre-estimate" of damage does not depend upon the calculations, if any, undertaken by a party in coming to a total figure. Miscalculations, the inclusion of individual sums which may be regarded as

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1 Writing before his appointment, Peter Vickery QC, "*Liquidated Damages and Penalties – Confining Contractual Freedoms*", 2005, LexisNexis, paper

2 (1986) 162 CLR 170 at 193-194

extravagant, or even the complete lack of any kind of calculation do not make the sum a penalty. The test is not such a narrow, or literal, one.

As for the intervention of the courts Mason and Wilson JJ also observed [3]:

> *"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."*

Breach of Contract – Ruling principle of damages

At this point it is worth recalling the ruling principle in assessing general damages for breach of contract. This has recently been reasserted by the High Court in ***Tabcorp Holdings Ltd v Bowen Investments Pty Ltd*** [4]. That case concerned a claim for damages by a landlord as a result of breach of a covenant in the lease by the tenant carrying out work, which resulted in the substantial remodelling of the foyer of the leased building without the approval of the landlord. The trial judge held that there had been a breach of covenant, but awarded damages in the sum of $34,820, being the difference between the value of the property with the old foyer, and the value of the property with the new foyer constructed by the tenant. On appeal, the Full Court of the Federal Court of Australia had increased the judgment sum to $1.38 million, made up of $580,000 to reflect the cost of restoring the foyer to its original condition, and $800,000 for loss of rent while the restoration work was taking place. The High Court upheld the decision of the Full Court.

In doing so, the High Court emphatically rejected the proposition that a party entering into a contract was at complete liberty to break the contract provided damages adequate to compensate the innocent party were paid - in this instance being damages in the amount of the diminished value of the landlord's reversionary interest. Rather, the High Court reaffirmed the 'ruling principle' [5] that the measure of damage at common law for breach of contract was that stated by Parke B in ***Robinson v Harmon*** [6]:

> *"The rule of the common law is, that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed".*

So what is the basis of the public policy that has developed concerning whether a liquidated damages clause is, in fact, a penalty? I proffer the

3 (1986) 162 CLR 170 at 193
4 (2009) 83 ALJR 390; [2009] HCA 8
5 (2009) 83 ALJR 390, [13]
6 (1848) 1 Exch 850 at 855; (1848) 154 ER 363 at 365

suggestion that it is really rooted in the concept of fairness in dealing between the parties.

Breach of Contract - the Liquidated Damages Clause

The law concerning the propriety of liquidated damages clauses was authoritatively set out almost 100 years ago in ***Dunlop Pneumatic Tyre Co Limited v New Garage & Motor Co Limited*** [7]. The relevant principles were espoused by Lord Dunedin in his speech and these principles have more recently been reiterated by the High Court in ***Ringrow Pty Ltd v BP Australia Pty Ltd*** [8] (discussed below). The principles rely on good faith or honesty in contracting.

The guiding rules as to whether a clause is a penalty have been formulated to ensure that only **honest pre-estimations** of damage are effective to form genuine liquidated damages. A determination which is **out of all proportion** to the actual damage suffered will not conform with legal principles as they will not have been made in good faith.

Three general propositions were established in ***Dunlop's*** case. They are:

1. Though the parties to a contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed to mean what they say, the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages.

2. The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage.

3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach.

To assist in this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:

(a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to

7 [1915] AC 79
8 (2005) 224 CLR 656

have followed from the breach;

(b) there is a presumption (but no more) of penalty when a single lump sum is made payable by way of compensation on the occurrence on one or more or all of several events some of which may occasion serious and others but trifling damage;

(c) it is however, no obstacle for the sum stipulated being a genuine pre-estimate of damage but the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the two parties;

(d) it will be held to be a penalty if the sum stipulated is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have flowed from the breach.

The High Court of Australia last considered the ***Dunlop*** principles in ***Ringrow*** [9]. The Court delivered a single majority joint judgment and quoted at length from Lord Dunedin's speech. The court stated that his Lordship's statement continues to represent the law in Australia. It accepted that his Lordship's speech may also be applied to the transfer of property, as well as to the payment of money. In such a case the court said that Lord Dunedin's statement requires a different approach from that employed in typical penalty cases and explained that one relevant comparison would be between the price payable by one party to the other on a retransfer of property and the actual value of what is transferred. However, the court stressed that a mere difference in amount is not enough to constitute for a penalty. The difference must be "**extravagant and unconscionable**" or there must be a **degree of disproportion sufficient to point to oppressiveness**. The majority stated [10]**:**

> *"The principles of law relating to penalties require only that the monies stipulated to be paid on breach or the properties stipulated to be transferred on breach will produce for the payee or transferee advantages significantly greater than the advantages which would flow from a genuine pre-estimate of damage."*

The court steered away from trying to define with any form of precision what the advantages were which must be significantly greater for an outcome to be considered a penalty. The court did state that the law of penalties should

9 *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656
10 (2005) 224 CLR 656 at 667, [27]

be remembered as an exception to the concept of freedom of contract. Therefore to be a penalty, the amount or benefit must be extravagant and unconscionable in amount. The mere fact that it is lacking in proportion will not be enough. It must be "**out of all proportion**"[11].

Is a Breach of Contract really necessary?

Recently in ***Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd*** [12] the Court of Appeal in New South Wales had the opportunity to further consider and apply the principles set down in ***Ringrow.*** This case concerned whether the termination of a mortgage originator contracts with its ultimate financiers and thus depriving him of trailing commissions constituted a penalty. At first instance the mortgage originator was successful and a breach of contract itself was held not to be necessary to attract the relevant public policy principles. However, this decision was overturned in the Court of Appeal by 2:1 majority.

This case is useful insofar as it demonstrates that the Court of Appeal in New South Wales under Allsop P applied without hesitation the principles set out in ***Ringrow***. The court held by majority that the doctrine of penalties only applies when payment is **payable on breach or termination following breach**.

This had already been authoritatively stated in ***Legione v Hateley*** [13] in which Mason and Deane JJ stated:

> *"A penalty, as its name suggests, is in the nature of punishment for non-observants of a contractual stipulation: it consists of the imposition of an additional or different liability upon breach of the contractual stipulation."*

In ***Ringrow*** [14] the court further stated:

> *"The law of penalties, in its traditional application is attracted where a contract stipulates that on breach the contract breaker will pay an agreed sum which exceeds what can be regarded as a genuine pre-estimate of the damages likely to be caused by the breach."*

So, it may now be better understood that the purpose behind the penalty doctrine is that parties ought not be able to agree that a party in breach will be liable to pay a sum of money, as a so called damages equivalent, if the sum chosen is not in fact representative of the amount that would likely be awarded by a court. As a matter of public policy such a clause would be struck down. It is important that such a clause does not offend public policy and it will not do so if there is a **genuine pre-estimate of the likely damage to**

11 (2005) 224 CLR 656 at 669, [32]
12 [2008] NSWCA 310
13 (1983) 152 CLR 406 at 445
14 (2005) 224 CLR 656, [10]

be suffered. Such an estimate requires the application of good faith and fairness in dealing between the parties in order to estimate that genuine pre-estimate of loss.

Can a liquidated damages clause be triggered without a breach?

Special leave had been sought and obtained in the ***Interstar*** case; however it was settled prior to hearing. [15] The consequence of this was that the High Court has not yet authoritatively determined whether the penalties doctrine is also to apply to situations other then where payment is required upon a breach. It also deprived the High Court of considering whether it was possible to extend the doctrine of relief against forfeiture in such circumstances. One can glean this possibility from the statement by Allsop P[16] where his Honour said:

> *"It is a small step from accepting that the doctrine [of penalties] applies to the transfer of property, to applying it to forfeiture of property and a clause designed to encourage performance. The relationship between penalties and relief against forfeiture at this point becomes less then pellucid."*

It can be seen that if such a relationship is to develop such a relationship and in its role would be a matter for consideration by the High Court as the current approach must be seen as having taking the doctrine of penalties as a rule of law, not equity.

Proportionality – the 'out of all proportion' test

Whether a clause is a genuine pre-estimate of damages involves an assessment of proportionality. The test in Australia would now appear to be one requiring a court to have regard to "all the circumstances, including the nature of the subject matter of the agreement"[17] in order to determine, as a matter of degree, whether a clause provided for a disproportionate penalty or was truly compensatory.

In Jacobs on *Commercial Damages*[18] he usefully suggests a number of factors relevant to proportionality include:

(a) the relationships between the parties at the time of the contract;

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15 See thoughtful analysis contained in Peden, "*Liquidated damages and what would the High Court have decided in the appeal in Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd*", Leading Edge Seminar Series, paper, 16 October 2009

16 [2008] NSWCA 210, [104]

17 *Esanda Finance Corp Ltd v Plessnig* (1989) 166 CLR 131 at 153

18 Sydney Jacobs, *Commercial Damages*, LBC, 2008, ch 25 contains this very useful list of factors

(b) the genesis of the clause and discussions relating to it;

(c) the bargaining position of the parties and whether they were each fully advised and whether, in all the circumstances, the party now seeking to impeach the clause, appreciated the likely imposition of a penalty upon breach, but nevertheless agreed to the clause because of some perceived benefit;

(d) whether a penalty clause was imposed upon a party with less bargaining position in the context of a contract of adhesion; and

(e) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, which is relevant to the oppressiveness of the term of the defendant. The court should not, however, be too ready to find the requisite degree of disproportion less they impinge on the parties' freedom to settle for themselves the rights and liabilities following a breach of contract. [19]

The 'out of all proportion' test as reinforced in ***Ringrow*** has now been applied by intermediate appellate courts on a number of occasions. [20]

It suffices now to address just a few of these decisions as have already discussed the decision in ***Interstar***.

The Court of Appeal in Victoria applied such a test in ***Yarra Capital Group Pty Ltd v Sklash*** [21] when it had to consider whether a clause in a short term loan agreement between two money lenders was in the nature of a penalty or a provision for payment of liquidated damages. The loans were unsecured and provided for payment of default interest, a very high rate, if repayments were not made on time. Chernov JA referred to the comments of Mason and Wilson JJ in *AMEV*. He said that the parties to the agreement were operating in a short term money market where the cost of borrowing was very high and "it would be a complex and expensive exercise to seek to establish, with any sort of precision, what damage is likely to flow from a failure by the appellants to repay the principal on the due date"[22]. In those circumstances he was not satisfied that the default

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19 *Multiplex Constructions Pty Ltd v Abgarus Pty Ltd* (1992) 33 NSWLR 504; *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd* (1989) 15 NSWLR 564; *Thorpe v Capper,* unreported, Supreme Court of Western Australia, 2 October 1998, per Sanderson J.

20 *Joelco Pty Ltd v Balanced Securities Ltd* [2009] QSC 236; *Fermiscan v James* (2009) 81 IPR 602; *J-Corp Pty Ltd v Mladenis* [2009] WASCA 157, *Silent Vector Pty Ltd t/as Sizer Builders v Squarcini* [2008] WASC 246; *Bay Bon Investments Pty Ltd v Selvarajah* [2008] NSWSC 1251; *South Australian Farmers Fuels Pty Ltd v Whittingham* [2008] SASC 211; *Harrison Ford Pty Ltd v Ford Motor Company of Australia Ltd* [2008] VSC 235; *GT Corporation Pty Ltd v Amare Safety Pty Ltd* [2008] VSC 143.

21 [2006] VSCA 109

22 [2006] VSCA 109, [17]

clause was so out of proportion with a loss likely to flow from the breach that it would constitute a penalty.

More recently, in November 2009 the Victorian Court of Appeal in ***Allforks Australia Pty Ltd v Zachariadis*** [23] had before it with a hire purchase agreement and a claim for liquidated damages and it applied the ***Ringrow*** **'out of all proportion test'.** The court also considered academic writings [24] when discussing differences between situations where accurate pre-estimations of loss are possible and those situations where damages are difficult to assess. The court cited with approval the academic writings supporting the proposition of the 'out of all proportion test' applied in ***Ringrow***, prima facie, not applicable where accurate pre-estimation of loss is possible.

The court also cited with approval the extract from Peden & Carter [25] the authors' comment:

> *"...it must be generally inappropriate to look at the difference between the actual loss and the amount determined under the formula and to conclude whether the formula provides for a penalty by reference to whether the difference is small or great. Instead, the question is whether, at the time it was agreed, it could be seen that the application of the formula would produce an amount which would be* ***out of all proportion*** *to the loss of damage likely to be suffered." (emphasis added).*

Unconscionability

In ***Multiplex Constructions Pty Ltd v Abgarus Pty Ltd*** [26]**,** Cole J, after considering ***AMEV Finance Limited v Artes Studios Thoroughbreds Pty Ltd*** [27]**,** said that Clarke JA had contemplated two alternative attacks on a clause. **First**, that it was based upon extravagance of damage and **secondly**, that it was based upon unconscionability or the imposition of an unreasonable burden on the defendant.

The undermentioned extract from Cole J's judgment,[28] is important in it gives guidance as to the **evidence** to marshal in aid of submission's going to unconscionability:

> *"Whether a burden is unconscionable may well depend upon the circumstances of the parties at the date of the contract, their*

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23 [2009] VSCA 258
24 Peden & Carter, "*Agreed Damages Clauses – Back to the Future?*" (2006) 22 JCL 189 at 196.
25 [2009] VSCA 258, [153]
26 (1992) 33 NSWLR 504
27 (1989) 15 NSWLR 564
28 *Multiplex* at 509-510

> *perceptions at that time regarding their respective positions should breach of contract occur at a later and perhaps distant time, the equality or inequality to accept an imprecise or in some respects ill-defined obligation to pay damages as the price of obtaining what presumably was regarded as a profitable contract. The relationships between the parties at the time of contract concerning the proposed clause and it imposition touch upon these matters, as does the question of their understanding of the likely imposition generated by the clause. In my view, these matters, and thus evidence relating to them, are admissible in order that the court may weigh any question of unconscionability, quite apart from an empirical examination of whether damages under the clause is excessive*."

In appropriate circumstances recourse may also be had to ss 51 AB and 51AC of the *Trade Practices Act* 1974 dealing with unconscionable conduct.

Some methods of drafting to avoid being a penalty

Events of Default

As the determination as to whether a clause constitutes a penalty is one of construction, it is therefore crucial for the draftsperson to draft a liquidated damages clause with precision bearing in mind the case law. One useful consideration is to ensure the drafting of a thorough list of '**Events of Default**' upon which termination may be authorised. This avoids the necessary implication or expressed contractual promise by the promissor that those events would not occur. This also has the effect to then oust the Courts from the interpretation at common law, for instance at what may be considered "good faith".

Execution under Seal

Another way is to execute the agreement under seal. Often, such clauses are drafted with a view to providing, as far as it is possible to do so, in effect an "estoppel by deed" provision which cites a series of agreed facts relating to the background to the liquidated damages clause.

These may include such matters as:

- the development of the clause;
- the purpose of the clause and what it seeks to achieve;
- the factors taken into account by the parties in its formulation; and,
- the equal bargaining position of the parties in relation the negotiation of the clause.

Such clauses may even go so far as attempting to provide a statement of the ultimate issue to the effect that the amount agreed is a "genuine pre-

estimate of loss" or that the agreed sum is not "extravagant" or "exorbitant" in comparison with the greatest loss that could be suffered, or is not "unconscionable" or even that the agreed sum is not a "penalty".

This is useful as the basic principle of estoppel by deed is that in any action on a deed, a party to the deed cannot dispute any distinct statement of fact which he made within the deed. [29]

Reward for early completion

In other instances draftspersons have approached payment schemes so that they appear to and possibly do include incentives and then work back from that position. By this I refer to those forms of contracts that provide that if the contract is completed by a certain date the price payable is, for example, $10,000 but if it is completed by later date the price is reduced to $5,000.

There are alternative ways of using the inducement drafting such as an agreement by the purchaser to pay the developer $10,000 by 12 monthly instalments. However provided each payment is duly and punctually made then the recipient agrees to accept a lesser sum per month. This may also be contrasted to a further form of drafting whereby incentive appears to be paid should the development be concluded by a fixed date then the price is say $20,000, however if it is finished earlier the price payable is $25,000.

It can be seen from these examples that it is not likely that the law of penalties could be attracted because the extra payments being received are not being triggered by a breach. Breach is the determinant in the law of penalties.

Acceleration clauses

A frequent cause for litigation in respect of penalties relates to hiring contracts and their premature termination. Rather than going through the facts of all these cases a number of propositions from leading High Court cases are set out which will assist a draftsperson dealing with these contracts.

In ***O'Dea v Allstates Leasing System (WA) Pty Ltd*** [30] Gibbs CJ said:

> *"...The first respondent became entitled under the contract to receive the accelerated payments of the rental without any rebate and to receive back the vehicle sooner than would otherwise have been the case without giving credit for its value and in these circumstances the amount receivable by the first respondent was manifestly excessive in*

[29] *Discount & Finance Ltd v Gehrig's NSW Wines Ltd* (1940) 40 SR (NSW) 598 per Jordan CJ at p 602
[30] (1983) 152 CLR 359 at 369

comparison with the greatest loss that it would possibly suffer as a result of the default in payment of the instalments."

In ***AMEV-UDC Finance Limited v Austin*** [31] Mason and Wilson JJ stated [32]:

> *"...Where a lessee is under no present obligation to pay the entire rent, a provision requiring him to pay the whole of the balance of the rent for the unexpired term, without rebate for accelerated payment of future instalments, on his breach of his agreement in failing to make prompt payment of an instalment of rent, is a penalty if in the circumstances the lessor is entitled to repossess and resale the goods list and is not bound to account to the lessee for the proceeds of sale, even if they exceed the appraisal or residual value. The point is that such a provision cannot amount to a genuine pre-estimate of damage because it must necessarily exceed by wide margin the greatest loss which the lessor can suffer as a result of default in payment of instalment. The lessor would receive both the entire rental and possession of the vehicle, which would greatly exceed his damage."*

However, in an earlier decision of ***IAC (Leasing) Limited v Humphry*** [33] the High Court had stated that[34]:

> *"If provision is made for an appropriate rebate of future instalments of rent and for the lessee to have the benefit of any excess of the net sale price over the residual value, so long as it is the subject of a bona fide estimate... the clause will not impose a penalty."*

This is not to say that because a payment made on termination on an agreement which in fact is greater than the damages which may otherwise be awarded for a breach of contract, will as a result constitute the court determining the clause to be a penalty. Rather, it is whether such result is out of all proportion to the damage likely to be suffered that will guide a court to a determination that such a clause offends public policy.

Citicorp Australia Ltd v Hendry [35] involved consideration of a chattel lease and the following propositions emerge:

- A contractual term which purportedly requires an accelerated payment of future rentals by a lessee in breach under a lease of chattels may constitute a penalty despite provision in the contract for a rebate of rentals to allow for acceleration of payments.

- A chattels lease which contains a lease-finance arrangement for the acquisition of a chattel by a lessee and a large disparity between the

31 (1986) 162 CLR 170
32 (1986) 162 CLR 170 at 180-181
33 (1972) 126 CLR 131
34 (1972) 126 CLR 131 at 141-5
35 (1985) 4 NSWLR 1

effective rate of interest and the rate of discount may characterise an acceleration clause as a penalty.

- The immediately preceding proposition is more likely to apply where the discount rate is a fixed percentage (without any provision for indexation adjustment to accommodate variations in commercial interest rates) irrespective of the time at which the clause might be applied during the lease term.

Evidentiary Issues

Returning briefly to this matter as Justice Vickery[36] has also commented a number of evidentiary issues arise in establishing whether or not a sum agreed as liquidated damages may be set aside by a court as a penalty.

Burden of Proof

The first issue relates to the burden of proof.

It is well established that the burden of proving that a liquidated damages provision is a penalty because it is extravagant or exorbitant in comparison with the greatest loss that could have been suffered, or is unconscionable, rests squarely with the party asserting that position.[37]

It follows that it is incumbent upon the party alleging the penalty to adduce evidence to discharge the burden by establishing a sum which was the greatest loss that the party suffering the delay could have suffered, as best this was able to be assessed at the time of the parties entering into the contract. A simple comparison can then be undertaken between the "greatest future loss" figure and the agreed sum stipulated in the contract.

The usual means open to a party to prove this claim is by the calling of an appropriately qualified expert with experience of contract management in the relevant industry.

Alternatively, the challenging party may adduce evidence to establish that the agreed liquidated damages clause was, in all the circumstances, relevantly unconscionable.

Time at which the Assessment is to be made

The second issue relates to the time at which the assessment of the alleged extravagance and exorbitance or unconscionability is to be undertaken. Here the observations of Cole J mentioned under the heading above of '*Unconscionability*' are to be remembered.

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36 Peter Vickery QC, supra
37 *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428 at p 1447

It is equally well established that the time for making the assessment is the time of entry into the contract which contains the liquidated damages clause.

However, the exercise is more easily stated than implemented in practice. It is likely to be a difficult and somewhat illusive undertaking in most cases, involving an endeavour to predict the future loss to be suffered by one party to the contract over the life of the contract in the event of the other party's default which triggers the obligation to pay, which may occur well into the future.

May damages be recovered if a liquidated damages clause is held to be a penalty?

Where a clause is struck down as a penalty, the plaintiff may claim general damages for breach. [38] The case law on this may be summarised as follows:

- in contracts involving the leasing of equipment, an agreed damages clause which gives no rebate for accelerated payment and no accounting for proceeds of sale on repossession, will amount to a penalty; and
- where a contract provides for nothing more than acceleration of an existing or antecedent debt, this is not a penalty. However, the rules as to penalties apply where a clause seeks to impose an additional or different obligation above the acceleration of payment.
- Where there has been a termination for non-repudiatory breach by the lessee, then, in the absence of a properly drafted clause, a lessor is only entitled to recover instalments in arrears plus interest. However a properly drafted clause might allow the hirer of chattels to recover a discounted proportion of future instalments.
- It remains unresolved whether a penal clause is merely unenforceable or void ab initio.

Esanda Finance Corp Ltd v Plessnig [39] affirmed what Mason and Wilson JJ held in ***AMEV-UDC Finance v Austin*** [40], that a properly worded lease for chattels may allow the owner to recover a discounted proportion of future instalments.

The clause upheld by the Court allowed recovery as follows:

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38 *Scandinavian Trading Tanker Co AB v Floater Petrolera Ecuatoriana* [1983] 2 AC 694; *Turner v Superannuation & Mutual Savings Ltd* [1987] 1 NZLR 218; *AMEV-UDC v Austin* (1986) 162 CLR 170.

39 (1989) 166 CLR 131

40 (1986) 162 CLR 170

RA = (TR + E) – (AP + V + R) where:

RA = recoverable amount

TR = total rent payable

E = storage, maintenance and resale expenses

AP = all moneys paid by the hirer

V = the best wholesale price reasonably obtaining for the goods

R = rebate designed to compensate the hirer for early repayment.

Fixed or Floating Interest – penalty?

Fixed rates of interest are recoverable. Jacobs [41] has also suggested such a clause would be framed around recovering unpaid capital together with some formula in relation to interest to the following effect:

N x 1 ÷ D where

N = the number of months to run on the loan;

I = the interest rate fixed by the facility; and

D = the discount for payment in advance.

For example, the rate at which the lender itself borrows and/or re-finances and the rate which the borrower must repay, as it fluctuates from time to time, depending on the soothsaying of the Reserve Bank, government financial policy, and the state of the world economy.

Floating rates of interest clauses may be recoverable on general principles. The approach is to assess whether the liquidated damages clause is valid. If so, the matter rests there. If not, the lender's claim for interest is either on some other express term or on an implied term to the effect that interest runs at reasonable rates.

Capitalisation of interest – penalty?

The Full Federal Court in ***David Securities Pty Ltd v Commonwealth Bank of Australia*** [42] held that it was not a penalty if clauses in a mortgage have the effect of:

(a) capitalising due but unpaid interest; or

[41] Jacobs, *supra*, ch 25
[42] (1990) 23 FCR 1 at 27-31

(b) stipulating for an increased rate of interest on money due but unpaid provided that the increase operated only prospectively from the time of the default.

Default rates – penalty?

A modest prospective increase in rates upon default is enforceable consistent with an increase in the consideration for the loan by reason of the increased credit risk represented by a borrower in default. As long as the increase is prospective from the date of default, and not retrospective, and is modest, it will be enforceable.[43] This line of authority was recently re-affirmed in ***Beil v Manseel (No 2)*** [44] however, on the facts of that case, increase in the rates yielded the lenders a "significant advantage" over what their loss could be and thus constituted a penalty and was unenforceable.

Sale of land – forfeiture of deposit – penalty?

A deposit is a guarantee of performance and is forfeited when the purchaser defaults and the vendor terminates the contract. Even if the contract does not contain an express forfeiture clause, the deposit is forfeited: ***Howe v Smith*** [45]; cited with approval of the New South Wales Court of Appeal in ***Havyn Pty Ltd v Webster*** [46].

In other words, if the contract for sale is silent on the point, then there is an implied term that the vendor has the right to retain a deposit and that implied term can only be negatived by express provision to the contract: ***Havyn Pty Ltd v Webster***.[47]

The standard form contract for sale of land provides for forfeiture of deposit of up to 10% of the purchase price. This is now widely accepted as the threshold under which a forfeiture clause is likely to be construed as a genuine pre-estimate of damages. However, if the amount forfeited is higher than 10% there is more scope for arguing the doctrine of penalties or relief against forfeiture.

However, consider the differing effects of these decisions:

- In ***Smythe v Jessup*** [48] the forfeiture of a 40% deposit was held penal.
- Yet, in ***Coates v Sarich*** [49] the forfeiture of a 27% deposit was not held to be penal. The forfeiture of two of the instalments was declared penal

43 *Lordsvale Finance v Banke of Zambia* [1996] 2 All ER 156
44 [2006] 2 Qd 499; [2006] QSC 199
45 (1884) 27 Ch D 89
46 (2005) 12 BPR 22, 837; [2005] NSWCA 182 at [130]
47 (2005) 12 BPR 22; [2005] NSWCA 182
48 [1956] VR 230 at 232-233

but no relief flowed as damages exceeded the deposit and the two instalments.

- In ***Workers Trust and Merchant Bank v Dojap Investments*** [50] the Privy Council was faced with a deposit of 25%. It held that a deposit had to be reasonable and about 10% was reasonable. A vendor who sought to obtain a larger amount by way of forfeitable deposit had to show special circumstances that justified such a deposit otherwise it would be held to be a penalty. The 25% deposit was not a true deposit and the provision for its forfeiture was a clear penalty and had to be repaid.

It will be observed that the Court determines whether it is a penalty by reference to all the circumstances existing at the time of entry into the contract.

Conclusion

This paper has endeavoured to assist practitioners to understand the parameters of the law in this area as it has developed in more recent times. Notwithstanding its development the fundamental premise at law remains with the freedom of the parties to a contract to provide for their own regime of rights and responsibilities - provided they do not breach relevant public policy considerations and create a penalty.

David H Denton, S.C.
Chancery Chambers

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[49] [1964] WAR 2
[50] [1993] 2 All ER 370