

PENALTIES FOR NON-PERFORMANCE OF CONTRACTS

David H Denton, S.C.

David H Denton, S.C. has a national commercial law practice as a Senior Counsel in all States and in Fiji.

He has a keen interest in commercial arbitration and mediation, and in all aspects of company law, especially insolvency and shareholder disputes; planning and environmental tort matters.

He is a Certified Arbitrator and an experienced nationally accredited Mediator and holds (or has held) the following positions:

- President of the Commercial Bar Association
- Adjunct Professor, Victoria Law School, College of Law & Justice, Victoria University Melbourne
- President of the Australian Institute for Commercial Arbitration
- Chairman of the 'Law Hawks', In-House Legal Coterie, Hawthorn Football Club.

He is a member of chambers in Melbourne at *Chancery Chambers*; in Brisbane at *Sir Harry Gibbs Chambers*; in Cairns at *Macrossan Chambers*; and, in Hobart at *Michael Kirby Chambers*.

The Principles

1. A provision of an agreement which operates, in the case of breach or non-performance, to impose some additional financial obligation in the nature of a punishment on the defaulting party will *prima facie* be a penalty. Whether or not such provision is a penalty will depend upon whether the amount to be paid by the defaulting party is a genuine pre-estimate of damage or not.
2. The High Court has on several occasions considered the principles of penalty and their application: *LA.C. (Leasing) Ltd v Humphrey* (1972) 126 CLR 131, *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359, *Acron Pacific Limited v Offshore Oil* (1985) 157 CLR 514, *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 and *Esanda Finance Corporation Ltd v Plessnig and Another* (1989) 166 CLR 131.

I.A.C. (Leasing) Ltd v Humphrey (1972) 126 CLR 131

3. A lease agreement provided that in the event of the lessor agreeing to the lessee returning the goods prior to the expiration of the lease, the lessee would pay the remaining rental (rebated) to be paid under the agreement and return the goods to the lessor. If the goods were sold by the lessor for less than their appraisal value the lessee would indemnify the lessor for the shortfall. If the goods were sold for an amount greater than the appraisal value, this excess would be set-off against the amount of the remaining rental to be paid by the lessee. More generally the agreement otherwise provided that at the end of the agreement the lessee would indemnify the lessor for any capital loss suffered, being the difference between a lower amount realised upon sale and the appraisal value of the goods.
4. Walsh J, concluding that this did not constitute a penalty, noted at p141, [14] that the

relevant provisions were concerned with a genuine pre-estimate of damage and did not provide the lessor with a profit unrelated to any damage actually suffered.

5. As to the application of the principles relating to penalties, His Honour stated at pp142-143, [15]-[16]:

..... *There has been a conflict of judicial opinion on the question whether a provision/ which is so expressed that it may operate in the same manner in cases in which there is a breach of contract and in other cases where there is not any breach/ can be affected by the rules of law relating to penalties. The view has prevailed in England that those rules may be applied in appropriate circumstances to make such a provision unenforceable/ in so far as it operates, in the events which happen/ as a consequence of a breach of contract notwithstanding that the same results may be attached by the agreement to acts or events which involve no breach: see Bridge v. Campbell Discount Co. Ltd. (1962) AC 600. in which the opinion of the majority of the Court of Appeal in Cooden Engineering Co. Ltd. v. Stanford (1953) 1 QB 86 was approved. But there has been a pre-ponderance of opinion in favour of the view that it is only when a provision operates so that the event upon which an obligation is placed upon a party to pay a sum of money to another party to a contract is the breach by the former party of a term of the contract that the question arises whether an obligation arising upon that event is a penal provision. Thus if a sum has become payable because a party has exercised an option given by the agreement, the exercise of which is conditional upon a payment, the view has been taken that the question of a penalty does not arise. See the differing opinions stated in Bridge's Case (1962) AC 600; at pp 613, 614, 625, 626, 629 and 634 and see United Dominions Trust (Commercial) Ltd v. Ennis (1968) 1QB 54, at pp 64, 67 and 69.*

It has been held that each case must be considered, not only in relation to the particular terms of the agreement under which an obligation is created, but also having regard to all the surrounding circumstances, including the subject matter of the agreement. In such a case as the present one, it may be important to consider whether the subject matter is likely to depreciate in value quickly or slowly: see Lombank Ltd v. Excell (1964) 1QB415.

6. He concludes (at pp143-144, [17]-[18]) that:

The cases to which I have referred provide guidance as to the principles of law that have to be taken into account. But the decision of this appeal depends upon the nature and the terms of the agreement and upon the circumstances. There has been no suggestion in the evidence and no finding that the appraisal value was not based upon a bona fide estimate of the expected depreciation of the equipment during the period of the lease. In my opinion, there was no principle of law which precluded the parties from making an enforceable agreement that the hirer not the owner should run the risk of the occurrence of a greater amount of depreciation than was estimated whether this should occur as the result of the actual use of the equipment by the hirer or as the result of changes in the market value of goods of that description. The respondent undertook an obligation which was stated in the agreement to be by way of indemnity for a capital loss. There is

no reason to hold that that statement was a sham or a pretence. There is no basis for a conclusion that the provision was really intended simply as a sanction against a breach by the respondent of the agreement It is a mistake, in my opinion, to speak of the sum payable under this provision as being a sum payable as damages for a breach of contract and then to ask whether it is penal in amount or is a genuine pre-estimate of damage. As the learned trial judge said, a lender of chattels must take into account the loss of capital resulting from depreciation, particularly when hiring vehicles which have a high rate of depreciation. The circumstance that in this case the actual sale price was a long way below the appraisal value does not provide any reason for concluding that the provision which obliged the respondent to pay the difference was a penal one. It was agreed that it was the best price available and, as I have said, it was not suggested that the original estimate of depreciation was a sham. (Underlining added)

O'Dea v Allstates Leasing System (WA) Pty Ltd (1983) 152 CLR 359

7. A lease agreement entitled the lessor to retake possession of the relevant good (a prime mover) if the lessee defaulted under the agreement, upon which event all moneys due for the unexpired term of the agreement would become immediately due and payable (together with reasonable costs of the repossession). In such case (and also upon expiry of the agreement) the lessor could sell the good and the lessee was required to indemnify the lessor for any capital loss suffered by the lessor upon such sale if the price realised for the good was less than the appraisal value.
8. Gibbs CJ, having referred to a first class of case where provision is made for the acceleration of payment of a sum of money otherwise payable by instalments where there has been a failure to pay an instalment, refers then (at p367, [6]) to a second class of case which:

.....arises where the parties have stipulated that a sum shall become payable on a certain event which, although brought about by the party required to make the payment, does not involve a breach of contract It has been held that where there is a contract for the payment of a certain sum in a certain event, and that event has happened the sum is payable and no question of penalty versus liquidated damages arises: In re Apex Supply Co. (1942) Ch 108, at p 119; Alder v. Moore (1961) 2 QB 57, at p 65.....

Stating further at pp367-368, [6]:

.....It however, the agreement is terminated by the hirer himself, e.g. because he is unable to keep up his payments, it has been held that the question whether the sum payable is liquidated damages or a penalty does not arise, since what has occurred is that the hirer has exercised his option to put an end to the contract on paying a certain sum, and the sum for which he has made himself liable must be paid: Associated Distributors Ltd v. Hall (1938) 2 KB 83 . Conflicting opinions have been expressed as to the correctness of that decision (see Campbell Discount Co. Ltd v. Bridge (1962) AllER at pp 614, 631, 633; and United Dominions Trust (Commercial) Ltd. v. Ennis (1968) 1 QB 54, at pp 64, 67)

but the question whether it was correct does not fall for consideration in the present case.

In determining whether an amount is a penalty or liquidated damages his honour notes generally (at p368, [7]):

In Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd (1915) AC 79, at pp 86-87, Lord Dunedin said: 'The question whether a sum stipulated is a 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.' Similarly, in my opinion, the question whether the rules which relate to the distinction between penalties and liquidated damages are applicable must be judged as at the time of the making of the contract in question. The question is 'not of words or of forms of speech, but of substance and of things'; to use the words cited by Lord Radcliffe in Campbell Discount Co. Ltd v. Bridge (1962) AC 131, at p 137. (Gibbs CJ at p368, [7])

And at p373, [14]:

The question whether a contractual provision amounts to a penalty depends on all the surrounding circumstances existing at the time of the making of the contract as well as on the terms of the contract itself, and it is therefore not always possible to apply a decision given upon one contract to another case even though that case concerns a contract in identical terms (see Lombank Ltd. v. Excell (1964) 1 QB 415).

9. Murphy J stated the principle at p375, [2]:

Where a contract provides that failure to comply strictly with conditions on an obligation to pay a certain sum, results in an obligation to pay a higher sum, that obligation is treated as an unenforceable penalty unless the increase can be shown to be a genuine pre-estimate of the damage sustained by the non-performance of the conditions.

10. As does Wilson J at p378, [S]. Whether or not the provision in question is a penalty:

..... will fall to be determined by the proper construction of the contract in its entirety in the light of all the circumstances. In essence the task of a court in such a case is to discern the true intention of the parties: is the clause under challenge a genuine pre-estimate of damage, or is it a penal sanction imposed on the observance of the agreement by the lessee? The relevant principles for distinguishing between a genuine pre-estimate of damage and a penalty are well established; they are conveniently summarized in the form of propositions by Lord Dunedin in Dunlop Pneumatic Tyre Co. Ltd v. New Garage and Motor Co. Ltd (1915) AC 79, at pp 86-87.

11. And Deane J at pp397-398, [7]:

The ordinary rule is that an obligation which is imposed upon one party to a contract to pay a sum of money to another on breach of contract will only be enforceable if the sum to be paid is properly to be characterized as damages as distinct from a penalty.

12. However, if the agreement in question creates a present liability subject to an indulgence by permitting payments thereof in instalments and default in such payment entitles the relevant party to withdraw the indulgence and sue for the total amount it will not be a penalty (see Wilson J at p3821 [17] and the *Lamson Store* case below). The question in such cases then is whether or not the total amount payable in the event of default is a present debt already owing. If so¹ such provision requiring payment of the entire debt (already so owing) in the event of some default in the arrangements given by way of indulgence will not be a penalty.
13. Brennan J discusses the *Lamsen Store* case at pp386-389 [5]- [12]¹ noting at [6] that while Griffith CJ had not thought it material that the debt created by the agreement of the parties was payable *in futuro*, if the present case relied upon acceptance of that opinion he would wish to consider whether it should be followed. Brennan J then notes the limited application of the principles to those obligations arising under a breach of contract (at p3901 [14]):

The balance of opinion in this Court has favoured the view that no question of penalty arises unless the obligation to pay arises upon breach of contract. In I.A.C. (Leasing), Walsh J. said (1972) 126 CLR, at p 143:

"... there has been a preponderance of opinion in favour of the view that it is only when a provision operates so that the event upon which an obligation is placed upon a party to pay a sum of money to another party to a contract is the breach by the former party of a term of the contract, that the question arises whether an obligation arising upon that event is a penal provision. "

Acron Pacific Limited v Offshore Oil (1985) 157 CLR 514

14. A deed of moratorium provided for termination thereof in certain circumstances by the creditor companies thereto.
15. Mason CJ, Wilson, Brennan and Dawson JJ, after noting (at p518, [6]) that:

.....there is no penalty if the provisions of the Moratorium deed simply grant an indulgence for the payment of a debt that is due and payable: Wallingford v. Mutual Society (1880) 5 App.Cas.685, at p 702; O'Vea v. Al/states Leasing System (WA) Ply Ltd. (1983) 152 CLR 359, at pp 366-367,382,386.

then apply this principle to the case at hand (at p519, [8]):

The creditors' covenants in cl.7(1) and 10.2 not to enforce the debtors' liabilities during the Moratorium related to debts that were unconditionally payable on demand. The loss of the benefit of the creditors' covenants was therefore no more than the loss of the qualified indulgence which the creditors had agreed to give - that is, an indulgence qualified by the terms of cl.22. The loss of the benefit of the creditors' covenants was not a penalty.

16. Deane J restates the principles at p520, [2]:

The question whether the provisions of an agreement impose a penalty must, however, be determined as a matter of substance rather than of mere form (see, e.g., Clydebank Engineering and Shipbuilding Co. Ltd v. Castaneda (1905) AC 6, at p 9; Dunlop Pneumatic Tyre Company Ltd. v. New Garage and Motor Company Ltd. (1915) AC 79, at pp 86-87, 92; Campbell Discount Co. Ltd. v. Bridge (1962) AC 600, at p 624). if, as a matter of substance, the provisions of an agreement operate, in the case of breach or non- performance, to impose some additional or different financial obligation in the nature of a punishment (as distinct from a genuine ore-estimate of damage or withdrawal of a mere incentive), they will prima facie impose a penalty (cf., e.g., Clydebank Engineering, at pp.15, 19; Dunlop, at pp 86ff., 97, 100-101; Legione v. Hately (1983) 152 CLR 406, at p 445).

Concluding at p521, [4] that the relevant provisions:

..... Did not impose a punishment or even a liability to pay pre-estimated damages for breach. They represented the agreed machinery for the termination of an agreed forbearance in the commercial context that payment of a debt would pro tanto extinguish the obligation to pay and the right to receive future interest.

AMEV-UDC Finance Ltd v Austin (1986) 162 CLR 170

17. A hire purchase agreement provided that the full amount of rental was due forthwith but that provided rental instalments were paid on time, the owner would accept payment of the total rent by way of such instalments. If the hirer defaulted in any payment the owner could terminate the agreement at which time the unpaid balance of the rental would be payable. The owner could further repossess the relevant goods and dispose of them. If the amount realised upon their disposal was less than their residual value as provided for, the hirer would have to pay the difference (in addition to the unpaid rent).
18. Gibbs CJ refers at p174, [2]) to:

Export Credits Guarantee Department v. Universal Oil Products Co. (1983) 1 WLR 399; (1983) 2 All ER 205, where it was held that a clause which provided for payment of money on the happening of a specified event other than a

breach of contractual duty owed by the contemplated payor to the contemplated payee was not a penalty.

Noting then (at p176, [6]) that:

The appellant cannot successfully seek to rely on general equitable principles which relate to the relief against penalties when those principles have long since hardened into definite rules governing the position of parties to a contract which contains a clause imposing a penalty for breach. It is well established in the modern law that the liability of a party who has broken a contract which contains a penalty clause is to pay the damages that have resulted from the breach. In the present case, the additional damage in respect of which the appellant seeks to recover did not result from the breach: it resulted from the determination of the hiring which the appellant itself chose to bring about.

19. Mason and Wilson JJ (at pp180-181, [13]) reiterate the application of the principles to a situation where there is no present obligation in the breaching party to pay the amount payable upon breach:

Rogers J. correctly regarded the recent decision of this Court in O'Dea v. Al/states Leasing System (W.A.) Pty. Ltd.(1983) 152 CLR 359 as authority for the proposition that, 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 the 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 resell the goods leased 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 a wide margin the greatest loss which the lessor can suffer as a result of default in payment of instalments. The lessor would receive both the entire rental and possession of the vehicle, which would greatly exceed his damage (O'Dea, at p.379).

And then at pp184-185, [22]-[23] the application of penalties to an event other than breach of contract, perhaps expanding what might constitute such to include a termination consequent upon a breach:

Common to a number of the speeches in Campbell Discount was the view that the doctrine of penalties has no application to a stipulation which provides for the payment of an agreed sum on the happening of a specified event other than a breach of contract. The correctness of this view has since been affirmed by the House of Lords in Export Credits, at pp.402-403; pp.223-224 of All ER (see also L.A.C. (Leasing), at p.143). The reason given for this limitation on the scope of the doctrine is that it has never been the function of the courts to relieve a party from a contract on the mere ground that it proves to be onerous or imprudent (Export Credits, at p.403; p.224 of All ER). Unfortunately the proposition that the doctrine of penalties has no operation in relation to a sum agreed to be paid on the happening of an event which is not a breach of contract generates difficulties

when an attempt is made to apply the proposition to the exercise of an option to terminate a contract which is conditional upon, or associated with, a breach of contract.

What is the position if the option is exercisable by the owner in a hire purchase agreement or the lessor in a chattel lease on the happening of any one of a series of events, some of which are breaches of contract on the part of the hirer and some of which are not? If the option is exercised on the occasion of the hirer's breach of contract, it accords with principle and authority to say that the sum is payable in respect of the breach of contract and is a penalty, unless it is a genuine pre-estimate of the damage (O'Dea, at p 368; Cooden Engineering Co. Ltd v. Stanford (1953) 1QB86, at pp 96, 116; Campbell Discount; United Dominions Trust (Commercial) Ltd v. Ennis (1968) 1 QB 54, at pp 65, 68, 69; cf. LAC (Leasing), at pp 142-143). The point is that the doctrine is concerned with matters of substance, not of form Campbell Discount, at p.624; O'Vea, at pp.368, 403).

After discussing the principles and their historical development, at pp189-190, [32]-[33] Mason and Wilson JJ consider whether the magnitude of the sum indicates that it is a penalty:

Although the subsequent history of the doctrine of penalties in the nineteenth century throws little light on the way in which the jurisdiction to relieve was exercised, the judgment of Sir George Jessel M.R. in Wallis v. Smith (1882) 21 ChD 243, at p 256 et seq., is illuminating. His Lordship, who was given to expounding the virtues of freedom of contract (see p 266), like Lord Eldon Ch.J. in Astley v. Weldon, rejected the idea that the mere magnitude or extravagance of the sum agreed upon was indicative of its character as a penalty. For him the concept of a penalty was a sum of money agreed to be paid for breach of a covenant or promise in respect of which the damage was ascertainable and was "much less than the sum named as payable upon the breach" to use the words of Coleridge J. in Reynolds v. Bridge (1856) 6 El & Bl 528, at p 541; 119 ER 961, at p 966.

Wallis v. Smith was a staging post on the way as the doctrine became more closely identified with sums agreed to be paid on breaches of contract, a development which was fully reflected later in the landmark decisions of the House of Lords in Clydebank Engineering and Shipbuilding Company v. Don Jose Ramos Yzquierdo y Castaneda (1905) AC 6 and Dunlop Pneumatic Tyre Company, Limited v. New Garage and Motor Company, Limited (1915) AC 79. In both these decisions, in conformity with the doctrine's historic antecedents, the concept is that an agreed sum is a penalty if it is "extravagant, exorbitant or unconscionable" (Clydebank, at pp.10-11,17; Dunlop, at p.87). This concept has been eroded by more recent decisions which, in the interests of greater certainty, have struck down provisions for the payment of an agreed sum merely because it may be greater than the amount of damages which could possibly be awarded for the breach of contract in respect of which the agreed sum is to be paid (see Cooden Engineering Co. Ltd v. Stanford, at p 98). These decisions are more consistent with an underlying policy of restricting the parties, in case of breach of

contract, to the recovery of an amount of damages no greater than that for which the law provides. However, there is much to be said for the view that the courts should return to the Clydebank and Dunlop concept thereby allowing parties to a contract greater latitude in determining what their rights and liabilities will be, so that an agreed sum is only characterized as a penalty if it is out of all proportion to damage likely to be suffered as a result of breach (see Robophone Facilities Ltd v. Blank (1966) 1 WLR 1428, at pp 1447-1448; (1966) 3 All ER 128, at pp 142-143; U.K. Law Commission at pars.33/ 42-44).

At pp193-194, [41] their honours make the following statement of principle (and its basis in policy) regarding the approach that should be taken to provisions which may be alleged to be penalties:

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).

20. After reviewing the authorities, Deane J (dissenting) states at pp199-200, [4]-[5], expanding upon the requirement that the application of penalties is restricted to technical breach of contract:

.....I do not see any of those general statements as binding this Court For my part, for the reasons given above, I am not prepared to accept them as correctly stating the position either in equity or at common law. As I have indicated the restriction of equitable relief or common law unenforceability to the case where it is possible to identify a technical breach of contract on the part of the party claiming relief or unenforceability would, in my view, be contrary to historical fact, general principle and basic common sense.

On the other hand it is plain that the equitable and common law rules relating to penalties do not apply to every obligation to make a payment of money on the occurrence, or default of occurrence, of a specified event The general area in which they (the equitable and common law rules) are applicable is where there exists a contractual liability (whether under seal or for consideration) to pay or forfeit an amount or amounts either on or in default of the occurrence of an event which can be seen, as a matter of substance, to have been treated by the parties as lying within the area of obligation of the party liable to make the payment in the sense that it is his or her responsibility to ensure that the specified event does or does not occur and where the stipulated payment contains an element of compensation for the economic loss or damage which might be sustained by the other party by reason of the particular occurrence or default, It is within that general area that a liability to pay or forfeit money may be discerned, as a matter of substance, as going beyond any genuine pre-estimate of damage and as representing a penal sanction or security against the occurrence or non-occurrence of an event which the obligor and obligee have seen as falling within the responsibility of the obligor. There, the particular rules relating to penalties are applicable to determine the enforceability of the liability to pay or forfeit the designated amount regardless of whether there was any distinct contractual condition or warranty that the event would or would not occur. There, if the liability is unenforceable as a penalty and the quantum of damage sustained is ascertainable, a court can give a monetary recompense or compensation for what the obligee primarily expected or desired, namely, the occurrence or non-occurrence of the particular event (cf. *Pomeroy's Equity Jurisprudence*, 5th ed (1941), vol. 2, 432ff; *Peachy v. Duke of Somerset* (1721) 1Str 447, at p 453 (93 ER 626, at p 630); *Davis v. Thomas* (1831) 1Russ & M 506, at p 507 (39 ER 195, at p 195)).

Concluding further at pp203-204, [9]:

.....what I have suggested to be the correct approach, namely, that the rules relating to penalties are not technically confined to the strict area of payments arising upon breach of contract and that, in a case such as the present the event giving rise to the penalty (and in respect of which the penalty should be seen as compensatory) is properly to be seen as the act or event upon which liability was conditioned namely, the termination of the contract Even if one rejects that approach and treats the penalty area as confined to contractual liability consequent upon breach of contract, that conclusion still seems to me to be the preferable one.

21. However, Dawson J, after discussing the distinction between one party's breach of the contract and the other party's termination therefor (and the approach taken in the cases) concludes at p211, [12] that:

...treatment of the termination of an agreement upon breach in the same way as the breach itself for the purpose of determining whether a stipulated payment is capable of amounting to a penalty has no extended application. It would seem clear that a provision calling for the payment of money by one party on the occurrence of a specified event rather than upon breach by that party, cannot be a penalty: Campbell Discount Co. Ltd. v. Bridge; Export Credits v. Universal Oil Co. (1983) 1 WLR 399; (1983) 2 All ER 205.

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22. In the event of termination of the hiring governed thereby, a hire-purchase agreement provided that the owner could recover from the hirer the total rent and all moneys payable for the full period of the hire less all moneys paid by the hirer, the value of the goods and a rebate calculated in accordance with the agreement.
23. As noted by Wilson and Toohey JJ (at p138, [8]) the Court was in this case not concerned "with the characterisation of a clause which provides for the payment of a sum of money on the happening of a specified event other than a breach of contractual duty". Their honours then reviewed the Court's previous recent considerations of the doctrine of penalties at pp139-140, [9]- [10]:

The Court has considered the doctrine of penalties on a number of occasions in recent years: LA.C (Leasing) Ltd v. Humphrey (1972) 126 CLR; O'Dea v. Allstates Leasing System (W.A.) Pty. Ltd (1983) 152 CLR 359; AMEV-UDC Finance Ltd v. Austin (1986) 162 CLR 170. In considering whether a term of a contract is penal in character rather than a genuine pre-estimate of damage, Mason and Wilson JJ observed in AMEV-UDC (at p 193) that the test:

"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. "

Earlier in their reasons their Honours had discussed the first of these circumstances. After referring to the decisions of the House of Lords in Clydebank Engineering and Shipbuilding Co. v. Don Jose Ramos Yzquierdo y Castaneda (1905) AC 6 and Dunlop Pneumatic Tyre Co. Ltd v. New Garage and Motor Co. Ltd (1915) AC 79, they said (at p 190):

In both these decisions, in conformity with the doctrine's historic antecedents, the concept is that an agreed sum is a penalty if it is 'extravagant, exorbitant or unconscionable · Clydebank, at pp 10- 11, 17; Dunlop, at p 87. This concept has been eroded by more recent decisions

which, in the interests of greater certainty, have struck down provisions for the payment of an agreed sum merely because it may be greater than the amount of damages which could possibly be awarded for the breach of contract in respect of which the agreed sum is to be paid: see Cooden Engineering Co. Ltd v. Stanford (1953) 1 QB (86), at p 98. These decisions are more consistent with an underlying policy of restricting the parties, in case of breach of contract, to the recovery of an amount of damages no greater than that for which the law provides. However, there is much to be said for the view that the courts should return to the Clydebank and Dunlop concept, thereby allowing parties to a contract greater latitude in determining what their rights and liabilities will be, so that an agreed sum is only characterized as a penalty if it is out of all proportion to damage likely to be suffered as a result of breach: see Robophone Facilities Ltd. v. Blank (1966) 1 WLR 1428, at pp 1447-1448; (1966) 3 All ER 128, at pp 142-143; U.K. Law Commission, pars.33, 42-44. "

A similar view was expressed in Easley v. J.G. Collins Insurance Agencies Ltd. (1978) 83 DLR (3d) 1, where Dickson J., in delivering the judgment of the Supreme Court of Canada, said (at p 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."

As O'Dea and AMEV-UDC show, the fact that the "recoverable amount" payable by the respondents under cl.6 is payable upon termination of the agreement consequent upon breach, rather than in respect of the breach alone, does not mean that the clause escapes the scrutiny of the law relating to penalties. But it does mean that in determining whether the "recoverable amount" is a genuine pre-estimate of loss or a penalty, "relevant loss is not restricted to the loss flowing immediately and merely from the actual breach of contract: it includes the loss of the benefit of the contract resulting from the election to terminate for breach. " (AMEV-UDC, per Deane J, at p 197; see also pp 181,194, 205-206, 210).The respondents' submission to the contrary must be rejected.

Referring to the lower court's reasoning their honours note at p141, [13] that such:

.....overlooks the principle that the payment of an agreed sum is a penalty only if it is 'out of all proportion' or 'extravagant exorbitant or unconscionable'. AMEV-UDC, at p 190. See also O'Dea, per Deane J. at p 400. The reasoning of the majority places too much emphasis upon the superior bargaining position of a finance company, resulting in a conclusion that the mere possibility of unfairness lurking in the formula contained in cl.5 is sufficient to characterize cl.6 as a penalty. The adoption of such a criterion fails to allow for the latitude that necessarily attends the conception of a genuine pre-estimate of damage. The clause is to be construed from the point of view of the parties at the time of entering into the transaction. The character of a clause as penal or

compensatory is then to be perceived as a matter of degree depending on all the circumstances including the nature of the subject-matter of the agreement.

24. Brennan J at p143, [1]:

One of the tests stated by Lord Dunedin in Dunlop Pneumatic Tyre Company, Limited v. New Garage and Motor Company, Limited (1915) AC 79, at p 87, to assist in ascertaining whether a stipulated sum is a penalty is whether the sum "is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach' To apply this test, it is necessary to identify the breach prescribed by the clause which imposes the supposed penalty and to ascertain the measure of loss which might follow from that breach. If the stipulated sum is payable on the occurrence of any breach of the contract whether serious or trifling in its consequences, there is a presumption that the sum is a penalty: ibid.

25. Deane J restates the fundamental principle at p153, [3]:

The question whether particular provisions of an agreement defining the rights and liabilities of the parties upon termination for breach purport to impose a penalty must be determined as a matter of substance. If such provisions do no more than impose upon the defaulting party an obligation to pay an amount (whether specified or to be calculated in accordance with a nominated formula which represents a genuine pre-estimate of the damage including loss of bargain) which the innocent party will sustain by reason of the breach and consequent termination, the provisions will not impose a penalty. Nor will they impose a penalty merely because they operate to withdraw an incentive for observance by the defaulting party of the terms of the agreement. Such provisions will not be penal unless their operation is, as a matter of substance, to impose some additional or different financial obligation or burden upon the defaulting party in the nature of a disincentive or punishment for breach (cf. Acron Pacific Ltd. v. Offshore Oil N.L. (1985) 157 CLR 514, at p 520).

26. Gaudron J at pp157-158, [5]-[6]:

In AMEV-UDC this Court considered a contractual provision obliging a lessee to pay certain amounts in the event of early termination of a chattel lease. In that case termination was effected at the election of the lessor upon the lessee's breach. Mason and Wilson JJ (at p 194) expressed the view that an owner could "recover his actual loss on his early termination of a hire-purchase agreement or chattel lease, pursuant to a contractual right, for the hirer's non-fundamental breach, under a correctly drawn indemnity provision." Deane J. (at p 197) noted that "in determining whether the amounts payable by (a) lessee upon such termination are properly to be seen as a genuine pre- estimate of loss or as a penalty, relevant loss is not restricted to the loss flowing immediately and merely from the actual breach of contract: it includes the loss of the benefit of the contract resulting from the election to terminate for breach' I agree with these observations but prefer to express the relevant consideration (Whether in relation to a chattel lease or a hire- purchase agreement) in terms of an

assessment or calculation of the value to the owner or the hirer of the performance of the primary obligation according to its terms. See *Public Works Commissioner v. Hills* (1906) AC 368, at pp 375-376; *O'Dea*, per Wilson J. at p 383.

Where the parties to a hire-purchase agreement stipulate events within the general responsibility of the hirer (see AMEV-UDC, at pp 199-200) which will give rise to a right to early termination the further stipulation of an ensuing indebtedness on the part of the hirer in an amount which is a genuine pre-estimate or an amount calculated by a method giving a substantially accurate assessment of the difference between the value of the benefit which would accrue to the owner from the complete performance of the hiring and the value of the benefit (if any) accruing from early termination cannot, in my view, be characterized as a penalty. See, in relation to assessment of damages generally, Buchanan v. Byrnes (1906) 3 CLR 704, per Griffith C.J. at p 715.

OTHER CASES

Cameron v UBSAG (2000) 2 VR 108

27. Phillips, J.A., in the Victorian Court of Appeal, stated the law with regard to penalties (at p113, [17]):

The law relating to penalties was authoritatively expounded by the High Court in O'Dea v. Allstates Leasing System (W.A.) Pty. Ltd.[1]; see also Acron Pacific Ltd. v. Offshore Oil N.L.[4] and AMEV-UDC Finance Ltd. v. Austin [5] to which counsel took us. In O'Dea the Court held that the lessor of certain chattels was not entitled to recover the balance of the entire rent when default was made by the lessee of certain chattels during the term of the lease; the provision for acceleration of the instalments was a penalty, particularly in view of the concurrent right of the lessee to recover the chattels as well as all moneys due for the unexpired term, plus the costs of repossession. In form at least the lease in that case purported to create an immediate liability in the hirer for all instalments of hire, which led Brennan, J., who dissented on this point, to say that there was no penalty, but mere acceleration. The rest of the Court was not persuaded by the form of the lease and held that, when read as a whole, "it becomes apparent that at the date of the contract there was no presently existing obligation to pay the entire rental" (per Gibbs, C.J. [6]. The significance of this was made clear by the Chief Justice when he summed up in relation to one class of case in which there can be no question of penalty, saying [7]:-

"In all the cases of this kind there is a present debt, which, by reason of an indulgence given by the creditor, is payable either in the future, or in lesser amount, provided that certain conditions are met. The failure of the conditions does not mean that the creditor becomes entitled to damages; the consequence is that the sum which was always owed, but which the

debtor was allowed to pay by instalments or in a smaller amount, becomes recoverable at once or in full'

Stating then at p114, [19] with regard to the clause under consideration:

By the same token, however nor was clause 3 inserted in the deed in order to compel or induce compliance by the defendant with clause 2 - or, to put it another way to penalise or to punish the defendant for non-compliance with clause 2: see for example Ex Parte Burden, In re Neil [9] Esanda Finance Corporation Ltd v. Plessnig [10]. As I understand it, the law as to penalties is that if the parties to an agreement include a provision for the payment of a sum of money by one party to the other by reason of the former's defaulting in the performance of an obligation owed by him or her to the other under the agreement, then payment of that sum can be enforced against the party in default on/v if that sum is a genuine pre-estimate of the damage like/v to be occasioned by the default. If it is not a genuine pre-estimate of damage it is unenforceable as being a penalty - meaning a penalty imposed merely to induce or compel compliance with the obligation which has not been fulfilled and intended therefore to secure for the innocent party a benefit or advantage which is a/together collateral to purpose of the main agreement (because ex hypothesi it goes beyond mere compensation for the breach).....

Export Credits Guarantee Department v Universal Oil Co (1983) 1 WLR 399

28. The defendants agreed to indemnify the plaintiffs for sums paid by the plaintiffs under a guarantee provided by them if the defendants were in breach of contracts with other parties.
29. Concluding that such did not constitute a penalty, Roskill, L at p 403 states that:
.....one purpose/ perhaps the main purpose/ of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant But it is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an onerous or possibly even a commercially imprudent bargain..... The appellants accepted those terms which provided for the right of recourse to arise upon the happening of a specified event, and that specified event has now happened ...

Further,

.....this is not a case where the respondents are seeking to recover more than their actual loss as compensation by way of damages for breach of a contract to which they were a party. They are seeking/ and only seeking/ to recover their actual loss...

Campbell Discount Co Ltd v Bridge (1962) AC 600

30. The defendant defaulted under a hire-purchase agreement, pursuant to which default the agreement provided that he was to pay to the plaintiff the balance sum of money required to make up two-thirds of the total hire-purchase price. (The majority found that

the defendant had breached the agreement and not terminated it.)

31. Lord Morton of Henryton (at pp 614-615):

If the defendant had exercised his option to terminate the agreement (rather than having been found to have breached it) he "would have been bound to pay the stipulated sum...., not by way of penalty or liquidated damages but simply because payment of that sum was one of the terms upon which the option could be exercised.

Quoting at 615 from Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 86:

"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."

32. Lord Radcliffe at p622:

....a sum cannot be legally exacted as liquidated damages unless it is found to amount to 'a genuine ore-estimate of loss' If it does not amount to such a pre-estimate, then it is to be regarded as a penalty, and I do not think that it helps to identify a penalty, to describe it as in the nature of a threat "to be enforced in terrorem"

And stating by way of obiter at pp625-626 that it does not follow that the arguments that sustain a hirer upon his breach sustain him also when the hiring is determined under his option or by an event specified in the contract but not involving a breach, and "unconscionable" is not to be used as a universal panacea to adjust any contract between two competent persons where it "shows a rough edge to one side or the other".

33. Lord Denning states that equity relieves not only against penalties for breach of contract but also against penalties for non-performance of a condition (pp629-630). However, "when equity granted relief against a penalty, it always required the recipient of its favours, as a condition of relief, to pay the damage which the other party had really sustained" (p632).
34. Lord Devlin states the court should not enforce the relevant provision where its object and effect is shown to be to deter *the defendant from breaking his contract by imposing on him, if he does, a penalty in excess of the damages otherwise recoverable* (p632). *There is no half-way house between a penalty and liquidated damages. However large the sum stipulated may be, if it is a genuine, covenanted pre-estimate of damage, it is not stipulated as in terrorem and so cannot be a penalty.* (pp633-634)
35. Viscount Simonds dissented from the majority's decision that the defendant had breached and not terminated the agreement. However, he notes at p614 that: *I must dissent ...from the suggestion that there is a general principle of equity which justifies the court in relieving a party to any bargain if in the event it operates hardly against him.*

Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited [1915] AC 79

36. The appellant supplied tyres to the respondent. The respondent agreed not to sell the tyres for less than the appellant's list prices, in breach of which the respondent would pay to the appellant an agreed sum for liquidated damages. Held not to be a penalty.

37. Lord Dunedin:

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. (p86)

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. (pp 86-87)

It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach. (p87)

It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid. (p87)

There is a presumption (but no more) that it is a penalty when 'a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage' (p87)

It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost impossibility. (pp87-88)

38. Lord Parker of Waddington:

If, for example, the sum agreed to be paid is in excess of any actual damage which can possibly, or even probably, arise from the breach, the possibility of the parties having made a bona fide pre-estimate of damage has always been held to be excluded, and it is the same if they have stipulated for the payment of a larger sum in the event of breach of an agreement for the payment of a smaller sum. (p97)

39. Lord Parmoor. See ppl00-102 - Statement as to when the Courts will interfere and the limitations on interference with the agreement of contracting parties –

...there must be an extravagant disproportion between the agreed sum and the amount of any damage capable of pre-estimate. (p101)

Lamson Store Service Co Ltd v Russell Wilkins & Sons Ltd (1906) 4 CLR 672

40. A lease agreement provided that in the event of the lessee's bankruptcy, the whole of the rent for the term of the lease was immediately due and the lessors might enter the defendant's premises and remove the subject goods of the lease. The lessee was wound up and the lessor sought to prove in the liquidation for the whole amount of rent under the agreement. It was held that by the agreement an obligation to pay a sum equal to the whole period's rent was imposed on the lessee, with the provision that it might be paid in annual instalments if conditions were observed. It was therefore not a penalty.
41. Griffith CJ (Barton J concurring) at p681 quotes "the rule" from Lord Dunedin in *Clydebank Engineering and Shipbuilding Co. v Don Jose Ramos Yzquierdo y Castaneda* (1905) AC 6:

.....the criterion of whether a sum - be it called penalty or damages - is truly liquidated damages, and as such not to be interfered with by the Court or is truly a penalty which covers the damage if proved, but does not assess it, is to be found in whether the sum stipulated for can or cannot be regarded as a 'genuine pre-estimate of the creditor's probable or possible interest in the due performance of the principal obligation.'

Stating then at pp683-684:

If parties agree in plain words that in a given event they will pay a stipulated sum, I do not think that the Court ought to say that they did not mean what they said When by a valid contract between parties sui juris one party promises to pay the other a sum of money by instalments, with a stipulation that on default in payment of one instalment all the others shall become due immediately, the nature of the consideration for the promise is immaterial. The only question is whether it is a good consideration. If it is, it matters not whether it was an existing debt or a grant of an optional privilege, or any other thing that in law is regarded as a good consideration.(pp683-684)

Referring to *Protector Loan Co. v Grice* 5 QBD 592, he states (at p684) that:

It is true that in that case the consideration was a debt already existing. Here, on the other hand, the only debt is created by agreement of the parties, and is payable in futuro. But for the reasons already given, I do not think that this difference is material.

42. O'Connor J dissenting nonetheless applied the test applied by Griffith referred to above (see p689)

David H Denton, S.C.

Chancery Chambers