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Penalty Clauses in Agreements:
Enforcement and Avoidance

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PENALTY CLAUSES

Agreed damages or *liquidated damages* clauses are often included in commercial agreements in an attempt to provide the parties with some certainty as to their rights and obligations in the event of a default.

Importantly, despite its name, a liquidated damages clause provides a cause of action on a *debt* as opposed to an action for *damages*. There are numerous advantages of being able to sue for a debt rather than bringing a claim for damages, including:

- (i) Unlike damages, an entitlement to recover a debt may not be dependent on a breach of contract;
- (ii) Proof of loss is not required;
- (iii) The rules which relate to mitigation of loss in a damages claim do not apply to an action on a debt;
- (iv) Once it is established that the debt is payable, the onus shifts to the defendant to establish he/she has either paid the debt or is entitled to a set off.

However, where the sums stipulated by a liquidated damages clause are held to be *penal* in nature, that is, not a genuine pre-estimate of the amount of the loss likely to result from the breach, the clause may be characterised as a penalty clause and thus become unenforceable.

A brief history

The law of penalties seems to have its genesis in “penal bonds”, which were a promise to pay a stipulated sum, but with the condition that that promise was void if the promisor had performed the main obligation by a certain date. Whilst equity had been granting relief from such bonds, these arrangements were enforceable at common law until reforms by statute in 1697.

Before stating what are now regarded as the principles of the modern law of penalties, Lord Dunedin dealt with the long line of authorities on the topic in the following manner:

*“I do not think it advisable to attempt any detailed review of the various cases, but I shall content myself with stating succinctly the various propositions which I think are deducible from the decisions which rank as authoritative:- ...”*¹

I suggest it unnecessary to go behind this analysis. An extensive review by the High Court is contained in *AMEV-UDC Finance Limited v Austin and Anor*² for those interested.

The law against penalties

The modern rule against penalties is a rule of the common law – not equity.³ Historically, equity has been interested in granting relief against the effect of penalty clauses, but equitable relief in the area is now based in the general equity jurisdiction to grant relief against unconscionable or oppressive transactions.

It should be noted that, although there may appear to be similarities, the principles of equitable relief against forfeiture have no application to the law on penalties.

The modern law follows the speech given by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*⁴. That case concerned a breach of what was, in effect, an agreement for a resale price maintenance scheme.⁵ The impugned clause was held not to be a penalty clause, but the following principles were propounded.⁶ With some qualifications that I will come to, these principles are now regarded as the elements of the law against penalties:

¹ *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 86.
² [1986] 162 CLR 170.

³ See *AMEV-UDC Finance Limited v Austin and Anor* [1986] 162 CLR 170 at 191; *Interstar Wholesale Finance Pty Limited v Integral Home Loans Pty Limited* [2008] NSWCA 310 at [99].
⁴ [1915] AC 79.

⁵ Which would now, in Australia, attract the Trade Practices Act, s 48.

⁶ [1915] AC 79 at 86-87.

- (1) The use of the words “penalty” or “liquidated damages” may be indicative, but will not be conclusive on the question of whether the clause is a penalty.
- (2) The essence of an unenforceable penalty is a payment of money *in terrorem*.⁷ The essence of (an enforceable) liquidated damages clause is a genuine pre-estimate of damage.
- (3) Assessing whether the impugned provision is a penalty or liquidated damages is a question of construction. It is to be determined on the circumstances and on the terms of the particular contract at the time of the making of the contract – not at the time of the breach.
- (4) The tests which can be applied to the impugned clause include:
 - (a) If the sum is extravagant or unconscionable “*in comparison with the greatest loss that could conceivably be proved to have followed from the breach*”, it will be a penalty.
 - (b) If the breach is failure to pay a sum of money, and the impugned clause stipulates an amount greater than that which ought to have been paid (other than interest), it will be a penalty.
 - (c) Where a clause stipulates a sum payable on the occurrence of one or more events, some of which may occasion serious damage, but others merely trifling damage, there is a presumption (but no more) that the clause is a penalty.

The High Court has affirmed that these principles continue to express the state of the law in this area in Australia.⁸

⁷ *In terrorem* refers to a condition intended to frighten or intimidate.
⁸ *Ringrow Pty Ltd v BP Aust Pty Ltd* [2005] 224 CLR 656 at 663 [12].

There seems to be a tendency to apply what has been called the “classical test” which is in terms, whether the sum expressed in the clause was *a genuine pre-estimate of the damage* likely to be suffered by the innocent party. However, that phrase is a little generalised and perhaps misleading, but nonetheless useful in determining a preliminary question: If the sum expressed in the contract was a genuine pre-estimate of loss, then it will *not* be held to be unenforceable as a penalty.

However, if the sum was *not* a genuine pre-estimate of loss, then a further analysis of the clause is required, against all the principles stated by Lord Dunedin, and in subsequent authorities, will need to be applied.

These principles were recently considered in the NSW Court of Appeal in *Interstar Wholesale Finance Pty Limited v Integral Home Loans Pty Limited*.⁹ The Appellant was a finance company; the Respondent a mortgage broker.

The case concerned an agreement which gave the Appellant with a right to terminate in circumstances where:

...[the Appellant] considers, in its reasonable opinion, that [the Respondent] has engaged in deceptive or fraudulent activity...

The agreement further provided that, where the above right to terminate was exercised, the Respondent would be disentitled from any fees already received and any future trailing commissions. Properly construed, some of those entitlements had already accrued to the Respondent at the time of termination. The Respondent alleged that this provision in stripping it of its fees and commissions, offended the law against penalty and was unenforceable.

The mortgage broker was successful at first instance but failed on appeal, where it was held that the relevant clause did not engage the law of penalties for two reasons. Firstly,

⁹ [2008] NSWCA 310.

there had not been a breach of contract. Secondly, the amount of the “penalty” was deemed not to have exceeded likely losses to the required extent.

The starting point is the proper construction of the impugned clause in the contract. As stated in Lord Dunedin’s speech, the provision in question is to be assessed at the time the contract was made, not the time of the breach. The Court is concerned with substance, not form.¹⁰

The judge at first instance had proceeded on the erroneous basis that there need not be a breach of contract. The Court of Appeal held the contract right to terminate which had been exercised in *Interstar* was not predicated on a breach of contract.¹¹ The Court also confirmed that the law of penalty will not be engaged unless the payment is conditional on a breach of the contract.¹² If the payment is conditional on some other event, it cannot be characterised as a penalty.

Liquidated damages may be characterised as penal even where the stipulation is expressed in terms of the transfer of property rather than the payment of a sum of money,¹³ as was the case in *Interstar* where part of the “penalty” was a “transfer” of an accrued right to past and future fees.

As I have said, the test is more than whether the sum stipulated in the clause is a genuine pre-estimate of damage. In preferring to apply a higher threshold test for the engagement of the law against penalties, the courts have expressed their reservations on interfering with the rights of parties in unexceptional circumstances. The courts have picked up on the reference in Lord Dunedin’s principles to sums that are extravagant or

¹⁰ *O’Dea v Allstates Leasing System (WA) Pty Limited* [1982-1983] 152 CLR 359 at 368 at 373; *Interstar Wholesale Finance Pty Limited v Integral Home Loans Pty Limited* [2008] NSWCA 310 at [100].

¹¹ *Interstar Wholesale Finance Pty Limited v Integral Home Loans Pty Limited* [2008] NSWCA 310 at [139] to [141].

¹² *Interstar Wholesale Finance Pty Limited v Integral Home Loans Pty Limited* [2008] NSWCA 310 at [105] to [116].

¹³ See discussion in *Interstar Wholesale Finance Pty Limited v Integral Home Loans Pty Limited* [2008] NSWCA 310 at [101]ff, per Allsop P.

unconscionable “*in comparison with the greatest loss that could conceivably be proved to have followed from the breach.*”

Having stated that the law on penalties is an exception to the general rule that a good reason is required to attract judicial intervention into bargains upon which parties with full capacity have agreed, the High Court in *Ringrow* stated:

“*The propounded penalty must be judged extravagant and unconscionable in amount. It is not enough to say that it should be lacking in proportion. It must be “out of all proportion.”*”¹⁴

Acceleration clauses

It is common for lease agreements to contain an “acceleration clause.” That is, a term which “accelerates” the payment of rent by the lessee on the occurrence of certain specified events. Acceleration clauses bring forward the obligation to pay rent for the entire term of the lease, making that rent payable immediately.

The leading case on where acceleration clauses will be construed as a penalty is the High Court’s decision in *O’Dea v Allstates Leasing System (WA) Pty Ltd.*¹⁵

O’Dea was a case about a lease for 36 months of a prime mover. The lease agreement provided that the rent for the entire term of the lease was due and payable upon the signing of the lease agreement, but it also provided that the lessee could pay the rent by instalments. The lease agreement went further in providing a regime for prompt payment of the rental instalments. The lease agreement provided that, if there was a default in the prompt payment of rental instalments, the lessor could retake possession of the prime mover, and the lessor could enforce a debt for all rental instalments.

¹⁴ *Ringrow Pty Ltd v BP Aust Pty Ltd* [2005] 224 CLR 656 at 669 [32].

¹⁵ [1982-1983] 152 CLR 359.

On appeal, the High Court held the provision was a penalty. But this conclusion was only reached on after the proper construction of the agreement in that particular case. That construction was to the effect that at the date the contract was entered into, there was no present obligation to pay the rent for the entire term of the lease.

“The obligation was to pay by instalments, and if there were a default in payment of the instalments the whole became payable.”¹⁶

It was held that, in those circumstances, the obligation to pay the entire rent arose only by reason of the breach of the agreement.

However, had the lease agreement been construed as providing that the amount of unpaid rental instalments were an accrued debt at the time the lease terminated, it would not have been held to be a penalty.

In *O’Dea*, the High Court “distinguished” two classes of case of acceleration clauses from penalties.¹⁷

The first class was said to arise in circumstances where an amount is payable by instalments, and where one instalment is not paid punctually, then the whole amount becomes immediately payable. The difference with the situation in *O’Dea* was that the relevant clause required a breach of contract as a condition for the obligation to pay the rent for the entire term. Interestingly, *O’Dea* says that it will not be a penalty where there is an agreement to pay interest, on the condition that if payment is punctually made, then the rate will be reduced. This kind of provision seems reminiscent of the “penal bonds” which I referred to earlier and which were made the subject of statutory constraint in 1697, although that statute was repealed in 1957.

¹⁶ *O’Dea v Allstates Leasing System (WA) Pty Ltd* [1982-1983] 152 CLR 359 at 369 per Gibbs CJ.
¹⁷ *O’Dea v Allstates Leasing System (WA) Pty Ltd* [1982-1983] 152 CLR 359 at 366-367.

This first class is also expressed to include circumstances where a creditor agrees to provide a “discount” for early performance or part payment in full discharge, but retains the right to recover the original debt otherwise.

In all cases under this class, there is a present (accrued) debt. Only by reason of an indulgence provided by the creditor is the debt payable in the future or in some lesser amount, if conditions are met. Failure to meet the conditions entitles the creditor to the sum which was originally owed.

The second class of “permissible” acceleration clause highlights the importance of drafting in determining whether the clause will be enforceable. If, properly construed, the provision enlivens the creditor’s entitlement to the debt *without* a breach of contract, the law of penalties will not be engaged. Conversely, where the construction is less certain, a defendant may seek to avoid the debt as a penalty.

The New South Wales Court of Appeal applied *O’Dea* in a decision handed down earlier this year:

*“...if a sum of money is payable by instalments, and it is provided that in the event of one instalment not being punctually paid the whole sum shall immediately become payable, the acceleration of payment is not a penalty.”*¹⁸

Deposits in contracts for the sale of land

It is common for a deposit to be payable upon entry into a contract for the sale of land. It is common term of such contracts that a defaulting purchaser will “forfeit” that deposit. Such contracts often contain a clause to the effect that, if the deposit has not been paid prior to the default of the purchaser, then the unpaid amount may be recovered as a liquidated debt.

¹⁸ Hunt v Kallinicos [2009] NSWCA 5 at [18] quoting Gibbs CJ in *O’Dea v Allstates Leasing System (WA) Pty Ltd* [1982-1983] 152 CLR 359.

As a general proposition, deposits have been off limits to the law on penalties. However, there is some uncertainty on the point. The NSW Court of Appeal:

“The exception from the law relating to penalties relates and relates only to deposits, that is, to payments which truly have the character of earnest money paid on or in relation to the entering into the Contract, and although provisions of contracts almost always establish what the deposit is, it is not open to parties to avoid the operation of penalties law by designating a payment or an obligation as a deposit if it does not otherwise have that character.”¹⁹

The deposit in that case was, on appeal, held to be a penalty. Again, the question was decided upon the construction of the “forfeiture clause”, which was in these terms:

Special Condition 5:

In the event that the Purchaser pays less than ten percent (10%) of the purchase price as deposit then if the Purchaser commits a default hereunder the whole of the 10% deposit shall become due and payable notwithstanding that this Contract is not completed. This clause shall not merge on completion and the Vendor shall be entitled to sue for recovery of so much of the 10% deposit that remains outstanding as a debt due by the Purchaser to the Vendor.

The problem with a clause drafted in this manner is the “mixing” of the liability to pay part of the deposit with a breach of the contract. The Court of Appeal held that this affected the essential character of the obligation as an additional payment which the purchaser must make in the event of default.²⁰

A deposit properly characterised, paid as earnest and as a guarantee of the performance of the contract, ought not be unenforceable as a penalty. A deposit amount that exceeds or can be characterised other than a true payment in earnest, made upon the entry into the

¹⁹ *Luong Dinh Luu v Sovereign Developments Pty Ltd & Ors* [2006] NSWCA 40 at [24].

²⁰ *Luong Dinh Luu v Sovereign Developments Pty Ltd & Ors* [2006] NSWCA 40 at [34].

contract, may well be deemed to be an instalment of purchase money and attract the law of penalties.

In my view, any uncertainty in the application of the law of penalties to deposits can be obviated by drafting. It is critical that the deposit becomes a debt due and payable at the time of entry into the contract. The safer course is to ensure accrued entitlements survive the termination of the contract, rather than prescribe a payment regime which comes into effect on an event of default.

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