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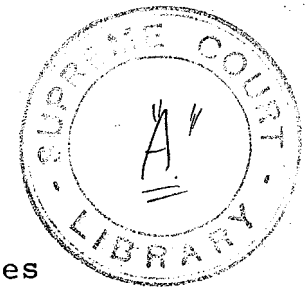


# LIQUIDATED DAMAGES AND PENALTIES

by

JUSTICE ANDREW ROGERS

A Judge of the Supreme Court of New South Wales

The topic raises for discussion the manner in which the law has sought to accommodate two conflicting legal principles and needs. However what I primarily wish to discuss is the extent to which, by this attempted reconciliation, the law has failed to meet the legitimate current needs of the commercial community.

In theory, and as a matter of principle, the law permits, and indeed to an extent encourages, parties to a contract to specify in advance a fixed sum, as the amount of damages payable by one to the other in the event of breach. The specified amount will be recoverable as liquidated damages so long as it represents a genuine attempt by the parties to estimate the damage likely to be suffered by the innocent party from the breach or breaches. Specifying a fixed sum will have the effect of avoiding uncertainty and possibly difficult questions of quantification and of remoteness (Robophone Facilities Limited v Blank 1966 3 AER 128 per Diplock LJ). I need to mention that Mahoney JA did not refer to Lord Diplock's words when, in Citicorp Australia Limited v Hendry (NSW Court of Appeal, unreported, 5 September 1985) he said (p 13):

> "The plaintiff submitted that, in judging whether such clauses provide a genuine pre-estimate of loss, the loss to be taken into account is not that recoverable at law but the loss which in fact the plaintiff is apt to suffer from the breach. The plaintiff recognised that a party to an agreement

> may suffer loss in fact which is not recoverable at law because, for example, it is not within either arm of the rules in Hadley v Baxendale (1954) 9 Ex 341; 156 ER 145; or was, by remoteness or otherwise, not so recoverable. Mr Bennett QC accepted that there was no decision which had considered this question and a fortiori none which provided positive support for it. Counsel informed the Court they were not able to find any consideration of the question in the legal literature.
>
> I do not think that the plaintiff's submission should be accepted: at least, I do not think that this Court should accept it as constituting the law."

Obviously Bennett QC had not drawn Robophone to the Court's attention.

At the same time, principle will not permit the parties to seek to deter one another from committing breaches of contractual obligations by fixing the amount payable by the guilty party to the innocent party in the event of breach at an amount which is unrelated to the likely damage and is fixed in terrorem. In the light of some later remarks, it is appropriate to draw attention to what fell from Lord Radcliffe in Campbell Discount Co Limited v Bridge 1962 AC 600 where he disapproved of the use of the expression "in terrorem" and said (p 621):

> "I believe that the line of demarcation is drawn in its simplest form (as Lord Dunedin himself said in Public Works Commissioner v Hills 1906 AC 368, 376; 22 TLR 489) if one says that a sum cannot be legally exacted as liquidated damages unless it is found to amount to 'a genuine pre-estimate of loss' to use the phrase originated by Lord Robertson in Clydebank Engineering & Shipbuilding Co Limited v Yzquierdo y Castaneda 1905 AC 6, 19; 21 TLR 58. If it does not amount to such a pre-estimate, then it is to be regarded as a penalty, and I do not myself think that it helps to identify a penalty, to describe it as in the nature of a threat 'to be

> enforced in terrorem' (to use Lord Halsbury's phrase in Elphinstone v Monkland Iron & Coal Co Limited (1886) 11 App Cas 332, 348). I do not find that description adds anything of substance to the idea conveyed by the word 'penalty' itself, and it obscures the fact that penalties may quite readily be undertaken by parties who are not in the least terrorised by the prospect of having to pay them and yet are, as I understand it, entitled to claim the protection of the court when they are called upon to make good their promises. The refusal to sanction legal proceedings for penalties is in fact a rule of the court's own, produced and maintained for purposes of public policy (except where imposed by possible statutory enactment, as in 8&9 Will 3, c 11; 4&5 Anne, c 16)." (emphasis added)

Mahoney JA expressed the same view in Citicorp (supra p 13) when he said:

> "Provisions such as the present are, in reality, not intended to be 'in terrorem' but to provide for the recovery of money in the case of a breach."

It may be preferable to describe a penalty as an amount "really intended simply as a sanction against a breach by the respondent of the agreement" per Walsh J in IAC Leasing Limited v Humphrey 126 CLR 131 at 144.

In order to determine whether a provision in a contract calling for payment of a specified amount in the event of breach falls within one category or the other, Lord Dunedin in Dunlop Pneumatic Tyre Co Limited v New Garage & Motor Co Limited 1915 AC 79 laid down a number of well-known guidelines which it is unnecessary to repeat. In my view, the decision of the High Court in O'Dea v Allstates Leasing System (WA) Pty Limited (1983) 152 CLR 359 has meant, in effect, that time honoured verbal formulae for avoiding the operation of the rules against penalties in leases and

financing documents will, in practice, no longer be available. Whilst the High Court has maintained the principle applied in Lamson Stone Service Co Limited v Russell Wilkins & Sons Limited (1906) 4 CLR 276, that where there is a present debt which, by reason of an indulgence, is payable in the future, so long as, for example, punctual payment is made, the entitlement to call for immediate payment in the event of a failure to comply raises no question of penalty, merely decribing the total amount under a lease as the entire rent and providing for its payment by instalments does not bring the principle into play. It will be a draftsman beyond price who will hereafter be able to pen a lease or financing agreement which will be construed as creating a present debt. The decisions since O'Dea (supra) serve to demonstrate the accuracy of this comment. I say this notwithstanding the offering of Mr Ong in "Chattel Leasing; Indulgences, Liquidated Damages and Penalties" (1986) 60 ALJ 272. The learned author suggests that (p 275):

> "In principle there is no impediment to the concept of an indulgence being applied to leases of chattels. Lessors of chattels would be protected against defaulting lessees if the former were to insert into their contracts a standard, unambiguously expressed clause specifying that a sum equal to, but distinct from, the aggregate of the rental instalments for the entire period of the lease should be due upon the execution of the contract, but that this sum (which is not rent) would not be payable so long as all the rental instalments were punctually paid, with the result that a failure to pay a single instalment punctually would revive the liabilty to pay the orignal sum (not rent) forthwith, notwithstanding that the lease might have been prematurely (but contractually) terminated by the lessor."

He claims (pp 278, 282) that what brought down the provision in O'Dea was that the sum in question was described as "rental" and was only due on condition that the lease ran its entire term. I would suggest that, presented with a provision of the kind suggested by Mr Ong, a court would unhesitatingly adopt the approach of Brennan J in O'Dea (supra) and opt for commercial reality and fact rather than verbal formulae and fiction. Nonetheless, the suggestion is imaginative.

The real interest in recent years lies in the attempt by the courts to accommodate to commercial realities the fact that provisions in financing agreements dealing with consequences of breaches are likely to be found to be unenforceable as penalties.

Considerable difficulty is occasioned by the requirement that the test to determine whether one is faced with a genuine pre-estimate of damage or a penalty has to be applied to the facts obtaining at the time of the making of the contract, not at the time of the breach. A profound irony confronting a businessman seeking to bring his common sense to bear upon the problem of fixing an appropriate amount by way of compensation is that the circumstances in which it is most acutely necessary to define the amount payable in the event of breach so as to avoid a lengthy trial is precisely where a genuine pre-estimate of the damage is most difficult to make. If a court, with all the advantages of hindsight, ultimately considers the figure

determined to be extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have flowed from the breach, it is a penalty, with the consequences I will discuss shortly. Another major problem confronting the commercial world at the present time, in this branch of the law, is the presumption that a payment 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. It is no wonder that Mahoney JA expressed the view, in Citicorp Australia Limited v Hendry (supra p 13) that the principle effectively precludes the use in commercial documents of a single clause to provide for the event of breach because, in many cases, the circumstances will be, potentially, so various as to prevent a single formula of words from providing, in each case, for the different amounts of damage which may accrue. In the same appeal, Kirby P said:

> "It would be no misfortune if the High Court of Australia were to take an early opportunity to reconsider this body of law. I am far from convinced that, as between the present parties, the result which follows in this case is just and conforms with sound commercial practice and business sense."

A businessman, if informed of the state of the law in this field, would frame his comments with considerably more emphasis. In its present application by the courts, the law as to penalties has become a weapon in the hands of the unscrupulous and those wishing to renege on commercial

obligations fairly imposed and accepted. In this respect, it replicates the situation which obtained in the early 1960s in the application of the Moneylenders Act until commercial transactions were substantially excluded from the provisions of the Act. Provisions which were initially designed to protect borrowers against unfair and extortionate moneylenders became weapons of oppression and resulted in unmeritorious borrowers avoiding all obligation to repay moneys they borrowed. It is indeed difficult to justify the continued application of the principles of the law relating to penalties in these days of Consumer protection legislation, the Contracts Review Act and the Moneylenders Act. It is true that there is still a restricted area where the principle might perhaps be required to achieve justice. Where the transaction is in the course of trade and the parties stand in an unequal bargaining position, until the Contracts Review Act is amended, it cannot reach into that area of commercial intercourse. Otherwise, the Contracts Review Act and Trade Practices Act provide the courts with a rapier to pierce unfairness and inequality in bargaining positions, enabling them to achieve a fair result in contrast to the blunt bludgeon of the principle of penalty. Unless and until the High Court reverses the decision of the Court of Appeal in Austin v United Dominions Corporation 1984 2 NSWLR 613, persons with commercial experience who assumed commercial liabilities in circumstances of full knowledge and commercial equality will be able to escape substantially

from the obligation to repair the effect of their breach on the other party to the contract.

If an example were needed of the present difficulties, let me assume the case of a lease of premises. Let it be assumed that it calls for payment of $1,000 for breaches of covenants to keep the premises clean, not to light fires at certain times, to keep the premises insured and in good repair and not to keep a pet on the premises without permission. To fix the one tariff for this variety of rag tag breaches would undoubtedly lead to a finding that the sum fixed was penal. Would it not be better if the court could have regard to the actual breach which occurred and, in the light of such facts, determine whether, in relation to that breach, the sum in question was properly to be regarded as imposed simply as a sanction, or as a genuine pre-estimate of the damage which might flow from that particular breach, irregardless of the fact that the same tariff applied to other greater or lesser breaches?

There is another set of circumstances of common occurrence in which the principle may operate unfairly. Let it be assumed that, in the context of a long term contract, the parties fixed liquidated damages at a certain figure. Let it be assumed that, at the relevant date, that is at the time of making of the contract, it was as good a pre-estimate of the damage as the parties could make. If subsequent events make that estimate completely unresponsive

to the actual loss suffered, the innocent party will still not be able to recover more. In Cellulose Acetate Silk Co Limited v Widnes Foundry (1925) Limited 1933 AC 20, a contract for the construction of an acetone recovery plant provided for a payment of twenty pounds per working week for delay in completion. The plant was completed thirty weeks late and the owners suffered losses of 5,850 pounds. Nonetheless, they could recover only 600 pounds for thirty weeks' delay.

The state of the law in the converse of the situation I have posed is in some doubt. Let it be assumed that the amount fixed at the time of making of the long term contract was much too high and, at that time, would have operated as a penalty. The fact that by the time the breach occurred it would have been a more than reasonable estimate is quite irrelevant under the law as it stands. Because it is a penalty, an action for an amount calculated in accordance with the formula would fail. Could a successful action be brought for the plaintiff's actual loss which exceeds the amount based on the penalty?

A negative answer was returned by the Supreme Court of Canada in Elsley v J G Collins Insurance Agencies Limited (1978) 83 DLR (3rd) 1. An employer sued on a covenant entered into by an employee not to compete after termination of employment. The agreement specified $1,000 as liquidated damages in the event of breach. The employer's actual

damage exceeded $1,000. However, the court held that the employer must be limited to the $1,000 stipulated, whether or not the promise to pay it was characterised as a penalty clause. The judgment of the Court was delivered by Dickson J, now Chief Justice of Canada. If one may be permitted to say so with great respect, the philosophical foundation of the conclusion is suspect. The Court said (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. If the actual loss turns out to exceed the penalty, the normal rules of enforcement of contract should apply to allow recovery of only the agreed sum. The party imposing the penalty should not be able to obtain the benefit of whatever intimidating force the penalty clause may have in inducing performance, and then to ignore the clause when it turns out to be to his advantage to do so. A penalty clause should function as a limitation on the damages recoverable, while still being ineffective to increase damages above the actual loss sustained when such loss is less than the stipulated amount." (emphasis added)

It will be seen that the policy statement which is ennunciated to justify the conclusion is in conflict with the passage I have earlier quoted from the speech of Lord Radcliff. His Lordship would appear to take particular issue with the statement to which emphasis has been added. So would Mahoney JA (cf Citicorp (supra)).

It seems to me that there is an element of confusion in what fell from the Court. It appears to import into a discussion of the law relating to penalty clauses, principles which

apply to contractual provisions for limiting exposure to damage. In some instances, the object of fixing, at the time of making of the contract and as part of the contract, the amount payable by way of of damages in the event of breach is not to arrive at a genuine pre-estimate of the likely loss but to limit the amount the plaintiff can recover and, consequently, the amount for which a defendant is exposed. From time to time, vendors insert provisions in contracts for the sale of goods limiting the liability, in the case of a breach of warranty, to $x. Such a provision is completely different in its intent and effect from a liquidated damages clause. It is a question of construction whether a given clause is a limitation clause on the one hand, or a liquidated damages or penalty clause on the other. The law relating to penalties has nothing to say to a clause construed as a limitation clause. The differences in result which flow from the difference in purpose have been recently described by the House of Lords. In Suisse Atlantique Societe d'Armement Maritime SA v NV Rotterdamsche Kolen Centrale 1967 1 AC 361, the charterparty fixed demurrage at $1,000 per day. The owners of the ship sued for actual damages suffered due to delay. The House of Lords held that the demurrage clause was an agreed damages clause and that the appellant owners were limited to the amount fixed by it. Viscount Dilhorne explained the distinction between the two types of clause I have mentioned (p 395):

> "If the clauses imposed a limit on liability, then the appellants would have to prove the actual loss

> they sustained and if it was less than the amount stated they would only recover the loss they proved. Here the parties agreed that demurrage at a daily rate should be paid in respect of the detention of the vessel and, on proof of breach of the charterparty by detention, the appellants are entitled to the demurrage payments without having to prove the loss they suffered in consequence."

Lord Upjohn (p 420):

> "An agreed damage clause is for the benefit of both; the party establishing breach by the other need prove no damage in fact; the other must pay that, no less but no more. But where liability for damage is limited by a clause then the person seeking to claim damages must prove them at least up to the limit laid down by the clause; the other party, whatever may be the damage in fact, can refuse to pay more if he can rely on the clause. As Greer J said in relation to a demurrage clause in Aktieselskabet Reidar v Arcos Limited [1926] 2 KB 83, 86: 'this clause was put in for my benefit as well as yours; it measures the damages I have to pay...'. Counsel for the owners sought to say that the agreed damages of $1,000 a day were much too low to be an estimate of damage and that it might be open to the arbitrators to hold that in truth this was in the nature of a penalty clause or a limitation clause limiting liability. I do not think it is open now to the owners to make this submission. It is quite clear on the authorities that the parties need not agree on the true estimate of damage. They are perfectly entitled to agree on a low rate. See Cellulose Acetate Silk Co Limited v Widnes Foundry (1925) Limited and the Chandris Case [1951] 1 KB 240, 249."

In Interoffice Telephones Limited v Robert Freeman Co Limited 1958 1 QB 190 the lease of a telephone installation contained a clause entitling the lessor to recover future instalments subject to certain rebates in the event of any breach of the agreement. The defendant repudiated the contract. The plaintiff sued for future rentals in accordance with the clause. At the trial it was conceded

that the clause was a penalty. Jenkins LJ said (p 194):

> "The argument therefore proceeded on the footing that the provisions of cl 8 expressed to be operative in the event of default should be disregarded and that the plaintiff should be entitled to recover whatever damages, on the proper principles as to the assessment of damages, it could claim to have suffered through the defendant's default."

That course received the approval of all members of the Court of Appeal.

Now, it is not clear whether his Lordship was able to make the statement simply because any amount of damages which the plaintiff might have been able to prove could on no account exceed that prescribed by the clause in question, or whether he took the view that whatever limitation might otherwise be imposed by the clause in question could be disregarded. Of course, in the latter case, the view would be in complete conflict with the Canadian view.

In Robophone Facilities Limited v Blank 1966 3 AER 128, an agreement for the leasing of telephone equipment contained a clause, the effect of which was to render the hirer liable on breach to pay the company the rentals accrued due and also 50 per cent of the total of the rental which would have become payable over the life of the agreement. In this case also the hirer repudiated the agreement. All the Lords Justices agreed that the clause was a penalty. Further, they all agreed that the plaintiffs were entitled, or as Harman LJ said, "relegated", to recovering such damages as they could prove. Diplock LJ said (p 142):

> "Where the court refuses to enforce a 'penalty clause' of this nature, the injured party is relegated to his right to claim that lesser measure of damages to which he would have been entitled at common law for the breach actually committed if there had been no penalty cause in the contract." (my emphasis)

In this instance clearly the actual damages were below what was provided for by the penalty clause.

The lesson which Lee J drew from the two English decisions in W&J Investments Limited v Bunting 1984 1 NSWLR 331 was that (p 335):

> "The conclusion that a penalty clause does no more than deny the lessor the right to recover damages in terms of that clause, and that is because the amount provided for in the clause is not in the context and circumstances of the agreement to be regarded as a genuine pre-estimate of the damages which flow from a breach of the agreement. But this conclusion does not have the consequence that a breach of the clause will not give rise to a right in damages, nor that on breach of the clause or repudiation of the agreement recovery of an amount equal to or greater than the amount referred to in the clause cannot necessarily be had." (my emphasis)

Evidently, his Honour was not referred to the Canadian decision. Neither did his Honour have the advantage of the judgment of the New South Wales Court of Appeal in Austin v United Dominions Corporation Limited 1984 2 NSWLR 613 given some six months later.

It will be necessary to refer later to the decision in Austin (supra). An appeal from that decision to the High Court has been heard but judgment has not yet been delivered. For the moment, I wish to refer in the present

context to the judgment of Mahoney JA. Without expressing a concluded view, his Honour said that (p 617):

> "It may be that, at law, the penalty provision was not put aside but that the plaintiff was entitled to prove his actual damages and the amount of the penalty provided the upper limit of the plaintiff's recovery."

This very tentative view of course accords with the judgment of the Supreme Court of Canada. As authority for the proposition, his Honour cited Bullen and Leake Precedents of Pleading 3rd ed at 217 (note (b)). Reference to the note shows that what the authors said was:

> "Upon the breach of a contract secured by a penalty, a plaintiff may either sue for the penalty, assigning the breach, - in which case he can recover the damage actually sustained, not exceeding the amount of the penalty; or he may sue for unliquidated damages for the breach, to be assessed by the jury irrespectively of the penalty. In the former case, the recovery of the full penalty will be a satisfaction for all breaches of the contract, but in the latter the plaintiff may sue toties quoties there are breaches, and recover a full indemnity."

A number of old decisions may be cited for this proposition. In Wilbeam v Ashton (1807) 1 Cam P 78, Lord Ellenbrough, in Elphinstone v Monkland Iron & Coal Co (1886) 11 App Cas 332 at 346, Lord Fitzgerald, and the Privy Council in Public Works Commissioners v Hills 1906 AC 368 at 375 all support the view that damages must not exceed the penalty. On the other hand, three charter party cases of Stroms Bruks Aktie Bolag v Hutchison 1905 AC 515, Wall v Rederiak Tiebolaget Luggude 1915 3 KB 66 and Watts & Co Limited v Mitsui & Co Limited 1917 AC 227 all allow the plaintiff to ignore the

penalty and sue for greater damages assessed in the ordinary way. In Cellulose Acetate Silk Co Limited v Widnes Foundry (1925) Limited 1933 AC 20, Lord Atkin, who gave the only speech in the House of Lords, explicitly said that he wished (p 87):

> "to leave open the question whether, where a penalty is plainly less in amount than the prospective damages, there is any legal objection to suing on it, or in a suitable case, ignoring it and suing for damages."

Despite the proclaimed neutrality of Lord Atkin, the overwhelming majority of writers favour the position that the penalty can be disregarded and unliquidated damages recovered in full. The clearest exposition of this view can be found in McGregor on Damages 14th ed para 345. The learned author there says:

> "It was held in Winter v Trimmer (1762) 1 Wm Bl 395 and again in Harrison v Wright (1811) 13 East 343 that the plaintiff could ignore this penal stipulation and recover for his greater loss. The same result was reached in this century in Wall v Rederiaktiebolaget Luggude [1915] 3 KB 66 where Bailhache J retraced the law in a very useful judgment which remains the clearest authority for the present rule. However the wording of the clause had become more complex (it was still held to constitute a penalty mainly because of its history: see para 386 where the case is considered further) and the earlier cases provide more useful illustrations of circumstances in which a penalty is likely to turn out less than the actual damage. The decision itself was approved soon after as to its interpretation of the particular clause as a penalty by the House of Lords in Watts v Mitsui [1931] 2 KB 393, and, as Scrutton LJ pointed out in Widnes Foundry v Cellulose Acetate Silk Co [1917] AC 227, Lord Sumner clearly took the view that 'the clause did not prevent the shipowners or charterers from recovering the actual amount of damage, though it might be more than the estimated amount of freight' (p 408). In view of this line of authority, the occasional dicta which state that

> the penalty marks the ceiling of recovery are unacceptable. (See Wilbeam v Ashton (1807) 1 Camp 78, per Lord Ellenborough: 'Beyond the penalty you shall not go; within it, you are to give the party any compensation which he can prove himself entitled to'; Elphinstone v Monkland Iron & Coal Co (1886) 11 App Cas 332, 346, per Lord Fitzgerald: 'The penalty is to cover all the damages actually sustained but it does not estimate them, and the amount of loss (not, however, exceeding the penalty) is to be ascertained in the ordinary way'. In Cellulose Acetate Silk Co v Widnes Foundry [1933] AC 20, 26 Lord Atkin wished 'to leave open the question whether, where a penalty is plainly less in amount than the prospective damages, there is any legal objection to suing on it, or in a suitable cases ignoring it and suing for damages'. Diplock LJ in Robophone Facilities v Blank [1966] 1 WLR 1428, referring to this express reservation of opinion, said that the matter was 'by no means clear'. Lord Atkin's comments are not however quite in point as is shown by his reference to prospective damages: they are more allied to the issue of limitation of liability by way of liquidated damges, which is dealt with elsewhere: see paras 384-387.) They are probably based upon the historical fact that the sum in a penal bond fixed the maximum amount recoverable. (See para 336. And it did indeed remain true that if the plaintiff sued in debt for the penalty itself, until this, apparently, ceased to be possible (see para 336, n 5) he would impose a ceiling on his recovery and be entitled to no more than the penal sum. See Wall v Rederiaktiebolaget Luggede [1915] 3 KB 66, 72, per Bailhache J: 'The result of suit for the penalty is therefore that the plaintiff recovers proved damages, but never more than the penal sum fixed'; and similarly Harrison v Wright (1811) 13 East 343, 348, per Lord Ellenborough.)"

Similarly, Cheshire & Fifoot's Law of Contract 9th ed at 608 suggests that, in the circumstances under discussion, the plaintiff has an election. He may either sue on the penalty clause, in which case he cannot recover more than the stipulated sum, or he may sue for breach of contract and recover damages in full. However, there is an argument that the charterparty cases on which the text book writers put

their reliance may be special cases.

A commentator (90 LQR 31) has drawn attention to the paradoxical situation which acceptance of the text book writers' view would entail. If the actual loss exceeds the sum properly agreed as liquidated damges, the plaintiff can recover no more than that sum. By contrast, if the agreed sum is a penalty, if the test book writers be correct, as the Canadian Supreme Court points out, the plaintiff could enjoy the intimidatory advantage of the existence of a penalty provision and then, when the bargain turns out to be a bad one, disregard the penalty and sue for the actual loss. In these circumstances, a person infringing the law would be in a better position than the person acting lawfully. Deplorable as this may be from the point of view of those who value respect for the law, it has to be recognised that this is precisely what the House of Lords held was the true position in Bridge v Campbell Discount Co Limited 1962 AC 600.

The Canadian Supreme Court was not referred to the decision in Dingwall v Burnett 1912 SC 1097. An intending lessee repudiated an agreement for lease which included a clause calling for payment of a "penalty" of fifty pounds for failure to perform the agreement. The owner claimed damages of 300 pounds. Lord Salvesen, with whom the Lord Justice Clerk and Lord Guthrie agreed, held the owner entitled to recover damages in full. His Lordship justified this on a

basis laced with a large dose of common sense. As he said, to hold to the contrary would be (p 1066) "to read a penalty clause which ex hypothesi does not asses the damage, as nevertheless assessing it where the actual damage sustained is more that the stipulated sum". This approach highlights, I suggest, the point I have sought to make earlier that the approach of the Supreme Court of Canada reads the failed penalty clause as a limitation clause.

The position so far as New South Wales is concerned is even more puzzling. In Austin (supra), Priestley JA came to the conclusion that the unenforceability of a penalty clause is no longer a matter of application of equitable principles, but arises at law. Then in Citicorp (supra at 18-20), he made his view even more clear. He said (p 18):

> "To say that the fact that the clause was a penalty meant that it was unenforceable was and is accurate enough for most circumstances. However, it seems to me that it is not a completely accurate way of describing the law concerning a penalty. In my opinion, at the present day, the fact that a penalty clause is unenforceable means that it has no legal effect; the party for whose benefit it would operate if it was enforceable can at no stage enforce it or obtain the help of the law in any way in deriving any benefit from it. It is the same as if it was not in the agreement at all. It seems to me to follow from this that it is a mistake to regard a penalty clause as bringing into existence any kind of obligation to pay or any method of calculating an amount payable which is not enforceable. The law today, in my opinion, is that a penalty clause does not bring into existence anything which with any trace of realism can be called an obligation at all even if it be qualified by the apparently self-contradictory adjective enforceable." (emphasis added)

He continued (p 20):

> "The concurrence of the administration of those rules, together in the case of penalties with the disappearance of any discretion in the court respecting what was in origin the discretionary relief against penalties but which had become hardened into the obligation of the court to refuse judgment to any person seeking to enforce a penalty, means that there is never any moment from the time of the coming into existence of a penalty provision when, or any court where it can in any way be be enforced. In my opinion, as I have already indicated, this is the same thing as such a provision never being of any effect at all."

The other two members of the Court agreed. In the result, it seems to me that, if Priestley JA is correct, then the approach of the Supreme Court of Canada is not available in New South Wales and the question left open in England by Lord Atkin has been concluded for us by the Court of Appeal until reviewed by the High Court. In the result, then, a penalty clause does not operate as a cap on the amount of damages recoverable by a plaintiff. It is interesting that if this is truly the consequence of his Honour's judgment, it would appear to have been arrived at without consideration of the authorities I have mentioned.

Another unresolved question in England is whether a provision which predicates payment of a fixed sum on the basis of a number of possible events, one of which is a breach whilst others are not, can be a penalty. The problem is typically illustrated by reference to a minimum payment clause in a hire purchase agreement. Such clauses commonly provide that, on premature determination of the agreement, the hirer shall bring his payments under it up to a

specified proportion of the price by way of agreed compensation for the depreciation in the value of the goods. The clause also specifies events on the occurrence of which the agreement may be determined. The owner is usually given the right to determine if the hirer commits a breach of a number of provisions of the agreement and on the happening of certain other events, for example insanity, bankruptcy etc. There is often also a right conferred on the hirer to return the goods after bringing payments up to a specified amount. On the one hand it is argued that only a sum payable consequent on a breach is capable of being a penalty. Others contend that, if it did not apply to such clauses, the whole law as to penalties could be evaded by simply including among the events on which the sum becomes payable one which was not a breach of the agreement. The view has been taken that, if the agreement is in fact determined on the ground of a breach, the law as to penalties applies (Cooden Engineering Co Limited v Stanford 1953 1 QB 86, Lamdon Trust Limited v Hurrell 1955 1 WLR 391; Citicorp Australia Limited v Hendry unreported Clarke J, 1 March 1984, p 11). However, it has been held in England that, if the agreement is determined by the lessee exercising a right to return the goods, the law as to penalties does not apply (cf O'Dea (supra) Gibbs CJ at 367-368). In the result, if the prevailing authority in England be correct, a lessee who wishes to return the goods may be better off if he simply defaults than he would be if he exercised his lawful right to determine the agreement.

A very real problem in this area has been revealed by recent decisions of the New South Wales Court of Appeal which purport to be based upon the decision of the High Court in Shevill v Builders Licensing Board (1981) 149 CLR 620. It has been a usual provision in leasing and financing contracts for a long time to provide that, upon breach of a provision of the contract, the lessor or financier may recover possession of the goods the subject of the contract and the whole of the balance of the rental would thereupon fall due and payable. Such a provision was clearly penal in nature and therefore, using the term somewhat loosely, not enforceable. Accordingly, the High Court took the view that, in circumstances where the lessor or financier recovered possession of the goods in question simply in exercise of the rights conferred by the contract, the agreement came to an end and, in the absence of anything further, the lessor or financier was only entitled to recover unpaid instalments. The rationale was that any additional loss was caused by the lessor's or financier's decision to terminate the contract and not by any conduct of the lessee. In United Dominions Corporation Limited v Austin 1983 1 NSWLR 636, the view was taken, at first instance, that, conformably with the principles ennunciated by the High Court in Shevill (supra) the contract made a clear provision entitling the lessor to damages for breach of contract, notwithstanding the fact that the lessor retook possession of the goods in exercise of contractual rights for breach of a non-essential term. The lessee did not

repudiate the contract. Although the provision was unenforceable by reason of the fact that it was a penalty, nonetheless it demonstrated the clear intention of the parties that the lessee should not be discharged from all further liability merely by surrender of the goods. The way of achieving substantial justice between the parties was thought to lie in granting relief to the lessee from the penalty provision on equitable grounds conditionally upon the lessee paying to the lessor a proper sum by way of damages. The Court of Appeal in Austin v United Dominions Corporation Limited (supra), by majority (Hutley JA dissenting), allowed an appeal. The majority, speaking through Priestley JA took the view that, even if it could properly be said that in relieving against a penalty the court was exercising equitable jurisdiction, the relief afforded at first instance was precluded by the reasoning of the judges in Financings Limited v Baldock 1963 2 QB 104, Anglo Auto Finance Co Limited v James 1963 3 AER 566 and in Bridge v Campbell Discount Co Limited 1962 AC 600. The judge accepted (p 629) that the point was not argued in the decisions mentioned:

> "However, the bases of the decisions in those cases, which seemed to me to be cumulatively present also in O'Dea and Shevill, in my opinion, require the new point to be answered in the same way; when the principles in those cases are applied to equity's remedy for penalties the result is the same; the only compensation available is for breaches in existence at the time of termination for breach of non-essential terms."

In its latest decision in Citicorp (supra), the Court of

Appeal rejected the argument of the financier on a different basis. In Citicorp it was submitted that the acceleration clause was not a penalty because it followed in substance the formula accepted as a genuine pre-estimate of the damage in IAC (Leasing) Limited v Humphrey 126 CLR 131. Under the lease, the lessor was entitled to two sources of funds. It was entitled to rent during the term of the lease and, at its termination, either to a lump sum payment of the residual value or the resale value of the chattel. The early termination affected the lessor in two ways: it lost the future rental and it recovered the goods earlier than would have been the case had the lease run its full term. The agreement under consideration in Citicorp contained a complicated formula under which a rebate from the total rent for the entire period was to be allowed to the lessee upon termination of the hiring. The rebate also included an allowance for the value of the depreciated goods recovered by the lessor. Where the formula was held to infringe the rule against a penalty, and to have failed as a genuine pre-estimate of the damage, was in the allowance it made for rebate of interest. Priestley JA explained the nature of the difficulty which confronted the financier in defining the appropriate rebate of interest at a time of rapidly fluctuating interest rates. His Honour said (p 9):

> "To make a genuine pre-estimate in the case of early termination of the leases presently being considered, the amount required to put the lessor in the position where, after obtaining that amount from the lessee, it could invest it for the balance of the term of the leases so that at the end of that balance in would be in the same position as if the lessee had fulfilled its obligations under the

> leases until the end of their terms, the rebate provision would have to aim at reducing the total contracted rent for the balance of the terms to a figure which when laid out by the lessor and after payment of expenses involved in such laying out would leave in the lessor's hands at the end of the balance of the terms a sum approximating that which fulfilment of the contract would have yielded."

However, the evidence showed that under the formula the rebate was to be calculated at ten per cent, whereas the effective rate of interest under the leases was in excess of twenty-four per cent. In other words (p 10):

> "By contracting for a rebate on unpaid rent for the unexpired portion of the term in the event of early termination at ten per cent, the lessor was stipulating for the recovery of a sum for that unpaid rent which would be considerably greater than would be necessary to lay out for the balance of the term in order to recover sums equal to those it would have received if the lessee had simply carried out all its obligations under the leases throughout their terms and if a commercial return of twenty-four per cent could be obtained."

His Honour recognised the difficulty propounded by the fact that interest rates were volatile. He suggested that there were at least two methods of coping with this problem. One was to insert a fixed figure for the rebate percentage, at around twenty-four per cent, and the other was to relate the rebate percentage figure to some appropriate and objective index. He recognised that the first method might have thrown up an unacceptable risk for the lessor but, he said, "I can see no such objection to the second" (p 10). I am not quite sure what index his Honour had in mind which would have accurately reflected the volatility of interest rates. For myself, I do not know of one. In "Agreed Damages

Clauses in Financing Contracts in the light of Citicorp Australia Limited v Hendry" 1986 ABL Rev 63, Barnes suggested (p 77) that there is no shortage of appropriate indices and instances the bank bill rate or the prime or base rate of a specified financial institution. I wonder whether such a rate would be sufficiently responsive to the test postulated by Priestley JA. It is, of course, necessary to note that Priestley JA also said (p 11):

> "It may well be that the terms of forty-eight months were sufficiently long in a period of volatile interest rates to justify thinking that it was commercially possible that interest rates could fall so sharply as to make the ten per cent figure a reasonable one. Such a consideration, however, could not apply to, at the very least the early months of the term during which, however, if default occurred on the lessee's part it would be open to the lessor to terminate for breach and recover the rent covering the balance of the term rebated by the ten per cent figure."

As Barnes pointed out, the discount rate must throw up a genuine pre-estimate at every point of the lease period against the possibility that the breach might occur at that time. Difficult of application as it may be, the judgment is the only beacon presently available which would guide a financier and its advisers in the structuring of a rebate clause which might be expected to survive the maze produced by the law relating to penalties.

It is ironic to reflect on the departure which this judgment of the Court of Appeal appears to exhibit from the standards previously thought to be applicable. The yardstick whereby the measurement of a genuine pre-estimate was required to be made was nowhere near the standard of accuracy which the

judgment appears to demand. In other words, one may think that, from a previous approach, where the dichotomy was between a genuine pre-estimate on the one hand and a sanction or in terrorem penalty on the other, the pendulum has swung to a requirement of near precision. This change in approach does not seem to have earned any real mention.

I should conclude by drawing attention to the fact that a concentration on the problems presented by leases and finance documents should not obscure the recent extension of the coverage of the doctrine of penalties. It would appear that not only is the doctrine alive and well but it is also extending to new areas. Thus, whilst usually a provision sought to be impugned as a penalty requires the wrongdoer to make a payment to the innocent party to the contract, that is not essential. In Gilbert-Ash (Northern) Limited v Modern Engineering (Bristol) Limited 1974 AC 689, it was submitted that the provision in a building contract which entitled the innocent party to withhold a payment was penal. Under the contract, payments were to be made to a subcontractor on the issue of arhitect's certificates. The contract gave the contractor the "right to suspend or withhold payment" if the subcontractor failed to comply with any of the provisions of the contract. That provision was described by the Law Lords, albeit in passing, as penal.

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