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Liquidated damages — the law of penalties

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The most common basis for an attack by a contractor on an otherwise operative liquidated damages clause is by arguing that the provision is penal in nature. The law of penalties is attracted where a contract stipulates that, on breach of the contract, the party in breach will pay an agreed sum which exceeds what can be regarded as a genuine pre-estimate of the damage likely to be caused by the breach.[1]

As a rule of thumb, a clause which seeks to impose liquidated damages will be upheld, provided it is a genuine pre-estimate of damages. The time to assess whether the provision is compensatory or penal is the time when the parties entered into the transaction. In practice, successful attacks on the average liquidated damages clause in a contract are rare. Generally, it is only if the amount sought to be imposed is so far in excess of the maximum conceivable as to be out of all proportion, that it is likely to be construed as a penalty.

This article considers two recent Australian cases concerning a challenge to the validity of a liquidated damages clause based upon the clause in each case being a penalty.

Ringrow Pty Ltd v BP Australia Pty Ltd

In *Ringrow Pty Ltd v BP Australia Pty Ltd*,[2] the High Court considered the law of penalties and confirmed that it was proper to proceed on the basis that *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*[3] continues to express the law applicable in relation to penalties in Australia.

The starting point for the appellant in that case was the following passage in Lord Dunedin's judgment (at 86–87):

> 2. the essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage ...
> 3. the question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of the making of the contract, not as at the time of the breach ...
> 4. to assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:
> (a) it will be held to be 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 ...
> (b) 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...
> (c) 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 other but trifling damage'.

One of the arguments relied upon by the appellant in *Ringrow* rested on a concept of proportionality which, it was argued, the option deed in that case contravened — that is, by calling for a reconveyance of certain property after termination of an agreement, rather than a lease for the balance of its term.

In rejecting the 'proportionality' doctrine contended by the appellant, the High Court noted the words employed by Mason and Wilson JJ in *AMEV-UDC Finance Ltd v Austin*[4] in

describing how extensive the difference must be before the transaction creates a penalty — namely, a 'degree of disproportion' sufficient to point to oppressiveness.

The High Court noted that Mason and Wilson JJ initially made the point that an agreed sum should only be 'characterised as a penalty if it is out of all proportion to damage likely to be suffered as a result of breach'.[5]

The High Court noted that their Honours later referred to proportionality as follows:

> [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 them. The Courts should not, however, be too ready to find the requisite degree of disproportion, lest they impinge upon the parties' freedom to settle for themselves the rights and liabilities following a breach of contract.[6]

The High Court considered that nothing in either passage supported the need to enquire into whether there is proportionality between the impugned provision and the legitimate commercial interests of the party relying on it.

Another reason for the court's rejection of the appellant's contended doctrine of 'proportionality' between breach and supposed remedy was based upon the recognised freedom of parties not acting under a relevant disability, to agree upon the terms of their future relationships. Once again, the court referred to the comments of Mason and Wilson JJ in *AMEV–UDC Finance Ltd v Austin*:[7]

> [T]here is much to be said for the view that the Courts should return to ... allowing parties to a contract greater latitude in determining what their rights and liabilities will be, so that an agreed sum is only characterised as a penalty if it is out of all proportion to damage likely to be suffered as a result of breach.

The High Court concluded that the propounded penalty must be judged 'extravagant and unconscionable' in amount, and that it was not enough that it should be merely lacking in proportion. To hold otherwise, said the High Court, would be a reversal of long-standing authority.

The High Court concluded that the propounded penalty must be judged 'extravagant and unconscionable' in amount, and that it was not enough that it should be merely lacking in proportion.

Tasmania v Leighton Contractors Pty Ltd

The other case for consideration, in the more conventional context of a construction dispute, is the decision of the Full Court of the Tasmanian Supreme Court in *Tasmania v Leighton Contractors Pty Ltd*.[8]

In that case, the issue raised on appeal was whether a clause in a deed of agreement entered into by the parties was one providing for the payment of liquidated damages or constituted a penalty rendering it unenforceable.

Facts

In June 1999, the parties contracted for the design, construction and maintenance of road works requiring the re-alignment of a highway to by-pass a town. Delay and ensuing costs were the subject of complex proceedings between the parties, one of which concerned the status of cl 11 of a deed entered into by the parties. This clause provided for the payment of $8000 per day in the event of non-completion of the construction by an identified date. Relying on the terms of the deed, the appellant had withheld from the respondent the sum of $8000 per day from April to November 2001. At trial, the respondent argued that cl 11 was unenforceable as it constituted a penalty.

The overall cost of the project was $30 million,which was to be paid by the Commonwealth of Australia to the appellant, either as a reimbursement or by way of progress payments.

Findings of primary judge[9]

Clause 11.6 of the deed provided:

> 11.6 *Liquidated damages*
>
> (a) if the date of Construction Completion has not occurred by the date for Construction Completion, the Contractor must pay liquidated damages at the rate of $8,000 for everyday after the Date for Construction Completion until the Date of Construction Completion or this Deed is terminated, whichever is first.
>
> (b) the amount referred to in clause 11.6(a) is a genuine pre-estimate of the Principal's damages if the Contractor does not achieve Construction Completion by the Date for Construction Completion.
>
> (c) The amount payable under this clause 11.6 will be a debt due from the Contractor to the Principal.

The primary judge did not consider there to be any relevant imbalance in bargaining power between the parties, and noted that the parties had conducted extensive negotiations and that detailed consideration had been given to the precise terms of the agreement.

The primary judge had regard to a calculation which provided a daily total of $7985 and commented (at [238]):

> The figures in that estimate are extremely high in themselves ... and the number of hours contemplated totally speculative in some cases. An allowance for two hours per day every day for legal advice is even more speculative. I infer that ... calculations in respect of

> direct costs were inflated to produce a figure of $8000 ...

Having considered authorities relevant to public utilities without anticipated direct loss of revenue, the primary judge concluded (at [241]):

> In the present case, it does not appear that any estimation was made in respect of the principal's loss other than direct costs of supervising an over-run contract and it is my view that these costs are extravagant and exorbitant as they are totally disproportionate to the likely actual costs anticipated to be incurred. Furthermore, the evidence is that the costs of the project were fully funded by the Commonwealth Government and the State has not been exposed to either its capital cost or the costs incurred after the Date for Construction Completion. In these circumstances I am of the view that the estimate of $8000 for each calendar day of the delay was not a genuine pre-estimate of the likely damage to the State resultant upon the late opening of the by-pass and is unconscionable.

Appeal to the Full Court

In a joint judgment, the Full Court noted that the legal firm advising the State of Tasmania had addressed the question of a public utility and loss in cautious terms and that effect had been given to that advice in the formulation of the figure of $8000, which was a reduction of an earlier suggested figure. The Full Court also noted that the respondent did not raise its inclusion in the deed as a matter of concern and that no amendment had been sought during the negotiation stage. Indeed, the respondent had amended its pleading on the first day of trial to include the plea of a penalty and had shown no earlier concern.

This led the Full Court to consider an initial evidentiary issue — that is, whether it was for the respondent to place before the court material to establish the status of the impugned clause or whether, on the evidence at large, the primary judge was permitted to make a finding adverse to the appellant.

On this matter, the Full Court held that the respondent was entitled to rest its case on evidence obtained through discovery and cross-examination, and was not required to prove matters independently of those derived from its opponent's case.

The Full Court next considered grounds of appeal based upon proportionality and unconscionability.

The Full Court noted that the primary judge had used the terms 'extravagant', 'exorbitant', 'totally disproportionate', 'not a genuine pre-estimate' and 'unconscionable' to characterise cl 11 as a penalty. The Full Court noted that, in doing so, the primary judge had adopted the terminology used by the House of Lords in a long line of authorities and that the words were often used as an aggregate describing differing conceptual approaches to the test. The terms encapsulated the following propositions (at [22]):

1. A comparison between the sum provided for in the event of a breach and the greatest loss which could conceivably be proven in the light of the total amount of the contract as a whole.
2. Comparison between the sum provided and the nature of the breach. If any breach activates the operation of a 'damages' term, irrespective of its import, then it might more readily be regarded as penalty ...
3. Equivalence of bargaining power at the time of agreement or whether one party was subject to unreasonable pressure in performance ...
4. The potential outcomes to which the clause was directed ...
5. The means, if any, used in the compilation of the sum provided for ...
6. The import of the contract provision for 'damage' to be considered at the time of the making of the contract, not as at the time of breach ...

The Full Court noted that in this case the primary judge correctly identified the relevant principles, and that the error claimed was one of application.

The Full Court considered in detail the approach adopted by the primary judge in reaching his decision that there had been no 'genuine pre-estimate' and

that the figure of $8000 was extravagant, exorbitant, disproportionate and unconscionable, and found that conclusion to be an incorrect application of principle. The Full Court identified the question as whether, given the nature of the contract, its complexity, value and the bargaining strength of the parties, the amount of $8000 was, in all the circumstances, a penalty as of the date of the agreement. The test was objective as of that date. The test was whether as at that date, allowing for potential incurred costs, public utility or loss of amenity, diversion of resources and future dealings with, or responses by, the Commonwealth, loss of capital or its equivalent, the sum was so disproportionate that it provided not for 'liquidated damages' but operated as a penalty which placed the then contracting party *in terrorem*.

The Full Court noted that the contract itself provided for the expenditure of public money amounting to over $30 million and that delay in completion would impact on a public utility. In noting the quantification of that impact would be problematic, the Full Court regarded various calculations as no more than an attempt to provide a general basis for the assessment of an overall figure. The Full Court noted that the calculation involved a projection of costs for a period of two years into the future and that expensive delay might require expensive advice and involve the transfer of administrative or other resources from the state to accommodate difficulties caused by the delay in providing for the maintenance of existing infrastructure during that period.

The Full Court also considered a further basis of appeal — namely that the primary judge erred in wrongly finding that, by reason that the principal was to have been reimbursed by the Commonwealth Government for all the costs of the project, the principal suffered no loss. The primary judge had concluded, as a part of his reasoning, that the terms of the deed (cl 11) amounted to a penalty since it was an artificial construct, rather than a genuine pre-estimate of likely damage to the appellant because the 'costs of the project were fully funded by the Commonwealth'.

The Full Court said that even accepting that, at the time of execution of the deed, the state was entitled to receive full and timely reimbursement, the fact remained that the state was required to be accountable for the expenditure of public money, irrespective of source. The Full Court went on to state (at [38]–[39]):

> Public utility does not of itself disentitle the State or public authority from seeking, by way of damages, compensation for loss, the components of which are incalculable. Delay or breach of a particular term of agreement might result in loss or harm to public convenience such as transportation costs, provision of temporary or substitute infrastructure, continued maintenance of alternate services or increased administrative costs. The provision of public money does not change the character of a compensatory provision into one of penalty simply because the expenditure is to be paid by another public authority … here the respondent was responsible to the appellant for loss occasioned by delay. That loss was calculated in advance and irrespective of whether another would reimburse for that loss, the responsibility remained as between the parties to the agreement.

Accordingly, the Full Court allowed the appeal, finding that the clause in the deed did not constitute a penalty rendering it unenforceable. ●

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Endnotes

1. *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71; BC200509730.
2. Above at [20].
3. [1915] AC 79.
4. (1986) 162 CLR 170 at 193.
5. Above at 190.
6. Above at 193–94.
7. Above at 190.
8. [2005] TASSC 133; BC200512034.
9. *Tasmania v Leighton Contractors Pty Ltd (No 3)* [2004] TASSC 132; BC200407556.