MELBOURNE UNIVERSITY:

MASTERS OF CONSTRUCTION LAW SEMINAR

LIQUIDATED DAMAGES

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Introduction

1. Dr Hamish Lal[1] in an article presented at a meeting of the *United Kingdom Society of Construction Law* on 15 October 2008 said:

> *"A question laden with jurisprudential tension, rich in judicial commentary and of fundamental legal, practical and commercial significance for construction lawyers and decision makers is this:*
>
> *"To what extent does English law allow parties to a contract to specify their own remedies in damages in the event of breach?"*
>
> *Put simply, penalty clause remedies are not allowed but LD clauses are. This so-called "rule against penalties" is an exception to the general principle of English law that a contract should be enforced in accordance with its terms…".*

LDs generally: Definitions

- A LDs provision is a stipulation in a contract for a fixed sum to be paid as damages for breach of the contract.[2]

- A failure by the contractor to achieve practical or substantial completion in accordance with the contract (as extended by extensions of time) and

[1] Dr Hamish Lal, "*Liquidated Damages"* (2009) Vol 25 **Construction Law Journal**, 569

[2] Finola O'Farrell Q.C, **"***Challenging and Defending Liquidated Damages"* (2004) Vol 56, **Amicus Curiae**, 20

assuming that there has been no prevention, would generally result in the contractor being obliged to pay LDs.[3]

- A LDs sum has two essential elements:
  (a) it is fixed by the contract; and
  (b) it is due for payment by the defendant.[4]

- A typical LDs clause provides that if the contractor fails to complete by a date stipulated in the contract, or any extended date, he shall pay or allow the employer to deduct LDs at the rate of money per day or week for the period during which the works are incomplete.[5]

- LDs is an agreed pre estimate of loss and damage specified in the contract for each day that the Date of Practical Completion exceeds the Date for Practical Completion.[6]

Why have LDs provisions in contracts?

It [7] has suggested that LDs provisions are inserted in contracts to serve a number of purposes:

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[3] Scott Laycock, "*Liquidated Damages"* (1996) Vol 12, **Building & Construction Law**, 97

[4] JW Carter, Elizabeth Peden & GJ Tolhurst, ***Contract Law in Australia.*** 5th Ed, 868

[5] Stephen Furst & Vivian Ramsey, ***Keating on Building Contracts***, 7th Ed, 278-9

[6] Philip Loots & Donald Charrett, **Practical Guide to Engineering & Construction Contracts**, 371

[7] George Golvan Q.C, "*Preserving Commercial Outcomes through Binding Liquidated Damages Provisions"* (2009) **Building Dispute Practitioners Society Newsletter** 4, John Twyford, "*Liquidated Damages: A Comparative Study of the Law in England, Australia, New Zealand and Singapore"* (2007) 133 **Journal of Professional Issues in Engineering Education & Practice**, 210; and M Furmston, **The Law of Contract**, 3rd Ed, 1686-7, and

(i) they provide certainty to both parties concerning the measure of damages that will flow in the event of a breach, i.e. they provide a cap on liability;

(ii) they provide an incentive to perform the contract in a timely manner;

(iii) they permit a contractor on a project that is running behind time to undertake a cost benefit analysis of whether it is more commercially beneficial to pay LDs or incur the additional costs of accelerating the works in order to make up the lost time;

(iv) they simplify the process of assessing damages for delay, without the necessity of difficult proofs and the expense of establishing what actual loss has been incurred. This is relevant to contracts, particularly construction contracts, where there may be great difficulty in proving the extent of actual loss incurred by reason of delay e.g. government contracts;

(v) the quantum of LDs need not be proved: LDs are recoverable as a debt, thereby obviating the transactional costs involved in proving the actual loss, such loss being quantified by the application of the rules set out in ***Hadley v Baxendale***;

(vi) the injured party is under no obligation to mitigate as he would in a normal common law claim;

(vii) LDs clauses have the virtue of informing both parties to a contract in advance, what the damages payable for an indentified breach would be at the time of entering the contract. This can be of equal advantage to the party who must pay the damages as it is to the party receiving the damages. The upper limit of the damages payable is fixed and a party can take this into account in the initial negotiations; and

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generally Brian Eggleston, **Liquidated Damages and Extensions of Time: In Construction Contracts** (3rd Ed)

(viii) Lanyon[8] has said that LDs clauses might promote economic efficiency on the basis that the damages compensate the non-breaching party with a future potential for the breaching party to gain a benefit from a reallocation of resources that outweighs the compensation.

Grounds on which LDs can be challenged

Fiona O'Farrell Q.C[9] discusses the grounds on which LDs can be challenged and those grounds can be summarised as follows:

(i) on a true construction of the LDs clause, it is not applicable to the event that has occurred (e.g. no breach or different breach);

(ii) there is a condition precedent to the application of the LDs provision (e.g. a certificate of non-completion) that has not been satisfied;

(iii) the LDs clause is invalid or void for uncertainty;

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[8] Elizabeth Lanyon, "*Equity & the doctrine of penalties*" (19996) 9 **Journal of Contract Law** 234 at 240. The economics arguments are dealt with in CJ Goetz and RE Scott, "*Liquidated Damages, Penalties and the Just Compensation Principle: Some notes on an enforcement model and a theory of efficient breach"* (1977) 77 **Columbia Law Review** 554, K Clarkson, R Milles & T Muris, *"Liquidated damages v penalties: sense or nonsense?"* (1978) **Wisonsin Law Review** 351, S Rea, *"Efficiency Implications of Penalties and Liquidated Damages*" (1984) 13 **Journal of Legal Studies** 147, L A DiMatteo, *"A theory of efficient Penalty: Eliminating the law of liquidated damages"* (2001) 38 **American Business Law Journal** 633, LA DiMatteo *"Penalties as rational response to bargaining irrationally"* (2006) **Michigan State Law Review** 883, S Walt "*Penalty clauses and liquidated damages"*(2009) **University of Virginia Law School, The John M Olin Program in Law & Economics Working Paper Series**, Paper 57, G DeGeest & F Wuyts, *"Penalty clauses & liquidated damages"* (2000) 3 **Encyclopaedia of Law & Economics** 141, E L Talley, *"Contract renegotiation, mechanism design and the liquidated damages rule"* (1994) 6 **Stanford Law Review** 1195. Andrew Ham, "*The Rule against penalties in contract: An economic perspective:* (1990) 17 **Melbourne University Law Review** 649, Jeremy Thorpe, "*Economists Divided: Different Perception of Contract's Penalty Doctrine* (1994) 6 **Bond Law Review** 189 and C J Rossiter, **Penalties and Forfeiture** 139-140 and RA Posner **Economic Analysis of Law.**

[9] Finola O'Farrell Q.C, **op cit**, 21-23

(iv) the material contractual machinery is inoperable or has broken down; and

(v) the LDs clause is a penalty.

The first two grounds are relatively straightforward as matters of contract construction. The remaining three grounds have given rise to difficulties in application.

The Third Ground: The LDs clause is invalid or void for uncertainty

If, on a proper construction of the contract the LDs clause does not make sense and cannot be made to make sense, or is too uncertain, it will not be enforced. (See ***Bramwell Ogden Ltd v Sheffield City Council*** (1983) 29 BLR 73; ***Arnhold & Co v A-G of Hong Kong*** (1989) 47 BLR 129).

A LDs clause will not be held to be invalid merely because it is difficult to construe. It is only where the clause is unworkable or too uncertain to ascertain what the parties intended that the courts will declare it to be invalid and unenforceable.

The consequences of a clause being void for uncertainty is that it will be severed from the contract, and it is a nullity. As a result, the amount specified in the LDs clause will be excised from the contract and not applicable. For this reasons, it will not act as a cap on the damages recoverable by the owner.

The Fourth Ground: The material contractual machinery is inoperable or has broken down

Where a LDs clause is invalidated as a penalty, it will not act as a cap and an award of damages may be made which exceeds the amount agreed by the parties (***AMEV-UDC Finance Ltd v Austin*** (1986) 162 CLR 170).

In construction contracts, the LDs clause is usually inserted in respect of damages caused by delay in completing the works.

The employer's ability to rely on a such clause is lost if the employer prevents the contractor from completing by the completion date without any effective mechanism for extending time for completion.

If the employer causes delay and there is no effective mechanism for awarding an extension of time to the contractor for such delay, the contractor is relieved of his obligation to complete by the contract completion date (or any extended date) and time is at large (***Peak Construction (Liverpool) Ltd v McKinney Foundations Ltd*** (1970) 1 BLR 111).

The Fifth Ground: The LDs clause is a penalty

The Dunlop Case

If a LDs clause is a penalty, it will not be enforced. The test as to whether a LDs clause constitutes a LDs provision or a penalty was set by Lord Dunedin in ***Dunlop Pneumatic Tyre Co Limited v New Garage & Motor Co Limited*** (1915) AC 79 ("**Dunlop**").

In Dunlop, a manufacturer sold tyres to a dealer on the condition that it would not sell the tyres for less than the list price. If the dealer breached this condition, it had agreed to pay UK£5 per tyre in LDs. The dealer sold the tyres for less than the list price and the manufacturer claimed LDs. The House of Lords held that the

stipulated amount was not a penalty because damages were impossible to forecast and the amount to be paid was a genuine pre-estimate of the likely loss flowing from the breach.

Lord Dunedin (at pp 86-88) set out the following often-quoted principles (abbreviated) when assessing a LDs clause:

> *1. Though the parties to a contract who use the words "penalty" or "liquidated damages" may prima facie be supposed to mean what they say, the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages.*
>
> *2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage.*
>
> *3. The question whether a sum stipulated is 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 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 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".

On the other hand:

(d 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 an impossibility. On the contrary, this is just the situation when it is probable that pre-estimated damage was the time bargain between the parties.

In ***Ringrow Pty Ltd v BP Australia Pty Ltd*** (2004) 2009 ALR 32 65, the Full Federal Court said:

that dictum is the "*classic passage*" of exposition of the doctrine of penalties: RP Meagher, JD Heydon & MJ Leeming, Meagher, Gummow and Lehane's Equity: "***Doctrines and Remedies***", 4th ed.

In ***Ringrow Pty Ltd v BP Australia Pty Ltd*** (2003) 203 ALR 281, 302-3 Hely J said:

"*The modern rule against penalties is a rule of law… A penalty is in the nature of a punishment for non-observance of a contractual stipulation; it consists of the imposition of an additional or different liability upon breach of the contractual stipulation… whether a provision is a penalty is to be judged at the time of the making of the contract, and not as at the time of breach. The issue is a matter of substance rather than of mere form, and depends upon all of the surrounding circumstances existing at the time of the making of the contract, as well as on the terms of the contract itself… A stipulation may be penal in character even where the penalty is not expressed in terms of money… the penalty doctrine is not*

> *confined to clauses providing for the payment of money, but extends to clauses providing for the transfer of moneys worth*"

Penalties: Definitions

Furmston[10] has noted that the jurisdiction to set aside a stipulated damages clause as a penalty is anomalous:

> "*The rule against penalties is an exception to the general rule of English law that a contract should be enforced in accordance with its terms*" (***Euro London Appointments Ltd v Claessens International Ltd*** (2006) EWCA 385 Civ para 17).

If a LDs provisions is found to be a penalty it will not be enforced. However, this begs the question: what in law is a penalty?

The law of penalties arises where a contract stipulates that on breach the contract breaker must pay an agreed sum which exceeds or is out of all proportion to the likely actual loss caused by the breach and, in substance, is used for the purpose of pressuring the other party into performance.

A penalty clause is a clause which provides for payment of a sum of money by one party to another in the event of a breach of contract, the sum being designed to secure performance of the contract rather than to compensate the payee for loss occasioned by the breach.[11]

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[10] M Furmston, **op cit** 1686, see also ***Alfred McAlpine Capital Projects Ltd v Tilebox Ltd*** (2005) BLR 271.277

[11] K Lewison, "***The Interpretation of Contracts***" (2nd Ed), Chapter 15, 419

A penalty consists of "*the imposition of an additional or different liability upon breach of a contractual stipulate*".[12]

The general notion is that there must not be a gross disproportion between the likely loss and the agreed damages.[13]

The essence of a penalty is a payment of money stipulated as in terrorem of the offending party. In ***Legione v Hateley*** (1983) 152 CLR 406, 445, Mason & Deane JJ described a penalty as:

> "*A punishment for non observance of a contractual stipulation (consisting) of the imposition of an additional or different liability upon the breach of the contractual stipulation*".

The law of penalties, in its standard application, is attracted where a contract stipulates that on breach the contract breaker will pay an agreed sum which exceeds what can be regarded as a genuine pre-estimate of the damage likely to be caused by the breach (***Ringrow Pty Ltd v BP Australia Pty Ltd*** (2005) 224 CLR 656, 662).

The basis on which a penalty will not be enforced by the Courts is that it is extravagant and unconscionable in amount and not a genuine pre-estimate of damage.

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[12] Elizabeth Lanyon, **op cit** 235, see also Garry A Muir "*Stipulations for the payment of agreed sums*" (1983) 10 **Sydney Law Review** 503; Rosslyn T Varghese, *"Penalties and agreed damages"* (1992) 8 **Building & Construction Law** 270; Scott Laycock, *"Liquidated damages"* (1996) 12 **Building & Construction Law** 97; John Dorter, "*Performance"* (1999) 15 **Building & Construction Law** 361.433-444; PD Baron "*Confused in words: Unconscienability and the doctrine of penalties"* (2008) 34 **Monash University Law Review** 285; Paula D Baron, *"The doctrine of penalties and the test of commercial justification"* (2008) 34 **University of Western Australia Law Review** 42, and T Thompson, "*A fresh look at liquidated damages"* (2006) 22 **Construction Law Journal** 289.

[13] Michael Furmston, "*Contract Planning: Liquidated Damages, Deposits & the Foreseeability Rule*" (1991) 4 **Journal of Contract Law** 1.5

The jurisdiction to relieve against penalties and the nature of the circumstances necessary to invoke the jurisdiction was the subject of extensive analysis in ***AMEV-UDC Finance Ltd v Austin*** (1986) 162 CLR 179 per Mason and Wilson JJ. In formulating the test to be applied for distinguishing between provisions which are so unconscionable or oppressive that their nature is penal and not compensatory as a genuine pre estimate of loss was said by their Honours at p 103 to be:

> *"…one of degree and will depend upon a number of circumstances, including:*
>
> *(i) 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 terms to the defendant; and*
>
> *(ii) the nature of the relationship between the contracting parties, a factor relevant to the unconscienability of the plaintiff's conduct in seeking to enforce the term".*

Where a clause attempting to stipulate a sum for breach is held to be a penalty, the penalty clause cannot be enforced and is disregarded, and the party must rely on an action for unliquidated damages.

A provision will not be held to be a penalty just because it is difficult to make a pre estimate of the loss likely to be suffered in the event of a breach.

The courts are slow to hold that a LDs provision is a penalty where these is credible evidence that a genuine assessment has been made (***City Inn v Shepherd Construction Ltd*** (2003) BLR 468).

However, the court will not shy away from striking down provisions that are shown to be penal in nature.

A LDs provision has to be a genuine pre-estimate of loss and damage arising from delay in the completion of the contract, assessed at the time of entry into the contract. If the amount is not a genuine pre-estimate of the damage likely to be caused by the breach, then it is regarded as a penalty and is not recoverable.

George Golvan Q.C.[14] has noted it is a rationale grounded in public policy that Courts will not enforce a penalty provision (see: Lord Diplock in ***Robophone Facilities v Blank*** (1966) 1 WLR 1428). From the substantial body of cases which have dealt with the issue concerning whether a LDs clause constitutes a penalty, he identified a number of key propositions. Each of them concern the position which applies at the time the contract was entered into, and not the position at the time of the breach:

- An amount will be held to be a penalty if the sum stipulated

  > *"is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach."*

- The onus of establishing a penalty is generally on the party who is sued upon the LDs provision.
- The usual calculation is a daily or weekly sum during the period of delay. A lump sum figure is presumed to be a penalty.
- It is not sufficient that the amount of LDs may be lacking in proportion to the damages likely to be suffered. The sum must be "*extravagant and unconscionable*", and out of all proportion to the damages likely to be suffered in consequence of a breach, to the point that it is oppressive.
- Whether a sum is a penalty or LDs essentially comes down to a matter of construction having regard to the circumstances of the case, which includes such considerations as the party's freedom to determine the terms of the agreement between them, as well as the difficulty and expense involved in

[14] G Golvan Q.C. **op cit**, p5

establishing the quantum of loss that will be suffered by reason of a breach. In ***Yarra Capital Group v Stephen Kent Goldberg*** (2006) VCA 109 there was an agreement for short-term unsecured loans at high rates of interest in the event of default. It was argued that the high rates of interest on default were penalties and therefore unenforceable. The Court of Appeal held at paragraph 17 that the default interest rates were not penalties and applied the general principle that where it would be a complex and expensive exercise to seek to establish with any sort of precision what damage is likely to flow from a breach, Courts are more reluctant to find that a stipulated figure is a penalty.

- There is a presumption that an amount is a penalty, when:

  > *"A single lump sum is made payable by way of compensation, on the occurrence of one or more events, some of which may occasion serious others but trifling damage."*

  Where there is a presumption that an amount is a penalty, the onus shifts to the party suing on the clause.
- It is no obstacle to the recovery of LDs that the consequence of a breach is such as to make precise pre-estimation almost impossible.
- The test is one judged by the party's objective intentions at the time of the contract, not their subjective intentions based on what they say or genuinely believe. The fact that the parties use terns such as "LDs" or "penalty" is not conclusive, and a Court must still ascertain whether a sum is in truth a penalty or LDs.

  The parties may generally intend to arrive at a pre-estimate of loss in their agreement, but if the pre-estimate is extravagant or unconscionable in comparison with the greatest loss that could conceivably be proved to have followed from the breach, then it is a penalty.
- It is irrelevant whether a party actually suffered any loss or whether the actual loss suffered is less than the sum stipulated.

LDs clause is a penalty: Where to next?

Michael Hollingdale[15] has posed the question of what options are open to a Principal if its LDs clause is successfully challenged and it cannot claim LDs for delayed completion by the Contractor?

A Principal in some circumstances may still be able to seek general (unliquidated) damages as an alternative (***Rapid Building Group Ltd v Ealing Family Housing Association*** (1984) 24 BLR 5). This alternative would usually be more costly and time consuming. With general damages, the onus is on the party making the claim to prove the loss suffered.

If a Principal is entitled to general damages for delayed completion, the damages will usually be an amount which would place the Principal in the same position as if the contract had been completed on time (***Robinson v Harman*** (1848) 154 ER 363). This may result in the damages awarded being greater than the amount of unenforceable LDs.

However, O'Farrell[16] after considering the authorities, concluded that:

(i) if the LDs clause is a penalty, the clause remains part of the contract and the Principal will be entitled to claim general damages subject to a cap at the level of damages stipulated in the contract;

[15] Michael Hollingdale, **op cit**, p 424

[16] Finola O'Farrell Q.C, **op cit** p 22-3; see also Mallesons Stephen Jaques, "*Liability caps and liquidated damages*", **Asian Projects and Construction Update** – 28 September 2002.

(ii) if the LDs clause fails because it is inoperable or is void for uncertainty, it falls from the contract and the Principal's entitlement to general damages will not be subject to a cap; and finally,

(iii) if the LDs clause fails as a result of an act of prevention by the Principal, it is likely that the Court would permit recovery of general damages but subject to the cap of the stipulated damages.

Other relevant issues when considering LDs clauses:

Michael Hollingdale[17] has provided a brief list of some of the considerations Courts have taken into account when assessing an LDs clause:

(i) The determination of what is a genuine pre-estimate of loss is not restricted to loss flowing immediately from the actual breach but includes the loss of a benefit of the contract resulting from an election to terminate for breach.

(ii) The fact that no loss has been suffered is irrelevant: ***BFI Group v DCB Integration Systems Ltd*** [1987] CILL 348. In that case, the LD clause was attacked on the grounds that BFI Group could not demonstrate that it had suffered any loss by reason of delay in completion of the works. The court held the LDs clause was valid, and that there was no question of it being a penalty.

(iii) The parties' subjective intention is irrelevant. The object is to construe the contract to determine whether it was the objective intention of the parties that the LDs clause was to be a coercive penalty, or whether the intention was that it be a genuine pre-estimate of the value of the loss.

(iv) If challenged as a penalty, the onus is on the party defending the amount being claimed as LDs to establish it is a genuine pre-estimate of damage.

[17] Michael Hollingdale, "*Designing & Enforciding Liquidated Damages Clauses to Maximise Recovery*" (2005) 21 **Building and Construction Law** 412.414-5

(v) 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 the ***AMEV-UDC*** case (at 193) that the test is one of degree and will depend on a number of circumstances, including:

(a) 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

(b) the nature of the relationship between the contracting parties, a factor relevant to the unconscionablilty of the plaintiff's conduct in seeking to enforce the term.

(vi) The question of what is a genuine pre-estimate would be answered by considering whether the pre-estimate was reasonable. The test is primarily an objective one which does not turn upon the genuineness or honesty of the party who made the pre-estimate.

Failure to insert a date for practical completion in your contract: Effect on right to claim LDs.

The application of a LDs clause is dependent upon there being a fixed or certain date from which the damages can commence to run (i.e. the date for practical completion).

The failure to insert a date for practical completion in a contract is a situation where the Principal will be unable to recover LDs (***Kemp v Rose*** (1858) 65 ER 910).

What is the effect of "Nil" or "N/A" LDs in a contract?

The topic is well covered in the paper by Trevor Thomas[18]. However, since its publication in 2008 there have been a number of further decided cases that deal with the issue. Generally, Australian Courts have been reluctant to interpret "$NIL" LDs clauses as preventing a party from recovering general damages. This is in stark contrast to the position under English law.

The applicable general principles

Both Australian and English Courts have referred to the same general principles when considering the effect of "$NIL" LDs clauses, namely:

(i) the task of the Court in these cases is one of contract interpretation: what were the parties' objective intentions in agreeing to a LDs clause of this kind? (It follows therefore that previously decided cases may not always be of assistance to the Court);

(ii) in considering whether a LDs clause has been intended by the parties to operate as an exhaustive remedy for delay, the Court must have regard to the principle stated by Lord Diplock in ***Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd*** (1973) 1 BLR 73 at 96 [NB: applied consistently in Australia ever since (See ***Concut Pty Ltd v Worrell*** (2000) HCA 64 at para 23)]:

> "*…in construing such a contract one starts with the presumption that neither party intends to abandon any remedies for its breach arising by operation of law, and clear and express words must be used to rebut this presumption…*
> *…so when one is concerned with a building contract one starts with the presumption that each party is to be entitled to all these remedies for its breach as would arise by operation of law… To rebut that presumption one must be able to find in the contract clear and unequivocal words in which*

[18] Trevor Thomas, "*$Nil Liquidated Damages: An Exhaustive Remedy for Delay under a Construction Contract*", (2008) 24 **Building and Construction Law** 82, and see also Alastair Oxbrough, "*Liquidated Damages for Delay: Does NIL really mean NIL?*", in **Molino Cahill Lawyers** Publication (http:/www.molinocahill.com.au/wp-content/uploads/2005/09/Article-Liquidated-damages.pdf)

> *the parties have expressed their agreement that this remedy should not be available in respect of breaches of that particular contract by the court after breach, so that they remain unliquidated until so determined…"*

The 2 most well known cases on the topic are:

- ***Temloc Ltd v Errill Properties Ltd*** (1988) 39 BLR 34; and
- ***Baese Pty Ltd v RA Bracken Building Pty Ltd*** (1990) 6 BCL 137.

The English Position: Temloc

The English case of ***Temloc*** suggests that where the parties have agreed on a rate of LDs (irrespective of the quantum of the rate- even a rate of "nil") and the contract makes it clear that the means of compensating the Principal's expectation is by way of LDs, the Principal cannot elect to recover unliquidated damages.

Whilst the English Courts apply the general principles set out above, a more fundamental rule of law has emerged to the effect that LDs clauses constitute an exhaustive remedy, regardless of whether a positive or NIL rate has been stated in the contract.

In ***Temloc***, clause 24 of the contract provided that the Contractor would be liable to pay LDs to the Principal at the rate stated in the Appendix if it failed to complete the works by the completion date. Inserted in the Appendix beside the reference to clause 24 was "£NIL". The works were delayed and a dispute followed, part of which concerned the Principal's claim for general damages arising from the Contractor's failure to complete on time. The Contractor argued that it was not liable for general damages for delay as the parties had agreed in the contract that LDs would be NIL, and that this left no room open for the Principal to make an alternative claim for general damages.

The Court of Appeal agreed. Nourse LJ at p 13 said:

> "*…I think it is clear, both as a matter of construction and as one of common sense, that if (1) clause 24 is incorporated in the contract and(2) the parties complete the relevant part of the Appendix, either by stating a rate at which the sum is to be calculated or, as here, by stating that the sum is to be NIL, then that constitutes an exhaustive agreement as to the damages which are or are not to be payable by the contractor in the event of his failure to complete the works on time… The damages payable in respect of late completion of the works are one head of the general damages which may be recoverable by an employer for the contractor's breach of a building contract. Their character is not in any way altered according to whether the rate at which they are payable is agreed by the parties in advance, so that they become liquidated, or determined by the conduct after breach, so that they remain unliquidated until so determined…*"

The English Courts have consistently approved of and followed the reasoning in ***Temloc*** in subsequent decisions (see ***Surrey Health Borough Council v Lovell Construction Ltd*** (1988) 42 BLR 25 at 37, ***Pigott Foundations Ltd v Shepherd Construction Ltd*** (1993) 67 BLR 48 at 67-8, ***Chattan Developments Ltd v Reigill Civil Engineering Contractors Ltd*** (2007) EWHC 305 (TCC, Ramsey J at para 29-31) and ***Biffa Waste Services Ltd & Anor v Vanguard Industrial Ltd & Anor*** (2008) EWHC 6 (TCC, Ramsey J at para 108-119)).

The Australian Position: Baese[19]

In contrast to the English cases, the Australian Courts have approached the issue of "$NIL" LDs clauses with a great deal more caution.

[19] The rationale of ***Baese*** has been criticized by the case note editor in (1990) 6 **Building and Construction Law** 137, the editorial team in (1991) 52 **Building Law Reports** 130. 131-3; Stephen Furst and Vivian Ramsey **op cit** 280; and Trevor Thomas **op cit** 93.

Giles J in the NSW Supreme Court undertook a different analysis to ***Temloc***, in the ***Baese*** case. In that case the rate for unliquidated damages was "nil". Giles J did not find ***Temloc*** persuasive and said each case needs to be considered in the light of the particular terms in the contract.

Giles J distinguished ***Temloc*** and held that the clauses in the contract which established the Principal's entitlement to claim LDs were discretionary rather than mandatory in nature, so that the Principal could in effect choose to ignore them and claim general damages.

Giles J analysed the JCC B contract and concluded there was no intention for LDs to be exhaustive. He concluded unliquidated damages were recoverable.

In ***CS Phillips Pty Ltd v Baulderstone Horaibrook Pty Ltd*** (unreported) NSWSC, 20 October 1994, Giles J held that where the parties to a contract completed the rate of LDs in the contract particulars as being "Not Applicable", this was sufficient to evidence an intention that no damages, whether liquidated or unliquidated, would be applicable.

The most recent Australian case is ***J Corp v Mladenis*** (2009) WASCA 157 where clause 11.9 of the contract provided for LDs of $NIL per day.

The Court of Appeal was not convinced that this operated to exclude the Principal's right to claim common law general damages for delays in completion caused by the Contractor.

In delivering the judgment of the Court, Newnes JA emphasized the importance of the general principles set out above when approaching the question of how to interpret LDs clauses, particularly those which provided for a NIL rate of damages.

> "*…whether the effect is to exclude any damages from being payable in the event of a breach or simply to exclude LDs must depend upon the proper construction of the contract as a whole. And it is trite law that great caution must be exercised in seeking to apply the meaning given to a word or words in one contract to the same word or words in a different contract…"* (para 19).

His Honour considered the ***Gilbert Ash*** case and said:

> "*…I am unable to find in the contract any clear words expressing an intention that the respondents are not to be entitled to claim unliquidated damages for delay. I do not regard clause 11.9 as constituting clear words to that effect. Clause 11.9 in its terms simply provides that no amount shall be payable by the appellant by way of LDs…"*(para 47).

In ***Silent Vector Pty Ltd t/as Sizer Builders v Squarcini*** (2008) WASC 246, the defendant property developer entered into a contract with the plaintiff, builder using AS2124-1992 for the construction of a 12 storey apartment building. Disputes arose and were referred to arbitration. The defendant made a claim for general damages for delay in completion of the project by the date <u>for</u> practical completion. The plaintiff argued that because the parties had written "N/A" in the contract details as the agreed rate for LDs, that as a matter of law, the defendant was not entitled to general damages for delay. The arbitrator determined the issue as a preliminary point in favour of the defendant.

On an application for leave to appeal from the decision of the Arbitrator the Court considered the cases and identified the competing constructions of LDs clauses in building contracts where "NIL" and "N/A" had been considered.

Jenkins J held that in determining which meaning is to be ascribed to the contract, the terms of the contract must be scrutinized with care. Her Honour could find no error in the way the Arbitrator had gone about the task.

The Court distinguished ***Baese, Temloc*** and ***Phillips Pty Ltd v Baulderstone Hornibrook Pty Ltd*** on the basis of the different contract wording.

Her Honour found that because of the way the standard form had been amended, allowing the Court to determine the case was unlikely to add to the certainty of commercial law. This meant that the plaintiff did not reach the threshold under the Act for obtaining leave to appeal from the Arbitrator's decision.

What is the effect on LDs by ordering variations after the date for practical completion?

The ordering of variations by the Superintendent after the date for practical completion may prevent the recovery of LDs. This situation arose in ***SMK Cabinets v Hili Modern Electrics Pty Ltd*** [1984] VR 391, where variations were ordered by the Principal after the stipulated date for practical completion. These variations delayed the completion of the works. There was no extension of time clause in the contract, other than a clause which provided for an extension of time for inclement weather. The LDs clause provided for $35 per day.

The Full Court of the Supreme Court of Victoria held that ordering variations after the date for practical completion where that is the primary cause for the delay in competition will, unless the contract provides otherwise, and in the absence of an applicable extension of time clause disentitle the Principal from recovering LDs which might otherwise have been allowed. This will be the case even if the Contractor, through his own delays, would not have been able to complete the work

on time. However, the Principal's right in respect of LDs already accrued to that point in time will not be affected by the subsequent ordering of variations.

Hollingdale[20] notes that care should be used when applying this case to a particular situation, as there was no extension of time clause for variations. This would be unusual in most construction contracts. Directing a variation without granting a reasonable extension of time in these circumstances would clearly invoke the prevention principle and disentitle a principal from recovering LDs under the contract.

What is the effect of termination of the contract on the LDs provision?

Termination of a contract will bring a Principal's right to LDs to an end. (***British Glanzstoff Manufacturing Co Ltd v General Accident Fire & Life Assurance Corp Ltd*** (1913) AC 143).

Any right to LDs accruing before termination of the contract may be enforced by the Principal (***Hyundai Heavy Industries Co Ltd v Papadapolous*** (1980) 1 WLR 1129.

LDs and government contracts[21]

One of the tests for determining whether a LDs clause is valid is whether it could be said that the amount specified in the clause is a genuine pre-estimate of the loss flowing from the particular breach that triggers the clause. The courts apply this test as at the time of contract formation so that it is necessary to be able to show that some

[20] Michael Hollingale, **op cit** 418

[21] See generally **Government Contracts** (4th ed) by N. Seddon p 12-14.

attempt was made to calculate the amount at the time of drafting the contract. If this test cannot be satisfied then the clause is vulnerable to being struck out as a penalty.

In many government contracts making this calculation is difficult or, in some cases, impossible. For example, if the contract is to provide human services to third parties how can a breach that adversely affects the third party be said to cause any loss to the government? If the contract is for providing goods or services to the government, the calculation may be difficult because of the peculiar nature of government functions and tasks. Loss of profit is almost never a basis for calculating government damages. If a navy ship is delivered late, what price can be put on lack of defence preparedness?

The Clydebank case may be of interest here (***Clydelbank Engineering & Shipbuilding Co v Don Jose Ramos Yzquierdo y Costeneda*** (1905) AC6). There a contract for the construction and delivery of 4 torpedo boats for the Spanish Navy provided for payment of £500 per week (expressed to be a "penalty") for each week of delay beyond the agreed date for the delivery of each ship. In quite trenchant language the House of Lords negated the idea that the obvious difficulty, amounting to practical evidentiary impossibility, of estimating the likely actual loss from delayed performance by the Shipbuilding Company, stamped the stipulation as a penalty.

Tom Hughes QC[22] notes that an interesting sidelight on ***Clydebank*** was the rather absurd argument put on behalf of the shipbuilder by a team of 3KCs and 2 juniors: it was that the relevant shipbuilding program was undertaken in the context of the Spanish- American war of 1898. Had the ships been delivered on time, so it was submitted (report at p. 12), they would probably have gone to the bottom of the ocean

[22] Tom Hughes AO Q.C, "*Contractual Penalties*", Dec 2005-Feb 2006 **Commercial Law Quarterly** 31 at 33

under the superior fire power of the US Navy. Therefore the LDs were extravagant. In his own inimitable fashion, Lord Halsbury dismissed this argument with his customary pithiness:

> *"My Lords, I confess after some experience, I do not think I ever heard an argument of that sort before, and I do not think I shall often hear it again, Nothing could be more absurd than such a contention."*

Seddon notes that the courts have responded to this problem by recognizing the difficulty and waiving the genuine pre-estimate requirement in government contracts when it is impossible to make such an estimate. This does not mean that the courts no longer regulate LDs clauses in government contracts. The agreed damages must still not be unconscionable in amount. But the genuine pre-estimate test will not be applied where it is impossible to apply.

In ***State of Tasmania v Leighton Contractors Pty Ltd (No 3)*** (2004) TASSC 132 (Cox CJ) a LDs clause relating to late delivery of a public road was challenged by the Contractor. The clause provided that the Contractor was to pay the Principal $8,000 per day for each day of delay. At the trial evidence was given as to the calculation of the LDs daily sum. The calculation included an estimate of actual direct costs to be incurred by the Principal in the event of delay but did not include any loss by way of interest on the Principals outlay.

Cox CJ held at paragraph 241 after reviewing the relevant authorities, that the LDs clause was a penalty and concluded that:

> "*… 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 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 $8,000 for each calendar day of delay was not a genuine pre-estimate of the likely damage to the State resultant upon the late opening of the bypass and is unconscionable…"*

The Full Court (***State of Tasmania v Leighton Contractors Pty Ltd*** (2005) TASSC 133) overturned the findings of Cox CJ and held (para 31):

- *" The figure of $8,000 was not arbitrarily chosen and the calculation could not be said to be non-genuine. The Full Court recognised that the calculation involved a projection of costs two years into the future;*
- *although Cox CJ recognised that "loss of revenue by reason of the delay is not in itself a proper reason for claiming that the State could suffer no damage other than … direct costs" he gave it no weight. The Full Court was of the view that some component of loss of public utility or access to infrastructure ought to have been considered as a category separate to actual direct costs;*
- *an interest component which had been identified would provide a guide or confirm the approach suggested in (ii) above;*
- *another formula could have been used by the principal's advisors including:*

(a) the cost of maintaining the existing road;
(b) infrastructure costs; or
(c) costs of transfer of resources during the delay period;

- *Cox CJ had not engaged in an assessment of past loss or an award of damages after the event."*

The Full Court held at paragraph 31(5):

> *"…The question was whether, given the nature of the contract, its complexity, value and the bargaining strength of the parties, the amount of $8,000 was, in all the circumstances, a penalty as at the date of the agreement. The test was objective as of that date. The test was whether as of 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 "LDs" but operated as a penalty which placed the then contracting party in terrorem. The contract was for*

> *an amount of $30M with the potential for complexity, delay and potential cost variations, all matters shown at trial to be real…"*

The Tasmanian Full Court stressed that in government contracts it is not necessarily appropriate simply to attempt to add up the costs of delay by reference to daily costs of keeping personnel and contractors on the job:

> "*Some component for loss of public utility or delay in access to infrastructure ought to have been considered [by the trial judge], not in the evaluation of the components of the 'direct costs', but as a separate matter…"*(paragraph 31(2))

The case shows that government agencies can legitimately include factors such as the value of the loss of public infrastructure and accountability for expenditure of taxpayer's money in assessing the probable loss to be suffered as a result of breach.

Accepting these circumstances, the Full Court held at paragraph 38 that the State still had a responsibility to be accountable for how public monies were spent and was, therefore, entitled to require reasonable compensation for delay and the inability of the public to use the infrastructure in question. Their Honours stated that, in considering whether damages for a breach ought to be regarded as a penalty, the test of disproportionality applied equally to public and private institutions and that the provision of public money does not change the character of the compensatory provision into one of penalty simply because the expenditure is paid by another public authority. The Full Court therefore held that factors such as the value of the public's inability to use the road and delays in access to public infrastructure were relevant considerations in determining the State's loss as a result of the delays.

According to Seddon, this means that, in deciding on a sum for the purpose of a LDs clause in a government contract, it is legitimate to arrive at an amount which cannot strictly be justified as a genuine pre-estimate but which nevertheless performs the

function of trying to ensure that the contractor delivers on time. Of course, if a financial measure can be used, it should be (such as the cost of capital tied up) but the entire sum does not have to be justified by reference to financial measures in a public project.

Sedden[23] notes that the special exemption in government contracts from the requirement of making a genuine pre-estimate for the purpose of an LDs clause when it is impossible to do so is of some importance because the use of contracts by governments raises some difficult problems of enforceability. The use of such a clause may be one measure for enhancing the enforceability of a contract that otherwise would not be enforceable through an action for damages because damages could not be assessed.

What if there is a breach of contract but no damage:
(i) loss need not be suffered;
(ii) LDs do not need to be proved.

It is only one step from the principle that LDs can be recovered without proof of loss to the principle that they can also be recovered even when it is apparent there has been no loss. Why should the contract-breaker be excused from his promise to pay damages by inquiry or reference into the circumstances of the innocent party?

The issue came up in the often cited UK case of ***BFI Group of Companies Ltd v DCB Integration Systems Ltd*** (1987) CILL 348. DCB, the contractor, carried out alteration and refurbishment work at BFI's transport depot. BFI was given possession on the extended date for completion but it was another six weeks before roller shutter doors were installed. BFI utilized this time to fit out the premises and did not suffer

[23] N Sedden, **op cit** 14

any delay in commissioning or any loss of revenue. Various disputes went to arbitration and on the matter of delay the arbitrator held there was a delay in completion but he declined to award LDs on the grounds that BFI had suffered no loss. The case went to appeal where it was argued for the contractor that provisions for LDs presupposed some loss and served only to quantify such loss. Where it was found there was no loss they should not apply. Judge Davies rejected this argument and accepted it was irrelevant to consider whether there was any loss; the LDs provision worked automatically once breach was established.

When LDs are a genuine pre-estimate of loss or a lesser sum it is fundamental that loss does not have to be proved to obtain recovery. Providing they are within the terms of a binding contract the courts will not allow a challenge on the basis that loss cannot be proved.

The parties to a contract are bound by its terms and the courts will enforce those terms except where they are penalties or they are caught by other legal impediments. The courts will not alter the contract the parties have made for themselves.

What if the LDs sum is an underestimate of the actual loss suffered?

A LDs clause will not be struck down if the LDs are not a genuine pre-estimate solely because the amount is in fact grossly underestimated.

Diestal v Stevenson (1906) 2 KB 345 concerned an agreement for the sale of coal which provided that the seller was entitled to be paid one shilling for every ton of coal either not delivered or not accepted by the buyer. In an action for breach of

contract due to failure to deliver the coal, notwithstanding that the seller had suffered actual damages in excess of the amount stipulated in the contract, the seller was held to be entitled to recover only the liquidated amount.

A similar situation occurred in ***Cellulose Acetate Silk Co Ltd v Widnes Foundry*** (1925) Ltd (1933) AC 20. Cellulose (principal) engaged Widnes (contractor) to build an acetone recovery plant, The plant was a small part of a larger plant for the manufacture of artificial silk.

The parties agreed that the contractor was to be liable to pay LDs in the sum of £20 per week in the event completion was not achieved by the date for completion.

Completion was 30 weeks late. The principal claimed that its actual losses were £5850 and sought to recover these by way of general law damages rather than the LDs amount set out in the contract.

The House of Lords considered that the parties had turned their minds to the considerable consequential loss the contractor could be exposed to for delay and agreed to limit the contractor's loss to the amount of the LDs.

The House of Lords held that the principal was only able to recover £600, being the amount ascertainable by reference to LDs.

These two cases suggest that, where a LDs regime is enforceable and entitles the Principal to recover some quantum of damages notwithstanding that the quantum may be significantly less than the Principal's actual loss, the Principal cannot elect to recover general damages instead of LDs.

Burden of proof that LDs are a penalty

It is well established that the burden of proving that a stipulated sum is a penalty and not LDs rests on the party making the challenge (see Lord Diplock in ***Robophone*** at p 128, ***Murray v Leisureplay*** (2005) EWCA Civ at para 96 and ***State of Tasmania v Leighton Contractors Pty Ltd*** (2005) TASSC 133 at paragraph 42) .

Some recent decisions

Zachariadis v Allforks Australia Pty Ltd [2009] VSCA 258

The Court of Appeal decision in ***Zachariadis*** has reviewed the test applying to LDs clauses. Specifically, the court has confirmed the approach to deciding whether a clause providing for payment of a monetary sum upon breach of contract is valid as a LDs clause, or void as a penalty.

The case provides a timely reminder for parties negotiating contracts to ensure that LDs clauses truly represent a genuine pre-estimate of the innocent party's loss in the event of a breach of contract. Clauses which apply in a variety of circumstances (e.g. for any breach, however trivial) are likely to fall foul of the law relating to penalties.

Where possibly, it is good practice to agree on a formula for calculating the likely loss. This formula can provide for matters otherwise not known to the defaulting party, e.g. costs that the innocent party would incur as a result of the breach under its own hire purchase agreement with a financier.

In ***Zacharladis*** the Court upheld an appeal from the County Court, holding that a LD clause in a hire agreement was void as a penalty.

The clause in dispute provided that if the hire agreement was terminated for, among other things, any breach of the agreement by the hirer, then the hirer '*shall … pay to Allforks all Hire Charges that would otherwise have been payable from the date of termination of … to the Expiry Date'*.

The Court of Appeal held that the clause was a penalty. In doing so, it confirmed that the relevant test is the '*out of all proportion test*'. Under this test, a clause will be a

penalty if the amount payable on default is 'extravagant and unconscionable' or 'out of all proportion' to the greatest loss that might flow from the breach.

The court also confirmed that the '*out of all proportion test*' is to be applied by reference to the circumstances existing at the time the agreement was made, not at the time of the breach. Accordingly, it is not permissible for the court to compare the actual loss suffered with the amount payable pursuant to the clause.

The court held that the relevant clause was a penalty because:

1. It did not provide a means of calculating the net loss that Allforks would suffer if the hire agreement was terminated early.
2. The parties would have had no difficulty in drafting a clause which provided a formula for a pre-estimation of the loss likely to be suffered by Allforks if the agreement was terminated early. The court distinguished an earlier decision (***Yarra Capital Group Pty Ltd v Sklash*** [2006] VSCA 109) where a clause in a short term loan agreement between money lenders which provided for payment of default interest at a very high rate on default was held not to be a penalty. It was relevant to this finding that it would have been an extremely complex and expensive exercise to establish, with any sort of precision, what damage was likely to flow as a result of a failure to repay the principal on the due date. This was because the parties operated in the short term money market where the cost of borrowing was very high.

3. The clause operated when the hire agreement was terminated for 'any' breach no matter how trivial. The court observed that some breaches would produce little, or no, loss but if breached and the agreement terminated as a result, would render the hirer liable to pay the whole of the outstanding rent. The court said that '*the lack of any relationship between the breach and the amount*

payable under [the] clause … indicates that the clause was not a genuine pre-estimate of loss'.

Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd (2008) NSWCA 310[24]

In ***Interstar*** the Court of Appeal confirmed that a clause that provides for the payment of a sum of money may only be a penalty clause if it is expressed to operate upon a breach of contract.

The case is important because of its analysis of the relationship between the law of penalties, relief against forfeiture and the doctrine of freedom of contract.

The High Court granted special leave to appeal in May 2009 but the parties settled before the hearing and so the Court of Appeal decision will stand as a significant authority on these issues.

Two Interstar companies were in the business of lending money on the security of mortgages. Two companies Intergral were "mortgage originators" i.e. they found people seeking loans and brought them to Interstar, who loaned them money. They then managed the ongoing servicing of the loans. The parties had entered into two written agreements to regulate their relationship i.e. the Loan Originator and Management Agreement (**LOMA**). The agreements were substantially similar, they

[24] See Elizabeth Peden, *"Penalty clauses and what would the High Court have made of Interstar Wholesale Finance Pty Ltd v Integral Home Loans"* (2009) **Commercial Law Quarterly** 6, see also Peter Mulligan and Corrie Neal, "The law of penalties under the microscope" (2009) 47 **Law Society Journal** 42.

were just entered into between different parties on each site. The primary difference was the way the respondents were paid.

Pursuant to LOMA1 the respondents were paid on "originators fee" for each loan that was settled (also known as a "trailing commission"). The amount was calculated as a percentage of the loan amount from the settlement until the loan was discharged and the amount was paid periodically.

Under LOMA2 the respondents were paid an upfront fee based on the loan amount, and in addition an "originator's fee" calculated as under LOMA1.

On 17 March 2006 Interstar terminated both agreements by exercising a right of termination provided in clause 20.1(c) of each of the agreements. This clause entitled Interstar to terminate the agreement immediately if it considered "*in its reasonable opinion that the originator or originator's representative had engaged in deceptive or fraudulent activity in relation to an Application or Settled Loans*".

The LOMAs further provided in clause 20.3(c) that on termination pursuant to clause 20.1(c) the respondents were no longer entitled to the trailing "originator's fee" under the agreements.

If the agreements were terminated for other events the respondents would not have "lost" the trailing "originator's fee" following termination. However, Interstar would have been entitled to adjust the trailing "originator's fee" for its reasonable costs of organizing alternative administrations of the loans.

Integral commenced proceedings claiming that clause 20.1(c) was void because it operated as a penalty and therefore the originating fee continued to be payable.

At first instance, Brereton J held in favour of Integral that clause 20.1(c) was unenforceable as a penalty.

The Court of Appeal overturned that decision and held in favour of Interstar that clause 20.1(c) was not a penalty.
The Court of Appeal considered three main arguments:

The proper construction of the agreements

The Court held that the originator's fee was not earned by Integral until the consideration for it was undertaken. The consideration included the ongoing management by Integral of the loans which it had originated.
On termination of the agreements, Integral was relieved of its ongoing responsibilities under the agreements, including the management of loans. This meant that on termination Integral had not earned or fully accrued the originator's fee.
The Court therefore found that there was no need to consider whether clause 20.3(c) operated as a penalty because there was no forfeiture of fully earned property so as to engage the law of penalties.
This was enough to support a finding in favour of Interstar.

The law of penalties

The Court considered whether the law of penalties would invalidate clause 20.3(c) if it was incorrect in its finding that the originator's fee had not been earned or fully accrued.
The Court found that clause 20.3(c) may be a penalty even though it does not require the payment of money, but rather a transfer of property.

The Court assumed that the law of penalties can apply to the forfeiture of rights or property. However, the Court at paragraph 104 expressed some doubt when noting that "*the relationship between penalties and relief against forfeiture at this point becomes less than pellucid*".

If the law of penalties does extend beyond the payment of money to the forfeiture of rights and property, there appears to be a blurring or overlap between the two doctrines.

The Court found that it was constrained by precedent to limit the application of the law of penalties to breach of contract. However, it recognised that there is some inconsistency in the authorities and if a wider doctrine is to be enunciated then "*it is for the High Court of Australia to enunciate it…"* (paragraph 106).

In finding that the law of penalties only applies in respect of a breach of contract, the Court relied on the High Court decision of Walsh J in ***IAC (Leasing) Ltd v Humphrey*** (1972) 126 CLR 131 and the decisions of Mason and Dawson JJ in dissent in ***AMEV-UDC Finance Ltd v Austin*** (1986) 162 CLR 170.

On these bases, the Court held that even if the originator's fee had been earned or fully accrued, clause 20.3(c) was not a penalty clause. Interstar had terminated the agreements under clause 20.1(c) on the basis that it had formed the "*reasonable opinion*" that Intergral had engaged in deceptive or fraudulent activity. This was in the nature of an event, not a breach of contract.

It is to be noted that the agreements also included a provision in clause 6.2(h) that Integral "*act honestly in its dealings with all parties and not engage in misleading, deceptive or unethical conduct*".

If Interstar had terminated for breach of this clause then the law of penalties may have applied.

Were the consequences extravagant?

The Court went on to consider whether, if it was incorrect in its findings, the consequences for Integral was that it would suffer a penalty.

The Court noted that if Integral had actually engaged in deceptive or fraudulent activity, the damages that could have been caused to Interstar (i.e. to its business reputation) could have been significant.

In addition, significant damage could have been suffered even if, despite the fact that there was no actual deceptive or fraudulent activity there had been a reasonable foundation for an opinion that Integral had engaged in deceptive or fraudulent activity.

Accordingly, the consequences in clause 20.3(c) were not "*extravagant and unconscionable*" and so the provision was not void as a penalty.

The Current High Court Position[25]

The applicable principles for distinguishing between an enforceable LDs clause and an unenforceable penalty clause were restated by the High Court in ***Ringrow v BP Australia*** (2005) 224 CLR 656 where the court once again adopted the long established legal principles set out in ***Dunlop***.

[25] Elizabeth Peden & J W Carter, "*Agreed damages clauses – Back to the future?*" (2006) 22 **Journal of Contract Law** 189, J W Carter & Elizabeth Peden, "*A good faith perspective on liquidated damages"*(2007) 23 **Journal of Contract Law** 157; and David Wright, "*Relief from contractual penalties"*, (2006) **South Australian Law Society Bulletin** 16

The facts of the case are as follows:

On 27 May 1999, Ringrow Pty Ltd (**Ringrow**) entered into a contract with BP Australia Pty Ltd (**BP**) to buy a BP service station. Ringrow (or persons connected with the company) had operated a service station on the site as franchisee since 1988.

On completion of the contract, the parties entered into two related transactions – an Option Deed and a Privately Owned Sites Agreement (**POSA**).

A term of the POSA was that Ringrow would only purchase fuel from BP. The Option Deed applied if the POSA "*was terminated*" but in such an event BP was granted an irrevocable option to purchase the service station at its market valuation as an operational service station as determined by an independent valuer.

However, clause 25.2 of the Option Deed provided that the valuer was "*not to include in the determination of the market valuation any allowance for goodwill*" attached to the business.

The POSA had a term of five years and allowed for LDs in the event of breach reflecting the expected return to BP under the POSA over a five year period of $289,531. The POSA provided that if the POSA was terminated in the first year, the sum of $289,531 would be payable, if in the second year, 80% of that sum and so on.

At various times in 2002 Ringrow purchased fuel from a supplier other than BP. This was a breach of the POSA and BP gave notice of termination of the POSA, followed by a notice of exercise of the option to purchase the service station.

Ringrow argued that the option was void and unenforceable as a penalty.

At first instance, Ringrow failed in the Federal Court before Hely J and unsuccessfully appealed to the Full Court. Ringrow then appealed to the High Court.

Before embarking on a consideration of the arguments on appeal the High Court said at page 663:

> "*…Neither side in the appeal contested the foregoing statement by Lord Dunedin of the principles governing the identification, proof and consequences of penalties in contractual stipulations. The formulation has endured for 90 years. It has been applied countless times in this and other courts. In these circumstances, the present appeal afforded no occasion for a general reconsideration of Lord Dunedin's tests to determine whether any particular feature of Australian conditions, any change in the nature of penalties or any element in the contemporary market place suggest the need for a new formulation. It is therefore proper to proceed on the basis that Dunlop continues to express the law applicable in this country, leaving any more substantial reconsideration than that advanced, to a future case where reconsideration or reformulation is in issue…*"

Ringrow argued that there were three penal factors in the contractual arrangements between the parties:

The exclusion of goodwill from the resale price (page 663-4, and 666-7)

- The expert witness called by BP gave evidence to the effect that sources of goodwill other than location in relation to the particular service station were of insignificant value. The trial judge accepted this evidence.
- The result was that even though Ringrow had paid for goodwill on entry and was not entitled to be paid for goodwill on sale, it was not possible

to say what, if any, money sum it had lost. Hence it was not possible to say there was a penalty.

- A difference was not sufficient. In the words of Lord Dunedin, the difference had to be "*extravagant or unconscionable*" or the degree of disproportion had to be sufficient to prove oppressiveness.

The cumulative impact of the option upon the liability to pay LDs (ie: the proportionality argument) (page 665-7):

- In essence, Ringrow argued that there would be a penalty if BP repurchased the service station following exercise of the option and also claimed LDs.
- BP pointed to clause 1.2(e) of the POSA which provided that if BP exercised its rights under the Option Deed, then LDs would not be payable. Ringrow countered that BP could claim LDs and then exercise the option, giving rise to a "double" recovery.
- The Court held that since there was no evidence of the value of any goodwill it could not be said that the cumulative impact of the option on the LDs claim was oppressive or "*extravagant or unconscionable*".
- Ringrow had argued that there must be proportionality between the impugned provision and the legitimate commercial interest of the party relying upon it. If there is a manifest disproportion, the stipulation is presumptively a penalty.
- The High Court held that no such doctrine of proportionality existed. Instead the Court confirmed the test proposed by Lord Dunedin i.e. the propounded penalty, must be judged "*extravagant or unconscionable*".

"The indiscriminate factor" i.e. the right to exercise the option was unrelated to the extent or gravity of any contractual default by Ringrow (p 665 and 669)

- The Court agreed that the option could be exercised after termination of the POSA for mere technical breaches. However, this was only one factor to be considered. Ringrow did not demonstrate that the disparity between what BP was to receive on retransfer of the service station and a genuine pre-estimate of damage was so great as to trigger the penalty doctrine.

In the result the appeal was dismissed and the High Court confirmed the traditional approach to penalties and emphasized the parties' right to freedom of conduct. The decision provides certainty to this area of the law and also provides valuable insights as to how the doctrine operates in practice. The decision provides a useful guide for the construction and interpretation of LDs clauses.

Conclusion

As the law currently stands, ***Dunlop*** is still the principle Australian authority on the law of penalties. Establishing a mere disparity between the loss suffered due to breach and the amount of damages stipulated for the breach is not sufficient to amount to a penalty. The stipulated damages must be out of all proportion to the loss actually suffered, or, as otherwise worded, disparate to a degree of disproportion sufficient to point to oppressiveness.

As was noted by the Full Court in ***State of Tasmania v Leighton Constructions*** (2005) TASSC 133 at para 23, the High Court in ***Ringrow*** was presented with an opportunity to reconsider the approach to penalties established in ***Dunlop***. The High Court was of the view that such a consideration was not appropriate. The

High Court recognised, however, that it was foreseeable that the principles governing the law of penalties may need to be reformulated in a future case in the light of Australian conditions, "*the nature of penalties or any element in the contemporary marketplace*".

Tips on drafting and designing effective LDs clauses[26]

Some useful points to remember are:

(i) the LDs clause should be a genuine pre-estimate of the likely loss. There is a presumption that a single lump sum is a penalty;

(ii) the LDs clause should be certain and should specify:

(a) the amount of LDs payable or recoverable or the formula to be used to calculate the amount of LDs payable or recoverable;

(b) where applicable, the date from which the LDs are payable;

(c) where applicable, the date until which the LDs are payable;

(d) the payer and payee of the LDs;

(e) the time at which the LDs are payable or recoverable; and

(f) any rights of set off.

(iii) the contract should deal with the prevention principle. Where LDs are payable due to delay in completion, the contract should also include an effective extension of time clause;

(iv) where there are several LDs clauses in the contract, it should be clear that each clause compensates for a different and separate head of damage. If the damages are cumulative it is likely the clause will be found to be a penalty;

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[26] See: Michael Hollingdale, "*Designing & Enforcing LDs Clauses to Maximise Recovery*" (2005) 21 **Building and Construction Law** 412; G Golvan Q.C **op cit** p 6-7; Georgia Quick & Jennifer Thomas, "*Liquidated Damages for Delay – 10 points to remember*", Clayton Utz, **Project Insights**, 2 April 2007; and Patricia Wade, "*Outside the penalty box? The latest on liquidated damages*", **Ashurt London**, Commercial Contracts Brifing, December 2008

(v) if it is the intention of the parties that the LDs clause is to survive termination of the contract, this must be expressly stated, as without such an express statement the right to LDs will end on termination of the contract;

(vi) LDs clauses provide certainty to both parties, provide incentives to performance and facilitate the recovery of damages without the difficulty and expense of proof, but they need to be properly drafted to be effective;

(vii) ensure that the LDs calculation agreed upon by the parties is a genuine and reasonable pre-estimate of the losses likely to be suffered upon a breach;

(viii) keep a record of the basis of any calculation or rate and any supporting material;

(ix) incorporate recognition of the parties' relative bargaining power;

(x) ensure that the LDs clause is not void for uncertainty;

(xi) avoid cumulative calculations of the LDs in staged completion contracts;

(xii) set out the contractor's entitlement to claim extensions of time;

(xiii) avoid waiver issues;

(xiv) enable pass through to subcontractor;

(xv) ensure that adequate security is in place; and

(xvi) take care using the word "nil" in completing standard form contracts.

Richard Manly S.C.

Chancery Chambers

8 April 2010