The Rule Against Penalties – Legal Rule

A penalty is an obligation that arises under a contract that required a party to pay a sum, or give up a right, or take on an obligation on the occurrence of an event.

Liquidated Damages

- The liquidated damages clause shifts the onus of proof and provides a formula for calculating the quantum that reduces the cost to the claimant. – Boucaut Bay Co Ltd v Commonwealth
- Now D must prove conduct didn’t occur or that it’s a penalty etc.

Boucaut Bay Co Ltd v Commonwealth – Per Isaacs J

The mere fact a sum is stated to be forfeitable on the happening of various events is not conclusive of either a stated penalty nor liquidated damages because what the court has to do is determine whether the intention of the parties was that it should constitute liquidated damages. All the elements and circumstances are looked at.

Liquidated Damages can be used to protect:

- An income stream
- The value of an asset
- Performance of obligations under the contract: The Protector Endowment Loan Co v Grice (1880)

Fairness, Consideration & Proportionality

The CL provides that contracts can be formed by:

- 1 person unilaterally making a promise in a formally binding way (trusts)
- 2 people entering an agreement in which there is an exchange of consideration

There is no requirement that the consideration be ‘fair’ or ‘proportionate’: Ringrow Pty Ltd v BP Australia Ltd (2005)

A right to recover the full amount/value of the contract is enforceable, it must not provide a windfall, or other added benefit: The Protector Endowment Loan Co v Grice (1880)

So What is a Penalty?

A penalty is an amount provided in a liquidated damages clause that is intended to punish the party who breaches the agreement: Dunlop Pneumatic Tyre Co Ltd v New Garage Motor Co Ltd [1915]

Who has the burden of proving it’s a penalty?

The burden on showing the debt is a penalty is on the person trying to escape the debt or clause: Multiplex Constructions Pty Ltd v Abgarus Pty Ltd

The Test for a penalty

The established test for a penalty was laid down in Dunlop Pneumatic Tyre Co Ltd v New Garage Motor Co Ltd and affirmed in Ringrow Pty Ltd v BP Australia Ltd (2005)
Facts:
- Dunlop was a manufacturer of tyres sold through dealers
- New garage entered into agreement with Dunlop to become a supplier of the tyres to the public
- Agreed not to sell tyres for price lower than those set by Dunlop. New garage broke the agreement
- There was a 5 pound penalty for every time this happened which at the time was a significant amount of money. Dunlop tried to apply the term.

Held: per Lord Dunedin

outlined four important principles to be considered by the Court in determining whether a contractual clause is a penalty and thus unenforceable:

1. The use of the words “liquidated damages” or “penalty” in a contract will not definitively conclude that the particular clause is penal in nature and therefore unenforceable. It is only an indicative measure which the courts should give consideration to.

2. The essence of a penalty is a payment of money in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage (Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzuierdo y Castaneda)

3. The assessment of the clause and whether it constitutes liquidated damages or is a penalty is one of construction and the court must consider the individual circumstances of each contract at the time it is formed between the parties and not at the time when it has been breached.

4. To assist the Court in assessing the construction of the clause four aspects/tests should be examined:

   a. If the sum specified in the liquidated damages clause is extravagant or unconscionable when compared to the greatest loss that could conceivably be proved to follow, then it is a penalty (Clydebank Engineering)

   b. If the sum specified to be paid in the liquidated damages clause is greater than that ought to have been paid, then it is a penalty.

   c. When a single lump sum payment is payable on the occurrence of one or more events which may occasion serious damage and others only trifling damage, there is a presumption that it is a penalty.

   On the other hand

   d. If it is a genuine pre-estimate of damage between the parties, then it is likely not a penalty.

affirmed by the High Court of Australia in the later case of Ringrow Pty Ltd v BP Australia Pty Ltd [2005] as the current law pertaining to the rule against penalties. In Ringrow Pty Ltd v BP Australia Pty Ltd it was determined by the High Court of Australia that:
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.

If the Court determines that a clause is a penalty, the clause will be struck down in its entirety.

The court will also have regard to:

1. The nature of the contract at the time of entering the contract.
   a. The purpose and nature of the contract
   b. The position of the parties to protect their interests: Dunlop; Public Works Commissioner v Hills [1906]

2. The substance of the clause
   a. The name is not determinative: review of which is on the substance not the name: Clydebank Engineering

3. The object of the clause (what is it doing): Robophone Facilities Ltd v Blank [1966]

4. The amount of the penalty/debt
   a. If the clause provides for an extravagant or unconscionable amount in comparison to the amount of likely loss it is likely to be a penalty: AMEV-UDC Finance Ltd v Austin (1988)
   b. When considering the reasonableness of the LD Clause in comparison to actual loss, the freedom of the parties should not be limited lightly: Lordsvale Finance Ltd v Bank of Zambia; Robophone Facilities Ltd v Blank [1966]; AMEV-UDC Finance Ltd v Austin (1988)
   c. Where breach of contract is the failure to pay an amount, a clause requiring payment of more due to breach of a larger amount is a prima-facie a penalty – See Dunlop (4b)

5. The formula and the meaning of valuing the sum: Multiplex Constructions Pty Ltd v Abgarus Pty Ltd

6. The circumstances under which:
   a. The contract is entered
   b. The contract is performed; or
   c. The payment is paid

7. The amount of loss to be effectively estimated at the time of entering the contract: Tasmania v Leighton Contractors Pty Ltd (2005)