

**JOURNAL OF THE
CANADIAN COLLEGE
OF CONSTRUCTION
LAWYERS**

2017

Cited as (2017) 1 J.C.C.C.L.



THOMSON REUTERS®

© 2017 Thomson Reuters Canada Limited

NOTICE AND DISCLAIMER: All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher (Thomson Reuters Canada, a division of Thomson Reuters Canada Limited).

Thomson Reuters Canada and all persons involved in the preparation and sale of this publication disclaim any warranty as to accuracy or currency of the publication. This publication is provided on the understanding and basis that none of Thomson Reuters Canada, the author/s or other persons involved in the creation of this publication shall be responsible for the accuracy or currency of the contents, or for the results of any action taken on the basis of the information contained in this publication, or for any errors or omissions contained herein.

No one involved in this publication is attempting herein to render legal, accounting, or other professional advice. If legal advice or other expert assistance is required, the services of a competent professional should be sought. The analysis contained herein should in no way be construed as being either official or unofficial policy of any governmental body.

A cataloguing record for this publication is available from Library and Archives Canada.

ISBN 978-0-7798-8035-5

Printed in Canada by Thomson Reuters

TELL US HOW WE'RE DOING

Scan the QR code to the right with your smartphone to send your comments regarding our products and services.

Free QR Code Readers are available from your mobile device app store.

You can also email us at feedback.legaltaxcanada@tr.com



THOMSON REUTERS®

THOMSON REUTERS CANADA, A DIVISION OF THOMSON REUTERS CANADA LIMITED

One Corporate Plaza
2075 Kennedy Road
Toronto, Ontario
M1T 3V4

Customer Relations
Toronto 1-416-609-3800
Elsewhere in Canada/U.S. 1-800-387-5164
Fax 1-416-298-5082

www.carswell.com

E-mail www.carswell.com/email

JOURNAL OF THE
**CANADIAN COLLEGE
OF CONSTRUCTION
LAWYERS**

2017

PUBLICATIONS COMMITTEE

Brian Samuels

Editor and Chair

D. Geoffrey Machum, Q.C.

Bernard P. Quinn



The CANADIAN COLLEGE OF CONSTRUCTION LAWYERS is an association of lawyers who are distinguished for their skill, experience and high standards of professional and ethical conduct in the practice or teaching of construction law and who are dedicated to excellence in the specialized practice of construction law.

The JOURNAL OF THE CANADIAN COLLEGE OF CONSTRUCTION LAWYERS is an annual publication that covers a range of construction issues.

Liquidated Damages: Canadian Adoption, Divergence and the Necessity for Restatement

Jeff St. Aubin

Rocco Sebastiano

Editor's Note

Jeff St. Aubin and Rocco Sebastiano have considered a complex set of issues relating to liquidated damages. In light notably of the recent United Kingdom Supreme Court decision in *Cavendish Square Holding BV v. Talal El Makdessi* and of the necessity for a restatement of the law of liquidated damages in Canada, which they demonstrate in this learned text, they identify several of the difficulties inherent in such an endeavour and then provide some thoughtful suggestions as to how it could be accomplished in a coherent and useful manner.

We are reminded of the origin of the penalty rule and of the tension between the penalty rule and the principle of freedom of contract. The authors also consider whether the penalty rule should be abandoned or replaced with the doctrine of unconscionability. Their analysis of *Cavendish* then sets the stage for an affirmation of the need for Canadian courts to reassess their own approach to liquidated damages given the vast amount of legal discussion raised by that decision. From a Canadian perspective, they identify the following issues for judicial consideration and discuss each one in the fifth section of their text:

1. whether the penalty rule should remain operative;
2. the role, if any, that unconscionability should play in the law of stipulated damages;
3. if the penalty rule is to remain operative, then:
 - a. what is the appropriate time of assessment;
 - b. to what extent, if any, should actual damages incurred be relevant; and
 - c. should the *Cavendish* concept of a legitimate interest be adopted.

Given the lack of clarity and the inconsistencies in the Canadian common law at the present time, this article, written for the Journal of the Canadian College of Construction Lawyers, will provide very useful guidance in the interpretation of construction agreements, which often

contain liquidated damage provisions, and well beyond to every legal practitioner wrestling with the issues considered here by the authors, to whom we are very grateful.

1. INTRODUCTION

Stipulated damages¹ are a ubiquitous element of Canadian construction contracts, where such provisions are primarily employed to establish the quantum of damages payable by the contractor in cases of delay, although they are by no means so confined and their application is limited only by the ingenuity of the parties. Construction contracts are well suited to such provisions, as the ventures that they embody are often rife with risks, many of which are unknown at the time the bargain is struck. In addressing these risks, such provisions protect both owner and contractor, by relieving the former from the burden of proof and providing the latter with certainty regarding potential liability.

Many Canadian lawyers consider it axiomatic that a stipulated sum is enforceable as liquidated damages if it is a genuine pre-estimate of damages and unenforceable if it is a penalty. The deceptive simplicity of this distinction has been recognized as a potential reason for the dearth of academic commentary on the subject.² However, the dichotomy between these two measures has never been entirely clear, as recognized in *Astley v. Weldon*,³ where Lord Eldon noted of the jurisprudence that he was “much embarrassed in ascertaining the principles upon which those cases were founded”.⁴ More than eighty years later Lord Jessel, Master of the Rolls, also recognized such difficulty in *Wallis v. Smith*,⁵ where his judgment commenced with the following:

This appeal raises a question of very considerable difficulty, and one as to which it is not impossible that learned Judges may in future differ as Judges have differed in past times.⁶

The law of stipulated damages has been further complicated as a result of a divergent line of Canadian case law that has incorporated the doctrine of unconscionability as part of the analysis. The resulting state

¹ This paper employs the neutral term “stipulated damages” to refer to contractual provisions establishing an amount payable upon breach, whereas the terms “liquidated damages” or “penalty” depend upon or imply a determination regarding enforceability.

² Paul-Erik Veel, “Penalty Clauses in Canadian Contract Law” (2008) 66 UT Fac L Rev 229 at 231. (1801), 2 Bos. & Pul. 346.

³ *Ibid.* at 350.

⁴ (1882), L.R. 21 Ch. D. 243 (C.A.).

⁵ *Ibid.* at 254. Lindley L.J. also noted at 273 that “all the cases on this subject are cases of difficulty”.

of the law has been aptly described “as two distinct yet muddled strands of case law”.⁷

The focus of this paper is on the necessity for a restatement of the law of stipulated damages in Canada and the recommendations for what such a restatement should include. To establish the foundation for this analysis, the initial sections of this paper address the equitable origin of the penalty rule and its development at common law, including the adoption of the traditional doctrine in Canada. From that point, the focus shifts to the divergence in Canadian law from the traditional doctrine and consideration of whether the current path of Canadian courts should be realigned with the traditional doctrine or developed further independently, which may include the abandonment of the penalty rule or its replacement with the doctrine of unconscionability.

This paper includes a discussion of the United Kingdom Supreme Court decision in *Cavendish Square Holding BV v. Talal El Makdessi*,⁸ where the Court recast the analysis in one of the most important decisions on the law of stipulated damages in the last century. The innovations of *Cavendish* are analyzed and considered for Canadian adoption in the final portion of this paper, which sets out the questions to be resolved by Canadian courts and a recommended path forward.

2. THE DEVELOPMENT OF THE LAW OF STIPULATED DAMAGES

2.1 Origin of the Penalty Rule

The penalty rule is an equitable doctrine derived from the Courts of Chancery, which granted relief in relation to defeasible bonds that were otherwise enforceable at common law. These bonds were designed to require the performance of a particular act and achieved this by requiring the payment of a stipulated sum at a certain time but included a condition that the sum did not need to be paid if the particular act was performed.⁹ Over time, the use of defeasible bonds ceased but the principles underlying the penalty rule remained, which prohibited the

⁷ Veel, *supra* note 2 at 231.

⁸ [2015] UKSC 67 [*Cavendish*], heard with *ParkingEye Limited v. Beavis* [*ParkingEye*].

⁹ *Ibid.* at para. 4; S.M. Waddams, *The Law of Damages*, loose-leaf (Aurora: Canada Law Book, 1991), Ch. 5 at 8.40-8.50; Harvey McGregor, *McGregor on Damages*, 19th ed. (London: Sweet & Maxwell, 2014) at 15-003; Mike Demers, “Liquidated Damages and Penalty Clauses — The Road Ahead Post-Tercon” (2011) 1 J.C.C.L. 45 at 47. In *Astley v. Weldon* (1801), 2 Bos. & Pul. 346 at 354 Justice Chambre noted that “[t]he jurisdiction of Courts of Equity in relieving on penalties is of very high antiquity”.

stipulation of an amount to be paid for the primary purpose of securing the performance of an obligation. This doctrine evolved to render unenforceable contractual provisions that required the payment of a stipulated sum in the event of a breach of contract if such sum was penal.

This equitable relief was foisted upon the common law courts by statute at the end of the 17th century,¹⁰ but the common law courts developed the law related to stipulated damages with little reference to this statutory basis. In *Betts v. Burch*,¹¹ Lord Bramwell held that the stipulated damages under consideration fell within statute but noted “[a]s to the authorities, it is remarkable that from the first to the last the statute is not mentioned”.¹² In *Lord Elphinstone v. Monkland Iron and Coal Co.*,¹³ Lord Halsbury recognized this anomaly, and Lord Bramwell’s recognition of it, when he noted:

the learned judges apparently decided that at law as distinguished from equity they were entitled to consider penalty as that which was to be enforced *in terrorem*, without having had called to their attention at all the fact that the Act 8 & 9 William 3, c. 11, existed. It was with reference to that that Lord Bramwell made the not unnatural observation that they had gone right, although they were not aware of the ground upon which at law their judgment could be supported.¹⁴

The modern law of stipulated damages began to take form with the decision of *Astley v. Weldon*¹⁵ and continued its development throughout the course of the 19th century.¹⁶ A detailed exposition of this jurisprudence is not necessary for our purposes and would arguably only be

¹⁰ *Administration of Justice Act, 1696*, 8 & 9 William 3, Ch. 11, s. 8; *Administration of Justice Act, 1705*, 4 & 5 Anne c. 16.

¹¹ (1859), 4 H. & N. 506.

¹² *Ibid.* at 510.

¹³ *Supra* note 3.

¹⁴ *Ibid.* at 348. The comments of Lord Bramwell referred to by Lord Halsbury were not from *Betts v. Burch*, *supra* note 11, but rather from *In re Newman. Ex parte Capper* (1876), 4 Ch. D. 724 at 734 [*Newman*], where Lord Bramwell noted that “by some good fortune the Courts have in the majority of cases gone right without knowing why they did so”.

¹⁵ *Supra* note 3. *Cavendish*, *supra* note 8 at para. 8 noted “the now familiar distinction between a provision for the payment of a sum representing a genuine pre-estimate of damages and a penalty clause” began with *Astley v. Weldon*, *supra* note 3 and *Kemble v. Farren* (1829), 6 Bing. 141, 130 E.R. 1234 (C.P.). In *Wallis v. Smith*, *supra* note 5 at 261, Lord Jessel referred to *Astley v. Weldon*, *supra* note 3 as “the foundation of the subsequent cases on the subject”.

¹⁶ Notable decisions from this period include (in chronological order): *Kemble v. Farren*, *supra* note 15; *Sainter v. Ferguson* (1849), 7 C.B. 716; *Betts v. Burch*, *supra* note 11; *Johnston v. Robertson* (1861), 23 D. 646; *Craig v. McBeath* (1863), 1 M. 1020; *Forrest & Barr v. Henderson & Co.* (1869), 8 M. 187 [*Forrest*]; *Newman*, *supra* note 14; *Driver’s Trs* (1881), 8 R. 555; *Craig v. Dillon* (1881), 6 O.A.R. 116 (C.A.); *Wallis v. Smith*, *supra* note 5; *Watson v. Noble* (1885), 13 R. 347; *Lord Elphinstone v. Monkland Iron and Coal Co.* (1886), 11 App. Cas. 332 (H.L.) [*Lord Elphinstone*].

of historic interest, as evidenced by the description of these case as “innumerable and perhaps difficult to reconcile” by Lord Mersey in *Webster v. Bosanquet*.¹⁷

In a series of cases in the early 20th century the House of Lords and Privy Council established what would become the classic framework for determining the enforceability of stipulated damages.¹⁸ Of these decisions, it was the dictum of Lord Dunedin in *Dunlop Pneumatic Tyre Co. v. New Garage & Motor Co.*¹⁹ that would become the oft-cited test for the following century. The juridical prominence of Lord Dunedin’s dictum and its relevance to our analysis merits reproduction below:

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, yet the expression used is not conclusive. . .
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 pre-estimate of damage.
3. The question of 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 as at the time of the making of the contract, not as at the time of 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

¹⁷ [1912] A.C. 394 (Ceylon P.C.) at 397.

¹⁸ *Clydebank Engineering & Shipbuilding Co. v. Yzquierdo* (1904), [1905] A.C. 6 (U.K. H.L.) [*Clydebank*]; *Public Works Commissioner v. Hills*, [1906] A.C. 368 (South Africa P.C.) [*Hills*]; *Webster v. Bosanquet*, *supra* note 17; *Dunlop Pneumatic Tyre Co. v. New Garage & Motor Co.* (1914), [1915] A.C. 79 (U.K. H.L.) [*Dunlop*].

¹⁹ *Dunlop*, *supra* note 18.

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 others but trifling damage”. . .
- 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. . .²⁰

[citations omitted]

One of the challenges in applying the penalty rule is the interface between this equitable doctrine and the principle at common law that parties may contractually stipulate the damages payable on breach.²¹ The approach of Lord Dunedin in *Dunlop* sought to reconcile these competing principles by focusing the analysis on the relationship between the stipulated sum and the estimate of the damages that would have flowed from the breach, as opposed to focusing on the nature of what constitutes a penalty. Despite the approach in *Dunlop*, the necessity of demarcating between the permissible stipulation of damages and unenforceable penalties has continued to result in judicial consternation and inconsistency.

2.2 Canadian Adoption of *Dunlop*

Shortly following the House of Lords’ decision in *Dunlop*, the Supreme Court of Canada adopted the reasoning in *Canadian General Electric Co. v. Canadian Rubber Co.*,²² where Chief Justice Fitzpatrick held:

A penalty is the payment of a stipulated sum on breach of the contract, irrespective of the damage sustained. The essence of liquidated damages is a genuine covenanted pre-estimate of damage.²³

²⁰ *Ibid.* at 86-88.

²¹ *Kemble v. Farren*, *supra* note 15 at 148; *Sainter v. Ferguson*, *supra* note 16 at 730-731; *Johnston v. Robertson*, *supra* note 16 at 654; *Forrest*, *supra* note 16 at 200; *Lord Elphinstone*, *supra* note 16 at 346; *Clydebank*, *supra* note 18 at 11; *Dunlop*, *supra* note 18 at 97 and 100.

²² (1915), 52 S.C.R. 349 [*Canadian Rubber*].

²³ *Ibid.* at 351.

The Supreme Court of Canada's decision in *Canadian Rubber* is rarely cited in modern proceedings as its position as the seminal Canadian case on stipulated damages has been usurped by the Court's subsequent decisions in *H.F. Clarke Ltd. v. Thermidaire Corp.*²⁴ and *J.G. Collins Insurance Agencies v. Elsley*.²⁵ Each of these subsequent decisions introduced, intentionally or unintentionally, deviations from the established English doctrine which are addressed in the next section.

2.3 Canadian Divergence from English Doctrine

2.3.1 *Thermidaire*

In *Thermidaire* the Supreme Court of Canada did not opine in any significant manner on the law of stipulated damages, notably not even referencing *Canadian Rubber*. In reaching the conclusion that the stipulated sum constituted a penalty, the Court appears to have been significantly influenced by the damages actually incurred and the non-breaching party not having stemmed such losses by seeking an injunction, although, as noted by John D. McCamus, “[t]he precise ground for this conclusion is not entirely clear”.²⁶

The following passage from Chief Justice Laskin's decision encapsulates several interesting nuances:

What the court does in this class of case, as it does in other contract situations, is to refuse to enforce a promise in strict conformity with its terms. The court exercises a dispensing power . . . because the parties' intentions, directed at the time to the performance of their contract, will not alone be allowed to determine how the prescribed sum or the loss formula will be characterized. The primary concern in breach of contract cases . . . is compensation, and judicial interference with the enforcement of what the courts regard as penalty clauses is simply a manifestation of a concern for fairness and reasonableness, rising above contractual stipulation, whenever the parties seek to remove from the courts their ordinary authority to determine not only whether there has been a breach but what damages may be recovered as a result thereof.

²⁴ (1974), [1976] 1 S.C.R. 319 [*Thermidaire*].

²⁵ [1978] 2 S.C.R. 916 [*Elsley*].

²⁶ John D. McCamus, *The Law of Contracts*, (Toronto: Irwin Law, 2005) at 901.

. . . The interference of the courts does not follow because they conclude that no attempt should have been made to pre-determine the damages or their measure. It is always open to the parties to make the predetermination, but it must yield to judicial appraisal of its reasonableness in the circumstances.²⁷

The foregoing dictum places primacy on fairness and reasonableness over the intention of the parties, which is not in accordance with the traditional focus of the penalty rule on identifying and rendering unenforceable that which is penal. The reference to “reasonableness in the circumstances” is also unclear, not necessarily as a result of the words themselves, but rather by the approach of the Court, which appears to assess reasonableness in relation to the actual damages. To the extent that reasonableness is to be determined in relation to actual damages, this represents a significant departure from the traditional doctrine²⁸ and does not accord with the general principle of contractual interpretation which requires interpretation to be as at the time the contract was entered into.²⁹

A final observation regarding the Chief Justice’s decision is that it appears to allude to protectionism with respect to the Court’s jurisdiction. Specifically, the reference to “whenever the parties seek to remove from the courts their ordinary authority” implies that the legitimacy of stipulated damages is tainted. Any such concern should be irrelevant to the assessment of stipulated damages, as the authority of contract parties to pre-determine damages payable upon breach is derived from a reputable lineage of cases.³⁰

2.3.2 *Elsley and the rise of unconscionability*

The Canadian approach to stipulated damages diverged significantly from English doctrine as a result of the Supreme Court of Canada’s decision in *Elsley*, in which Justice Dickson (as he then was) noted:

²⁷ *Thermidaire*, *supra* note 24 at 330-331.

²⁸ In *Clydebank*, *supra* note 18 at 17, Lord Davey noted “I hold it to be perfectly irrelevant and inadmissible for the purpose of shewing the clause to be extravagant, in the sense in which I used that word, to admit evidence . . . of the damages which were actually suffered.” See also McCamus, *supra* note 26 at 902, where John D. McCamus noted “[t]he suggestion, albeit tacit, that courts may engage in a second look at enforceability of a provision in light of the actual circumstances of breach is inconsistent with the traditional doctrine and may be thought to unduly complicate the exercise of negotiating and drafting provisions of this kind”.

²⁹ Geoff R. Hall, *Canadian Contractual Interpretation Law*, 3rd ed. (Toronto: LexisNexis Canada, 2016) at 72 and the decisions cited therein: *Davidson v. Allelix Inc.* (1991), 7 O.R. (3d) 581, [1991] O.J. No. 2230 (C.A.) at 587 [O.R.]; *McDonald Crawford v. Morrow* (2004), 244 D.L.R. (4th) 144, [2004] A.J. No. 496 (C.A.) at para. 72.

³⁰ See footnote 21.

It is now evident that the power to strike down a penalty clause is a blatant interference with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression.³¹

These words have given rise to a line of case law that has incorporated the doctrine of unconscionability into the stipulated damages analysis,³² with such decisions being decided in parallel with a separate stream of jurisprudence that has adhered to the traditional penalty rule.³³ The divergent case law has resulted in a unique application of the doctrine of unconscionability such that it has effectively displaced the penalty rule, which leads us to consider whether the penalty rule should remain an operative part of Canadian law.

3. SHOULD THE PENALTY RULE REMAIN OPERABLE IN CANADIAN LAW

As noted in the previous section, the doctrine of unconscionability has emerged through Canadian decisions as a potential successor to the penalty rule. However, unconscionability is not the only basis for challenging the penalty rule, as the principle of freedom of contract and the unwillingness of courts to relieve from improvident bargains each represent independent challenges to justifying judicial interference on the basis of the penalty rule. The tension between the penalty rule and these principles underlies the difficulty in applying the penalty rule, as recognized by Lord Justice Cotton in *Wallis v. Smith*³⁴ where he held:

the difficulty arises from this, that there are certain rules of law which when they apply prevent the Court from giving effect to

³¹ *Elsley*, *supra* note 25 at 937.

³² An excellent summary of the case law that has incorporated unconscionability into the stipulated damages analysis was set out in *Veel*, *supra* note 2 at 240-244, which included *Prudential Insurance Co. of America v. Cedar Hills Properties Ltd.* (1994), 100 B.C.L.R. (2d) 312 (C.A.); *Redfearn v. Elkford (District)* (1998), 49 B.C.L.R. (3d) 172 (S.C.), affirmed 2000 CarswellBC 2365 (C.A.); *Nortel Networks Corp. v. Jervis*, 2002 CarswellOnt 21, [2002] O.J. No. 12 (S.C.J.); *Volvo Truck Finance Canada Ltd. v. Premier Pacific Holdings Inc.*, 2002 BCSC 1137; *Wolfe Chevrolet Oldsmobile Ltd. v. 552234 B.C. Ltd.*, 2004 BCPC 154; *869163 Ontario Ltd. v. Torrey Springs II Associates Ltd. Partnership*, 2004 CarswellOnt 4306, [2004] O.J. No. 4673 (S.C.J.), affirmed 2005 CarswellOnt 2782, [2005] O.J. No. 2749 (C.A.) [*Peachtree II*], leave to appeal refused 2006 CarswellOnt 316, [2005] S.C.C.A. No. 420; *Global Entertainment v. Yeo*, 2005 ABPC 117. See also *Birch v. Union of Taxation Employees, Local 70030*, 2008 ONCA 809, leave to appeal refused 2009 CarswellOnt 2410 (S.C.C.).

³³ *Veel*, *supra* note 2 at 239. A recent example of an appellate court addressing the penalty rule under the traditional doctrine is *Dundas v. Schafer*, 2014 MBCA 92, leave to appeal refused 2015 CarswellMan 209 (S.C.C.).

³⁴ *Supra* note 5.

the language used by the parties themselves, in which they have expressed what is supposed to be their intention at the time.³⁵

The following sections consider the various bases that each could be relied upon to support the modification or abandonment of the penalty rule.

3.1 Freedom of Contract

A recognized threat to the continued life of the penalty rule is the principle of freedom of contract, as judicial engagement of the penalty rule has the effect of setting aside one of the terms that had been agreed upon between the parties. Lord Jessel, Master of the Rolls, spoke to this tension when considering the penalty rule in *Wallis v. Smith*³⁶ where he stated:

I have always thought, and still think, that it is of the utmost importance as regards contracts between adults — persons not under disability and at arm's length — that the Courts of Law should maintain the performance of the contracts according to the intention of the parties; that they should not overrule any clearly expressed intention on the ground that Judges know the business of the people better than the people know it themselves. I am perfectly aware that there are exceptions, but they are exceptions of a legislative character.

. . . Judges have no right to say that people shall not perform their contracts which they have entered into deliberately, and put a different meaning on the contracts from that which the parties intended.³⁷

The Supreme Court of Canada and the United Kingdom Supreme Court have both recognized that the penalty rule is an intrusion on the freedom of contract,³⁸ which is an essential principle for certainty in contract law. Nevertheless, there remain certain considerations that support judicial interference with freedom of contract in limited circumstances and these are addressed in the following sections.

³⁵ *Ibid.* at 273.

³⁶ *Supra* note 5.

³⁷ *Ibid.* at 266.

³⁸ *Elsley*, *supra* note 25 at 937; *Cavendish*, *supra* note 8 at para. 33.

3.1.1 *Freedom of contract is not absolute*

Freedom of contract is not, nor has it ever been, absolute. The Supreme Court of Canada recently recognized permissible encroachment on the freedom of contract in *Bhasin v. Hrynew*,³⁹ with Justice Cromwell holding:

[the duty of honest contractual performance] operates irrespective of the intentions of the parties, and is to this extent analogous to equitable doctrines which impose limits on the freedom of contract, such as the doctrine of unconscionability.⁴⁰

Similarly, in *Tercon Contractors Ltd. v. British Columbia (Minister of Transportation & Highways)*⁴¹ the Supreme Court of Canada recognized that the court retains a residual power to decline the enforcement of a contract, although such discretion will rarely be exercised, noting that “[f]reedom of contract, like any freedom, may be abused”.⁴²

When one considers the strictures on freedom of contract, limited as they may be, there does not appear to be anything inherently offensive with judicial intervention on the basis of the penalty rule. In this regard, the penalty rule is arguably no more an intrusion on the freedom of contract than other accepted equitable doctrines such as the doctrine of unconscionability.

3.1.2 *Freedom of contract is a legal fiction*

An arguably more genuine, but certainly less fashionable, approach to addressing the tension between the penalty rule and freedom of contract is to explicitly recognize that freedom of contract should only be observed to the extent that there is equality of bargaining power between the parties and in all other instances is nothing more than a legal fiction.

Legal fictions serve a purpose. The efficient operation of the law requires simplifying assumptions, such as each person knowing the criminal laws that they are subject to⁴³ or that Parliament knows the existing state of the law,⁴⁴ but few would argue these to be true statements in every

³⁹ 2014 SCC 71.

⁴⁰ *Ibid.* at para. 74.

⁴¹ 2010 SCC 4 [*Tercon*].

⁴² *Ibid.* at paras. 117-18. See also *Millar, Re* (1937), [1938] S.C.R. 1.

⁴³ *Criminal Code*, R.S.C. 1985, c. C-46 s. 19, albeit that this provision operates so as to deny ignorance of the law as an excuse, but the effect is the same.

⁴⁴ *Young v. Mayor of Leamington* (1883), 3 A.C. 517 at 520, cited in *Minister of National Revenue v. Merritt*, [1942] S.C.R. 269 at 285.

instance. Similarly, freedom of contract is a useful assumption in that it provides certainty that courts will enforce a contract in accordance with its terms.

The error in relying on freedom of contract as an objection to the penalty rule is that many contracts are not derived between parties of equal bargaining power. The entering into a contract is often an act of necessity in circumstances where one party is unable to negotiate the terms. The classic example is a contract of adhesion, which by definition is a standard contract offered only on a take-it-or-leave-it basis.⁴⁵ It is likely that the majority of contracts are on such a basis and to infer that such arrangements represent freedom of contract simply on the basis that both parties consented to being contractually bound strains logic.⁴⁶

Construction contracts in particular are rarely an embodiment of freedom of contract.⁴⁷ Often it is the owner that is in the stronger position by virtue of being able to select from a number of eager contractors, each unlikely to forego the opportunity to undertake the project on the basis of certain unfavourable contractual terms. There may also be situations where the nature of the work, market conditions, or lack of owner sophistication can place the contractor in control of the relationship. Regardless of which party can dictate the terms of the contract, it is fair to say that a relationship with relatively balanced power as between the parties is the exception.

The incorporation of unconscionability into the stipulated damages analysis appears to implicitly recognize that a disparity in bargaining power undermines freedom of contract, thereby removing one of the impediments to holding the stipulated damages to be unenforceable. However, this does not mean that unconscionability should replace the

⁴⁵ *MacDonald v. Chicago Title Insurance Co. of Canada*, 2015 ONCA 842 at para. 33, leave to appeal refused 2016 CarswellOnt 16419 (S.C.C.); *Ledcor Construction Ltd. v. Northbridge Indemnity Insurance Co.*, 2016 SCC 37 at para. 39.

⁴⁶ *Cavendish*, *supra* note 8 at para. 35 addressed the relationship between the parties and cited *Phillips Phillips Hong Kong Ltd. v. Hong Kong (Attorney General)* (1993), 61 B.L.R. 41 (Hong Kong P.C.) at 57-59 [*Phillips Hong Kong*], where Lord Woolf took into consideration whether “one of the parties to the contract is able to dominate the other as to the choice of the terms of a contract” as part of the stipulated damages analysis.

⁴⁷ Recognized by Justice Iacobucci in *M.J.B. Enterprises Ltd. v. Defence Construction (1951) Ltd.*, [1999] 1 S.C.R. 619 at 641 where he noted that the tendering process is “heavily weighted in favour of the invitor”, relying on the language of Bingham L.J. in *Blackpool v. Blackpool Borough Council*, [1990] 3 All E.R. 25 (C.A.) at 30. To the extent that this statement may be interpreted narrowly to refer only to an imbalance during the tendering phase for a construction project, such an imbalance would more often than not translate into an inequality of bargaining power for the purposes of Contract B which typically forms part of the tender documents stipulated by the invitor.

penalty rule, as there may be instances where stipulated damages should not be enforced despite equality of bargaining power.

3.2 Penalties as an Improvident Bargain

It is an established principle of the common law that courts will not grant relief or modify the terms of a contract solely on the basis that the terms represent an improvident bargain.⁴⁸ This approach does not rely on the legal fiction necessary to support freedom of contract, but rather represents an established limitation on judicial intervention as it relates to the reasonableness or fairness of the bargain.

Viewing a penalty as an improvident bargain would represent a principled basis for abandoning the penalty rule, as it is difficult to distinguish between a party having accepted a penalty or a different contract term that may be regarded as onerous or unfair.⁴⁹ Furthermore, to the extent that the penalty rule relies on public policy as its justification, one can rightly question why public policy does not permit judicial interference in other aspects of a contract that are patently unfair, yet in relation to which judicial abstention is accepted largely without question.

One possible basis for distinguishing a penalty from a bad bargain is the element of contingency, as it may be argued that a party agreed to a penalty on the basis that they believed the triggering event would never come to pass.⁵⁰ However, this basis seems wholly inadequate, as many other contractual terms contain an element of contingency; as but one example, a party may agree to provide a lengthy and comprehensive warranty on the basis that they believe their goods or services will not fail, but if such a belief proves to be ill-founded then no court will provide relief from the consequences of having made such a bargain.

⁴⁸ *Betts v. Burch*, *supra* note 11; *Thorn v. Mayor of London*, [1876] AC 120; *Export Credits Guarantee Department v. Universal Oil Products Co.* (1982), [1983] 1 W.L.R. 399 (Eng. C.A.), affirmed [1983] 2 All E.R. 222 (U.K. H.L.).

⁴⁹ In *Betts v. Burch*, *supra* note 11 at 509, Martin B. held “For my own part, if the agreement were put before me and I were not embarrassed by the cases, I should be prepared to hold that parties are at liberty to enter into any bargain they please, and that we have nothing to do except ascertain their meaning and carry it out; and if they have made an improvident bargain they must take the consequences” (emphasis added).

⁵⁰ In *Forrest*, *supra* note 16 at 203, Lord Neaves noted “[w]e know quite well that parties, from sanguine expectations that things will all go right, will accede to almost any stipulation at that time, from not being able to realise the difficulties and the consequences”.

3.3 Unconscionability Applied to Stipulated Damages

The case law that has incorporated the doctrine of unconscionability into the stipulated damages analysis represents a significant departure from the traditional penalty rule doctrine. To assess this common law development, the following sections first consider the Supreme Court of Canada's decision in *Elsley* as the foundation for this departure, and then whether unconscionability is suitable for preventing the mischief that the penalty rule was intended to address.

3.3.1 *An incorrect interpretation of Elsley*

In *Elsley*, the Supreme Court of Canada was focused on the interpretation of a restrictive covenant and only after having determined that this restriction was enforceable did the Court turn to the assessment of damages. In conducting the damages analysis, the Court was faced with the unique situation of the stipulated damages having been set at a value less than what the provable damages were likely to be. As such, the focus of the analysis was whether stipulated damages serve as a limitation of liability.

The focus of the Court is important because it demonstrates that the analysis was unrelated to the determination of when stipulated damages are enforceable as liquidated damages or unenforceable as a penalty. To the extent that Justice Dickson's comments have bearing on such a determination, they are clearly *obiter*.⁵¹ More importantly, one must consider the judicial context of the decision. *Elsley* was decided in 1978, which was just four years after the Court had addressed stipulated damages in *Thermidaire*. If the intention of Justice Dickson was to recraft the analytical framework that had been so recently touched upon, then it is reasonable to assume that he would have done so in more express terms, as the incorporation of unconscionability would represent a significant change to the law of stipulated damages.

3.3.2 *The meaning of oppression*

The subsequent judicial interpretation of the comments of Justice Dickson hang on the use of the word "oppression",⁵² which is proble-

⁵¹ Although Justice Dickson's comments were *obiter*, it is recognized that this basis alone does not completely discount them. As Cotton L.J. noted in *Wallis v. Smith*, *supra* note 5 at 271: "I think one would be wrong in disregarding the opinion expressed by Judges, especially those of great learning, in deciding cases even although some of their expressions were not necessary or applicable to the case before them. They lay down the principle, even although in laying it down they may go (as possibly we are doing in the present case), beyond the exigencies of the case before them."

matic in several respects. To begin with, the comments of Justice Dickson were immediately following an excerpt from *Equity Jurisprudence*,⁵³ which referred to both an “oppressive purpose” and “oppression”, each without implying that the doctrine of unconscionability was the basis for relief. The language of Justice Dickson in the immediately subsequent passage appears to have been influenced by this terminology without indicating any related change to Canadian law.

It is also noteworthy that the term “oppression” had been part of the stipulated damages lexicon for almost a century by the time of *Elsley*. In *Wallis v. Smith*⁵⁴ the Master of the Rolls said of the penalty rule that “[i]t is very likely, and I believe it is true historically, that the doctrine of Equity did arise from a general notion that these acts were oppressive”,⁵⁵ while Lord Lindley also referred to consequences that the Court thought to be “oppressive”.⁵⁶ The common use of these words lends further credence to the view that Justice Dickson was not intentionally employing the term “oppression” as a change in the analysis of stipulated damages.

To the extent that the reference in *Elsley* to “oppression” has been interpreted as referring to unconscionability, one may also question why such a reference would be necessary to support a doctrinal change as the case law prior to *Elsley* is replete with references to a penalty being a stipulated sum that is “unconscionable”.⁵⁷ However, such prior references to a stipulated sum being unconscionable did not give rise to a view by the Supreme Court of Canada that the analysis should be conducted on the basis of the doctrine of unconscionability.

On the basis of foregoing, it appears unlikely that Justice Dickson intended to usher in a new approach to the law of stipulated damages, rather, the references to “oppression” in *Elsley* appear to be no more than *obiter* that employed common terminology and echoed the specific language of an immediately preceding quoted passage. To the extent that subsequent courts have employed this language as a basis for applying

⁵² See text at footnote 31.

⁵³ Story, *Equity Jurisprudence* (14th ed.) at s. 1728, cited in *Elsley*, *supra* note 25 at 936-37.

⁵⁴ *Supra* note 5.

⁵⁵ *Ibid.* at 260.

⁵⁶ *Ibid.* at 274. See also *Thompson v. Hudson* (1869), L.R. 4 H.L. 1 at 30 where Lord Westbury held that a large stipulated sum that was never intended as the real measure of damages constituted “an oppressive agreement”. This comment of Lord Westbury was quoted by Baggally J.A. in *Newman*, *supra* note 14 at 733.

⁵⁷ *Forrest*, *supra* note 16 at 193; *Clydebank*, *supra* note 18 at 10 and 18; *Webster*, *supra* note 18 at 398; *Dunlop*, *supra* note 18 at 83, 87, 89, 95, 97 and 101.

the doctrine of unconscionability to stipulated damages, it is arguable that *Elsley* has been stretched beyond its intended limits.

3.3.3 *Improper application of unconscionability*

The manner in which certain Canadian courts have incorporated unconscionability into the stipulated damages analysis is also curious, as the courts typically perform the traditional stipulated damages analysis and then only assess unconscionability if the stipulated sum is determined to be a penalty, in which case the penal sum is enforceable unless it is found to be unconscionable.⁵⁸ This layered application of these two equitable doctrines appears to run counter to the general principles of equity which are typically relieving in nature. Such layering renders the penalty rule incapable of independently supporting relief, while the doctrine of unconscionability is applied in a manner in which relief is also constrained by requiring that the penalty rule be engaged as a threshold to eligibility for relief on the basis of unconscionability.

This layered approach appears analytically unsound. It can lead to three possible outcomes, as the stipulated damages will be found to be (i) liquidated damages as opposed to a penalty and therefore enforceable; (ii) a penalty that is not unconscionable and therefore enforceable; or (iii) a penalty that is unconscionable and therefore unenforceable. The only operative purpose of the penalty rule in these circumstances is to identify enforceable liquidated damages and exempt them from the unconscionability analysis. The application of the penalty rule in this manner is unnecessary and arguably problematic, as it displaces the doctrine of unconscionability from its potential application to stipulated damages that are not penal. While stipulated damages found to be enforceable under the penalty rule are unlikely to constitute an unfair advantage for the purposes of unconscionability, such a result is a

⁵⁸ Veel, *supra* note 2 at 240-244 identified cases in which the stipulated damages were penal but held to be enforceable due to a lack of unconscionability or oppression: *Prudential Insurance Co. of America v. Cedar Hills Properties Ltd.* (1994), 100 B.C.L.R. (2d) 312 (C.A.); *Nortel Networks Corp. v. Jervis*, 2002 CarswellOnt 21, [2002] O.J. No. 12 (S.C.J.); *Volvo Truck Finance Canada Ltd. v. Premier Pacific Holdings Inc.*, 2002 BCSC 1137; *Wolfe Chevrolet Oldsmobile Ltd. v. 552234 B.C. Ltd.*, 2004 BCPC 154. See also *Fern Investments Ltd. v. Golden Nugget Restaurant (1987) Ltd.* (1994), 19 Alta. L.R. (3d) 442 (C.A.) at 447 where Hetherington J.A. held that “[a] penalty clause in a contract is enforceable unless it would be unconscionable or oppressive to give effect to it. . .”, as well as *Coal Harbour Properties Partnership v. Liu*, 2006 BCCA 385 at para. 24, which cited *Lee v. Skalbania* (1987), 47 R.P.R. 162 (B.C. S.C.) at 175, affirmed (1989), 4 R.P.R. (2d) xxxiii (note) (B.C. C.A.), in which Justice Gow held that if it is determined that the stipulated damages are a penalty then “[t]here arises the next question” of whether relief be granted, which “depends upon whether to enforce the penalty would be unconscionable, and that unconscionability has to be determined at the date of the invocation of the clause”.

possibility. The better approach would be to allow the doctrine of unconscionability to remain operative in relation to stipulated damages that are not penal.⁵⁹

It would appear that the layered application of the penalty rule and unconscionability is related more to a transitional intention rather than to any logical necessity. To put it colloquially, layering of the doctrines represents a “hedging of bets”, whereby a court can make a foray into unconscionability without completely forsaking the penalty rule. However, as the layered approach essentially relies on unconscionability and applies the penalty rule in name only, it should be considered whether unconscionability should expressly replace the penalty rule.

3.3.4 *Should unconscionability replace the penalty rule?*

The doctrine of unconscionability has been suggested as the appropriate mechanism for addressing penalties⁶⁰ and this section focuses on whether unconscionability is capable of adequately serving in this capacity.

Davey J.A. of the British Columbia Court of Appeal articulated the doctrine of unconscionability in *Morrison v. Coast Finance Ltd.*⁶¹ in the following terms:

a plea that a bargain is unconscionable invokes relief against an unfair advantage gained by an unconscientious use of power by a stronger party against a weaker. On such a claim the material ingredients are proof of inequality in the position of the parties arising out of the ignorance, need or distress of the weaker, which left him in the power of the stronger, and proof of substantial unfairness of the bargain by the stronger. On proof of those circumstances, it creates a presumption of fraud which the stronger must repel by proving that the bargain was fair, just and reasonable.⁶²

Despite the apparent judicial and academic embracement of the doctrine of unconscionability in place of the penalty rule, it is submitted that unconscionability is ill-suited to this role for the reasons set out in the following subsections.

⁵⁹ This topic is explored further at Section 3.3.5.

⁶⁰ Waddams, *supra* note 9, Ch. 5 at 8.340; Kevin E. Davis, “Penalty Clauses Through the Lens of Unconscionability Doctrine: *Birch v. Union of Taxation Employees, Local 70030*” (2010) 55 McGill LJ 151 at 153.

⁶¹ (1965), 55 D.L.R. (2d) 710 (B.C. C.A.).

⁶² *Ibid.* at 713.

A. Supreme Court of Canada approach to fundamental breach

The Supreme Court of Canada cases dealing with fundamental breach are relevant to this discussion as they considered whether unconscionability could replace the doctrine of fundamental breach. In *Syncrude Canada Ltd. v. Hunter Engineering Co.*,⁶³ Chief Justice Dickson favoured this position, noting “I am much inclined to lay the doctrine of fundamental breach to rest, and where necessary and appropriate, to deal explicitly with unconscionability”.⁶⁴ Justice Wilson (dissenting in part) disagreed with this approach, noting:

To dispense with the doctrine of fundamental breach and rely solely on the principle of unconscionability, as has been suggested by some commentators, would, in my view, require an extension of the principle of unconscionability beyond its traditional bounds of inequality of bargaining power. The court, in effect, would be in the position of saying that terms freely negotiated by parties of equal bargaining power were unconscionable. Yet it was the inequality of bargaining power which traditionally was the source of unconscionability. What was unconscionable was to permit the strong to take advantage of the weak in the making of the contract. Remove the inequality and we must ask, wherein lies the unconscionability?⁶⁵

The Court ultimately resolved the approach to fundamental breach in *Tercon* by developing a three-step analysis that considers (i) whether the exclusion clause applies to the circumstances; (ii) if the clause is applicable, whether the exclusion clause was unconscionable at the time the contract was made; and (iii) if the clause is applicable and not unconscionable, whether the Court should nevertheless refuse to enforce it on the grounds of public policy.⁶⁶

The approach of the Court in replacing the doctrine of fundamental breach is instructive because it demonstrates that the Court devised a specific solution to exclusion clauses rather than relying on the doctrine of unconscionability alone. Although the second step of this analysis incorporated unconscionability, the third step permitted the Court to deny enforcement of a contractual term even in instances where there was not unconscionability, thereby addressing the limitations of relying

⁶³ [1989] 1 S.C.R. 426 [*Hunter*].

⁶⁴ *Ibid.* at 462.

⁶⁵ *Ibid.* at 516.

⁶⁶ *Tercon*, *supra* note 41 at paras. 122-123.

on unconscionability in isolation by permitting the exercise of judicial discretion.

The specific limitations of unconscionability that made this doctrine inappropriate as the exclusive replacement of fundamental breach are relevant to the consideration of whether unconscionability can adequately replace the penalty rule.

B. Inequality of bargaining power

In order to establish unconscionability there must be inequality of bargaining power and an unfair advantage. Of these two elements, it is reasonable to assume that if a stipulated sum would constitute a penalty under the traditional analysis, then such an amount would also constitute an unfair advantage. The more difficult element of unconscionability, when applied to stipulated damages, is the inequality of bargaining power, which is not required for the penalty rule to be operative under the traditional doctrine.⁶⁷ It was this element of unconscionability that Justice Wilson focused on in *Hunter* when considering whether unconscionability could adequately replace the doctrine of fundamental breach.⁶⁸ In the context of fundamental breach, the Court in *Tercon* recognized that there are instances where an exclusion clause should not be enforced even if there is no inequality of bargaining power.

With respect to stipulated damages, there is nothing to prevent Canadian law from developing in a manner that requires inequality of bargaining power be established before stipulated damages will be found to be unenforceable. However, such an innovation would be a substantial departure from the traditional doctrine and would foreclose judicial intervention with respect to stipulated damages agreed upon between parties of equal bargaining power. If the penalty rule is to be reformulated or replaced, then it would be preferable that the courts follow the approach established in *Tercon* and devise a specific solution that retains judicial discretion on the basis of public policy. Such an approach would not only align with *Tercon*, but would also retain public policy as the basis for judicial interference with freedom of contract, which has long been recognized as the true basis for the penalty rule.⁶⁹

⁶⁷ *Imperial Tobacco Co. v. Parslay*, [1936] 2 All E.R. 515 (C.A.); *Cavendish*, *supra* note 8 at para. 257.

⁶⁸ See text at footnote 65.

⁶⁹ *Peachtree II*, *supra* note 32 at para. 23; *Cavendish*, *supra* note 8 at para. 243.

C. Uncertainty

One of the criticisms of the penalty rule is that it undermines contractual certainty as a result of the potential that the courts will not enforce a contract in accordance with its terms.⁷⁰ However, to the extent that the penalty rule is criticized on the basis of uncertainty, the doctrine of unconscionability does not appear apt at remedying this deficiency. In *Hunter*, Justice Wilson recognized the uncertain nature of unconscionability, noting:

Arguably, unconscionability is even less certain than fundamental breach. Indeed, it may be described as “the length of the Chancellor’s foot”.⁷¹

Paul-Erik Veel recognized the potential uncertainty that may result from the doctrine of unconscionability being incorporated into the stipulated damages analysis, noting:

It is quite plausible that in some circumstances there might be more rather than less uncertainty under the *Elsley* standard than under the approach in *Dunlop*. This stems from the fact that, although under the *Elsley* standard there might be more certainty over damages as more stipulated damages clauses in general are enforced, there might be less certainty *ex ante* as to whether any given stipulated damages clause is enforceable. Because the *Dunlop* rule is a relatively simple one that only includes a limited number of factors, it is relatively easy to predict whether a court will choose to uphold a given stipulated damages clause. In contrast, because the *Elsley* standard can incorporate additional considerations and is much more context-specific, the parties might be more uncertain as to whether the court applying that standard would uphold a given clause.⁷²

Beyond the stipulated damages clause itself, whenever the doctrine of unconscionability is found to be operative it will introduce uncertainty in relation to the enforceability of other clauses or the entire contract. If we consider the elements of unconscionability, it requires that there be inequality of bargaining power and an unfair advantage. If the stipulated damages are held to be unenforceable on the basis of unconscionability, then it will have been established that there is inequality of bargaining

⁷⁰ *Cavendish*, *supra* note 8 at para. 33, which also cited *Philips Hong Kong*, *supra* note 46 at 59.

⁷¹ *Hunter*, *supra* note 63 at 516-17.

⁷² Veel, *supra* note 2 at 248.

power between the parties, which will only leave the other element (an unfair advantage) necessary to establish unconscionability in relation to any other provision of the contract. As such, it does not seem unreasonable that a finding of unconscionability in relation to stipulated damages will cast a pall over the enforceability of the balance of the contract, as each provision that may be argued to constitute an unfair advantage will be susceptible to attack. In contrast, the penalty rule does not introduce any contractual uncertainty beyond the narrow ambit of stipulated damages and, to the extent that certainty is to be preserved, the penalty rule will achieve this more effectively than the doctrine of unconscionability.

3.3.5 *Unconscionability not displaced by the penalty rule*

There are merits to the doctrine of unconscionability, as it serves a vital role in protecting a weaker party from the overreaching of a stronger party. However, in addressing stipulated damages it is not necessary to elect for the penalty rule or unconscionability as alternatives to one another, as both equitable doctrines may co-exist.

A strong argument can be made that the penalty rule should not be replaced by the doctrine of unconscionability.⁷³ Similarly, in a situation where the elements of unconscionability can be made out in relation to a stipulated damages clause, it is difficult to rationalize why this type of provision should be immune from the doctrine of unconscionability and subject only to the penalty rule alone. If the circumstances are such that there is inequality of bargaining power and an unfair advantage, then such a provision should not be enforceable even if the unfair advantage does not rise to the level of being penal. Admittedly, these situations will likely be rare in practice, but it goes to the point of demonstrating that each equitable doctrine serves a unique purpose and the development of the common law does not require a binary selection.

Some may argue that to allow both doctrines to co-exist will magnify uncertainty. To an extent this is true, as it subjects stipulated damages to being found unenforceable on two separate bases. However, this outcome does not preclude the natural and logical application of both doctrines.⁷⁴ Certainty of contract is not to be had at all costs and, if it is, then the debate in relation to unconscionability as an adequate successor

⁷³ See Section 3.3.4.

⁷⁴ One can argue that the Ontario Court of Appeal applied this approach in *Birch v. Union of Taxation Employees, Local 70030*, 2008 ONCA 809 at para. 38, leave to appeal refused 2009 CarswellOnt 2410 (S.C.C.) where Armstrong J.A. noted that a penalty clause is not necessarily

to the penalty rule is moot, as unconscionability may itself exacerbate uncertainty and the penalty rule should be abolished on the basis of freedom of contract or that the stipulated damages represent an improvident bargain.

4. THE DECISION OF THE UKSC IN *CAVENDISH*

4.1 Introduction

The United Kingdom Supreme Court decision in *Cavendish* and *ParkingEye*, released in November of 2015, is the most important decision related to stipulated damages since *Dunlop*. The Court significantly modified the existing law by introducing the concept that stipulated damages could be held to be enforceable provided that the non-defaulting party had a legitimate interest in the performance of the contract. This approach decoupled enforceability from damages and thereby increased the likelihood that stipulated damages will be found to be enforceable.

4.2 Background

For our purposes, the underlying facts in *Cavendish* and *ParkingEye* are not of particularly significant relevance. Nevertheless, a complete lack of context may itself be a distraction to the reader, so a skeletal synopsis of the facts underlying each case is set out below.

In *Cavendish*, a dispute arose as a result of a sale of corporate shares. The seller sold a portion of his shares and received compensation by way of installment payments. The purchase agreement included a restrictive covenant prohibiting the seller from engaging in competitive activities, as well as a stipulated damages provision that, upon breach, would (i) disentitle the seller to any unpaid installments related to the share sale, and (ii) permit the buyer to purchase the seller's remaining shares at a reduced cost. The seller breached said restrictive covenant and then challenged the enforceability of the stipulated damages provision on the grounds that it was a penalty.

In *ParkingEye*, a dispute arose in relation to fines for automobile parking. ParkingEye controlled the access to a parking lot in which individuals were permitted to park for a set period of time, following

unenforceable in the context of a contract between a union and its members, but proceeded to note "I see no reason to suggest that the law of unconscionability does not apply to these kinds of agreements".

which they would be subject to a fine. The appellant parked beyond the specified time and then challenged the enforceability of the fine on the grounds that it was a penalty.

In both *Cavendish* and *ParkingEye*, the Court held that the stipulated damages were enforceable as liquidated damages. In reaching this result, the Court modified the law of stipulated damages and expanded the bases on which such provisions could be found to be enforceable.

4.3 Distillation of *Cavendish*

The Lords in *Cavendish* delivered their judgments in seriatim, each touching on a number of facets of the law relevant to stipulated damages. The analysis set forth, as well as the nuances as between the approaches of particular Lords, provides fertile ground for analysis and interpretation. Suffice it to say that the reduction of such a decision to a framework of stark rules and propositions cannot help but wreak injustice to the elegance of it. However, such an exercise is imperative for this analysis and the following sections set out the essential elements that emerged from the decision.

4.3.1 *Dismantling of the classic approach*

The Lords in *Cavendish* scrutinized the traditional approach of the courts in assessing the enforceability of stipulated damages and found it to be lacking in rigour, as evidenced by the view expressed by Lord Neuberger and Lord Sumption, which chastised the slavish application of *Dunlop*, noting:

Lord Dunedin’s speech in *Dunlop* achieved the status of a quasi-statutory code in subsequent case-law. Some of the many decisions on the validity of damages clauses are little more than a detailed exegesis or application of his four tests with a view to discovering whether the clause in issue can be brought within one or more of them. In our view, this is unfortunate. In the first place, Lord Dunedin proposed his four tests not as rules but as considerations. . . Second, as Lord Dunedin himself acknowledged, the essential question was whether the clause impugned was “unconscionable” or “extravagant”. . . Third, none of the other three Law Lords expressly agreed with Lord Dunedin’s reasoning. . .⁷⁵

⁷⁵ *Cavendish*, *supra* note 8 at para. 22.

Lord Neuberger and Lord Sumption noted that the law of penalties had become a prisoner of artificial categorization that had arisen due to an over-literal reading of *Dunlop*, giving rise to an improper distinction between a penalty and a genuine pre-estimate of loss.⁷⁶

4.3.2 Framing the question with the penalty rule

An element of the *Cavendish* decision that is relatively unfamiliar in Canadian jurisprudence is the express focus on the penalty rule. Assessing stipulated damages provisions through the lens of the penalty rule appears to have the effect of focusing the analysis, as the question becomes whether or not the penalty rule is engaged, as opposed to anchoring the analysis to a pre-estimate of damages, which is arguably just one indirect method of identifying the penal nature of a provision. This distinction may appear to be minor, but the slightness of the distinction is arguably coloured by a century of juridical analysis in which damages have been at the fore, resulting in the concepts of enforceable liquidated damages and a pre-estimate of damages becoming essentially synonymous. Lord Neuberger and Lord Sumption succinctly captured the essence of this distinction when they held:

The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss.⁷⁷

4.3.3 What constitutes a penalty?

Having established that stipulated damages will only be unenforceable if the penalty rule is engaged leads to the question of what constitutes a penalty. In *Dunlop*, Lord Dunedin held that “[t]he essence of a penalty is a payment of money stipulated as *in terrorem*”,⁷⁸ but in *Cavendish* this classic statement was found to provide inadequate guidance, with Lords Neuberger and Sumption noting that “[t]o describe [a penalty] as a deterrent (or, to use the Latin equivalent, *in terrorem*) does not add anything”,⁷⁹ while Lord Mance also found the phrase to be unhelpful.⁸⁰

⁷⁶ *Ibid.* at para. 31.

⁷⁷ *Ibid.* at para. 31.

⁷⁸ *Dunlop*, *supra* note 18 at 86.

⁷⁹ *Cavendish*, *supra* note 8 at para. 31. See also *Bridge v. Campbell Discount Co.*, [1962] A.C. 600 (U.K. H.L.) at 622, where the Court held that describing a penalty as a threat *in terrorem* did not add “anything of substance to the idea conveyed by the word ‘penalty’ itself” (cited in *Cavendish* at para. 28).

⁸⁰ *Cavendish*, *supra* note 8 at para. 140.

Lords Neuberger and Sumption, having discarded with an element of penalty dogma, proceeded in an attempt to redefine and articulate the nebulous concept of a penalty. The first step was to set out what a penalty is not, and in this regard it was held that the fact that a stipulated damages provision is not a pre-estimate of loss does not, in and of itself, mean that it is penal.⁸¹ This aspect of the decision is arguably the most important development in the law related to stipulated damages that emerges from *Cavendish*, as it decouples the previously necessary connection between a pre-estimate of loss and enforceability. The same was also expressly recognized:

A damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach. This must depend on whether the innocent party has a legitimate interest in performance extending beyond the prospect of pecuniary compensation flowing directly from the breach in question.⁸²

The concept of a legitimate interest thereby emerged as the benchmark, in place of pre-estimated damages, by which stipulated damages provisions will be assessed in determining whether they constitute a penalty. The “true test” for determining whether a provision is penal was articulated in the following terms:

The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter.⁸³

4.3.4 *What constitutes a legitimate interest?*

A legitimate interest embodies the traditional elements that support the enforceability of a stipulated damages provision (*viz.* a genuine pre-estimate of loss or a reasonable amount specified by the parties when pre-estimation is an impossibility, each represent a genuine interest of the non-defaulting party). However, a legitimate interest is also broader as “compensation is not necessarily the only legitimate interest that the innocent party may have”.⁸⁴

⁸¹ *Ibid.* at para. 31.

⁸² *Ibid.* at para. 28.

⁸³ *Ibid.* at para. 32.

It is in the expansion beyond compensation whereby the concept of a legitimate interest changes the law of stipulated damages and, in the process, improves the likelihood that such provisions will be found by courts to constitute enforceable liquidated damages. However, the question then arises as to what, above and beyond compensation for breach, represents a legitimate interest?

There was consensus amongst the Lords that a legitimate interest includes an interest of the non-defaulting party in the performance of the contract.⁸⁵ However, what does and does not constitute a legitimate interest in the performance of the contract is difficult to define, although guidance can be derived from *Cavendish*, which established that such an interest:

- a) will only rarely extend beyond compensation for breach;⁸⁶
- b) does not include punishment of the defaulting party;⁸⁷
- c) may be an interest of a third party;⁸⁸
- d) may be the protection of a business interest; and⁸⁹
- e) may be commercial or otherwise.⁹⁰

The application of these considerations assist in defining the contours of a legitimate interest. In *Cavendish*, it was held that the non-breaching party had a legitimate interest in the observance of the restrictive covenant to protect goodwill in the company, despite the fact that a breach would result in a minimal recoverable loss.⁹¹ In *ParkingEye*, there was a legitimate interest of the non-breaching party in earning revenue from the parking fines, as well as a legitimate interest of the third party landowner that derived revenue from the non-breaching party and required that the parking lot be managed.⁹²

⁸⁴ *Ibid.* at para. 32. See also para. 152.

⁸⁵ *Ibid.* at para. 28.

⁸⁶ *Ibid.* at para. 32.

⁸⁷ *Ibid.* at para. 32.

⁸⁸ *Ibid.* at para. 99.

⁸⁹ *Ibid.* at para. 152.

⁹⁰ *Ibid.* at para. 249.

⁹¹ *Ibid.* at paras. 75, 82 and 274.

⁹² *Ibid.* at paras. 99 and 286.

4.3.5 *The relationship between the parties*

In *Cavendish*, Lords Neuberger and Sumption were of the view that the relationship between the parties could give rise to a presumption of enforceability, noting:

In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of the breach.⁹³

Lord Mance was more circumspect with respect to the relationship between the parties, but also noted that the relationship “must be at least a relevant factor” in the analysis.⁹⁴

4.3.6 *Summarizing the Cavendish approach*

For the purposes of our analysis, it helpful to synthesize *Cavendish* into a statement that embodies its core elements in relation to the expanded concept of a legitimate interest. In this regard, the constituent elements can be ordered to form the following statement:

The Court should objectively determine, as a matter of construction as at the time the contract was made and having regard to the relationship between the parties, whether the stipulated damages impose a detriment on the defaulting party out of all proportion to the legitimate interests of the non-defaulting party.

5. WHAT PATH SHOULD CANADIAN COURTS TAKE?

5.1 Clarity is Required

The law related to stipulated damages in Canada has devolved from what was originally a test that had confounded eminent jurists⁹⁵ into two divergent lines of case law that are incompatible with one another, with one reliant on the traditional approach to the penalty rule and the other abrogating it in favour of the doctrine of unconscionability. Regardless of the decision in *Cavendish* and its potential bearing on Canadian law, the law of stipulated damages in Canada needs to be reordered by a clear

⁹³ *Ibid.* at para. 35.

⁹⁴ *Ibid.* at para. 152.

⁹⁵ See text at footnotes 4 and 6.

pronouncement from the Supreme Court of Canada on the analysis to be applied.

The value in *Cavendish*, whether one agrees with its logic or not, is that at a minimum it is almost certain to force common law courts around the world to reassess their own approach to stipulated damages. This result seems inevitable, as *Cavendish* has stirred legal discussion in an unprecedented manner and in time, it will be put before the Canadian courts in argument and will demand consideration. Such a process forces conscious analysis in place of rote application, and this analysis is intrinsically beneficial, for even if it leads to the rejection of *Cavendish*, it will mandate the conscious act of consideration and justification for whatever path the courts elect to follow. From the Canadian perspective, this process should extend beyond *Cavendish* and consider:

1. whether the penalty rule should remain operative;
2. the role, if any, that unconscionability should play in the law of stipulated damages; and
3. if the penalty rule is to remain operative, then:
 - a. what is the appropriate time of assessment;
 - b. to what extent, if any, should actual damages incurred be relevant; and
 - c. should the *Cavendish* concept of a legitimate interest be adopted.

Each of these considerations is addressed in brief in the next section.

5.2 Recommendations for the Path Forward

5.2.1 *Should the penalty rule remain operative?*

The continued existence of the penalty rule is the most important consideration and also the one that involves the most uncertainty as to an advisable path forward. One can rationalize limitations on freedom of contract,⁹⁶ but it is far more difficult to reconcile the penalty rule with the denial of relief from improvident bargains.⁹⁷ On balance, the penalty rule serves a valid purpose and should be retained, due in part to the unresolved question of whether relief from improvident bargains should

⁹⁶ See Section 3.1.

⁹⁷ See Section 3.2.

be reconsidered aside from unconscionability, which is an issue beyond the scope of this paper.

It should be noted that in *Cavendish*, Lords Neuberger and Sumption distinguish between the penalty rule and relief from an improvident bargain on the basis that the penalty rule is operative on breach:

There is a fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach. Leaving aside the challenges going to the reality of consent, such as those based on fraud, duress or undue influence, the courts do not review the fairness of men's bargains either at law or in equity. The penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves.⁹⁸

This logic does not withstand scrutiny. If the “fundamental difference” is only that the penalty rule operates on breach and applies to stipulated remedies, whereas relief from an improvident bargain applies to the primary obligations, this does not adequately explain why a contract breaker that agrees to be contractually bound by a penalty is entitled to relief, whereas a non-breaching party that agrees to be contractually bound by an improvident bargain is not. To the extent that Canadian courts take up the question of whether to retain the penalty rule, it is hoped that a more rational basis is offered to justify any distinction between these competing principles.

5.2.2 *The role of unconscionability in the stipulated damages analysis*

The doctrine of unconscionability should not preclude relief against penalties,⁹⁹ nor is it suitable as a stand-alone approach to assessing the enforceability of stipulated damages.¹⁰⁰ That being said, the doctrine of unconscionability is not displaced by the penalty rule and should remain capable of independently granting relief in relation to stipulated damages provisions.¹⁰¹

⁹⁸ *Cavendish*, *supra* note 8 at para. 13.

⁹⁹ See Section 3.3.3.

¹⁰⁰ See Section 3.3.4.

¹⁰¹ See Section 3.3.5.

5.2.3 *Recasting the penalty rule*

If one accepts that the penalty rule should remain operable and be capable of independently granting equitable relief without reference to the doctrine of unconscionability, then this leaves for consideration whether the penalty rule should be restated.

A. Time of assessment

The enforceability of stipulated damages should be assessed as at the time of contract formation.¹⁰² This approach was affirmed in *Cavendish*¹⁰³ and has been a steadfast element of the stipulated damages analysis.¹⁰⁴ It is notable that to the extent that *Thermidaire* deviated from this principle, it has been largely ignored in subsequent jurisprudence.¹⁰⁵

B. Consideration of actual damages

The enforceability of stipulated damages should not take into consideration actual damages.¹⁰⁶ Such an approach would render it virtually impossible for parties to have any reasonable certainty regarding enforceability at the time of contract formation.

C. Should the *Cavendish* concept of a legitimate interest be adopted?

The fundamental difference between the approach of Canadian courts and that in *Cavendish* is the latter's concept of a legitimate interest, which includes, but is broader than, the traditional bases for enforcing stipulated damages provisions, extending beyond compensation for breach¹⁰⁷ and including the non-defaulting party's interest in the performance of the contract.¹⁰⁸ It is this non-defaulting party's interest in the performance of the contract that represents an extension of the law of stipulated damages and to distinguish this aspect of the legitimate interest concept for the purposes of our analysis it will be referred to as the "**Performance Interest**".

It must be noted that even in cases where a Performance Interest is extricable, enforceability remains subject to the stipulated damages not

¹⁰² See Section 2.3.1.

¹⁰³ *Cavendish*, *supra* note 8 at para. 9.

¹⁰⁴ *Forrest*, *supra* note 16 at 198; *Clydebank*, *supra* note 18 at 17; *Hills*, *supra* note 18 at 376; *Webster v. Bosanquet*, *supra* note 18 at 398; *Dunlop*, *supra* note 18 at 87.

¹⁰⁵ See *Peachtree II*, *supra* note 32 at para. 24.

¹⁰⁶ See Section 2.3.1.

¹⁰⁷ *Cavendish*, *supra* note 8 at para. 32.

¹⁰⁸ *Ibid.* at para. 28.

being “out of all proportion”¹⁰⁹ to such a Performance Interest. This requirement of proportionality to support enforceability means that the recognition of a Performance Interest does not represent a heretical change to the law of stipulated damages, as any stipulated sum out of all proportion to a legitimate interest (which includes the Performance Interest) will be unenforceable as a penalty in accordance with the traditional penalty rule.

This leaves the question of whether the Performance Interest should be recognized as a legitimate basis for upholding the enforceability of stipulated damages. In this regard, *Cavendish* has been criticized for introducing additional uncertainty, with one commentator noting:

The “legitimate interest” test opens up ambiguities that go further, in the sense that the phrase “legitimate interest” creates a need to consider substance when there was no such predominant need to do so before.¹¹⁰

This may be true, however, the ambiguity inherent in the identification of a Performance Interest and the determination of proportionality is preferable to a non-defaulting party being unable to enforce stipulated damages that are proportionate to its Performance Interest. It would be better to entrust the courts with the resolution of ambiguity than to see them intrude on freedom of contract and render unenforceable stipulated damages which are not penal.

In light of the foregoing, Canadian courts should adopt from *Cavendish* the concept of a Performance Interest, as it is an incremental expansion of the common law that is supported by logic, whereas to deny the approach would leave in place the vagaries in the law of stipulated damages that *Cavendish* has brought to light.

6. CONCLUSION

The Canadian law of stipulated damages has diverged from the traditional doctrine over the course of several decades and is now unclear and inconsistent. To the extent that contractual certainty is sacred, it has already been sacrificed in the context of the enforceability of stipulated damages clauses in contracts. A comprehensive restatement of the principles relating to the enforceability of such clauses is necessary to

¹⁰⁹ *Ibid.* at para. 32.

¹¹⁰ Thomas Ho, “Against *Cavendish*: Towards a Procedural Conception of the Penalty Doctrine” (2016) 33:4 I.C.L.R. 451 at 457.

govern a contractual element that is pervasive, particularly in construction contracts.

At a time that Canadian courts should be looking to bring clarity to the law of stipulated damages, the United Kingdom Supreme Court has released one of the most important cases on the law of stipulated damages in a century. *Cavendish* provides an example of the thorough recasting of stipulated damages law required in Canada and offers innovations that are appropriate for adoption, specifically the concept of a legitimate interest that is broader than compensation for breach, which extends to the non-defaulting party's interest in the performance of the contract and is capable of supporting the enforceability of stipulated damages on that basis.

Canadian lawyers have a crucial role to play in this process. It is only through skillful arguments, both for and against the various aspects of the law of stipulated damages that need to be settled, that Canadian courts will be able to best determine the appropriate path for the development of Canadian law on the enforceability of stipulated damages. It is hoped that Canadian courts, including the Supreme Court of Canada, will regard *Cavendish* as an invitation to reassess the law of stipulated damages, similar to the acceptance of the invitation offered by *Dunlop* just over one hundred years ago.