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Penalty Clauses: Inequitable, but Not Inherently Extravagant

By: Jassmine Girgis

Case Commented On: *Super Save Disposal (Alberta) Ltd v Shenwei Enterprises Ltd*, 2017 ABQB 805 (CanLII)

Overview

This is an appeal from a decision of the Provincial Court, which found that a purported liquidated damages clause was, in fact, a penalty clause. The court struck the clause down for being "extravagant and unconscionable".

It was legitimate to find a clause comprised of gross profits to be "unfair and inequitable" in principle, but without knowing the value of the net profits and the difference between the two figures, it was problematic in this case to find its use to be "extravagant and unconscionable", and "unreasonable and oppressive".

Facts

The facts of this case are quite simple. Super Save and Shenwei entered into a waste disposal services contract (the "Contract"), which provided for Super Save to remove six yards of waste for Shenwei at an initial monthly charge of $328.65 plus tax, which was to increase to $381.32 per month plus tax, over time. The Provincial Court found that Super Save failed to pick up garbage five times from Shenwei's location, contrary to the Contract. It also found that Shenwei notified Super Save that it wished to terminate the agreement two times, and that Super Save had promised in return to credit the missed services to Shenwei, but that it had not done so. Eventually, Shenwei notified Super Save that it wished to terminate the Contract on January 4, 2014, and it contracted with a competitor for garbage removal. On January 13, 2014, Super Save told Shenwei that, due to its repudiation, Shenwei would need to pay liquidated damages in the amount of $18,684.68. No allegation of unlawful repudiation had been made, and indeed, the parties did not argue the issue in Provincial Court or at the Court of Queen's Bench (para 10).

History of Legal Proceedings

Super Save filed a Provincial Court Civil Claim on August 7, 2014, and amended it April 21, 2016. It claimed $20,605.65 and costs, and of that, $19,401.47 was claimed as liquidated damages. This amount comprised of 48 months times $363.16 plus GST (and the remainder, which was a debt claim, was later withdrawn).

Shenwei filed a Dispute Note on October 24, 2014 and amended it May 3, 2016. It acknowledged the Contract with Super Save and its termination based on Super Save's failure to perform as required under the Contract, and failure to credit Shenwei's account, as promised.

Shenwei maintained, in its defence, fundamental breach of contract or breach of a fundamental term, the right to repudiate the contract, that the liquidated damages clause was actually a penalty clause, and failure to mitigate damages on the part of Super Save.

At the Provincial Court, Judge D.G. Ingram found the purported liquidated damages clause to be unenforceable due to it actually being a penalty clause. Judge Ingram concluded the clause was "extravagant and unconscionable" and dismissed Super Save's claim for liquidated damages.

Super Save appealed the Provincial Court decision, arguing the trial judge erred in law and in fact, in having found that the clause amounted to a penalty clause, and that the amount was not a genuine pre-estimate of damages. Super Save also maintained that the trial judge made findings of fact unsupported by evidence, he erred in admitting certain evidence, and he erred in finding that Super Save had the onus of proving the liquidated damages claim was a genuine pre-estimate of damages rather than finding that Shenwei had to prove that the liquidated damages claim was a penalty clause.

Queen's Bench Decision

The Contract contained a term titled "Failure to Perform", which stipulated that if Shenwei terminated the agreement, Shenwei would be liable for, "as liquidated damages, an amount equal to the amount of the monthly charges plus applicable sales tax that would ordinarily become due to the contractor for the balance of the term", and specified that, "the foregoing liquidated damages are an accurate calculation of the anticipated lost income stream to the contractor for the balance of the term of the agreement," and were not "imposed as penalty" (para 9).

The parties did not argue the lawfulness of Shenwei's repudiation or fundamental breach of contract, so the issues were not addressed on appeal, though the latter argument had been made in Provincial Court.

Justice K. P. Feehan adopted much of the judgment below in his decision, where considerable reference was made to case law. On the issue of how to determine whether a clause is one for liquidated damages or a penalty, Judge Ingram relied on *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*., 1915 AC 79 [HL], to assess the difference between the two types of clause, where it was said, "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" (para 18). He went on to rely on *Cavendish Square Holding BV v Talal EI Makdessi/Parking Eye Limited v Beavis*, [2015] UKSC 67 to determine that the assessment as to the type of clause should be made when the contract is formed (para 23). As in *HF Clarke Limited v Thermidaire Corp Ltd*, [1976] 1 SCR 319, 1974 CanLII 30 (SCC), the concern of the court should be one of fairness and reasonableness (para 19) and as maintained in *Langille v Keneric Tractor Sales Ltd* (1987), 1985 CanLII 3137 (NS SC), the plaintiff should be put in the position it would have been in had the contract been performed. Finally, a court's intervention depends on whether the clause is a genuine estimate of the party's expected loss if the contract is breached (para 21, referring to *TriStar Cap v Super Save*, 2014 BCSC 690 (CanLII)), and the main consideration is whether the provision is penal in nature (paras 25-27, relying on *Cavendish* and *Dial Mortgage Corporation Ltd v Baines*, 1980 CanLII 1170 (AB QB)).

Counsel for Super Save argued that, due to the nature of the business of Super Save, the qualitative difference between Super Save's gross income and net profit was negligible. Super Save's business consisted of 120 customers; those customers were all along a route, and Super Save picked up their garbage. The loss of one customer, therefore, did not reduce the overall cost Super Save had to incur, as it still had to purchase gas, hire the driver, insure the vehicle and generally run the business. It is due to this point that Judge Ingram had found that Super Save was attempting to claim gross income, which would have been a windfall, since all that had been lost was the anticipated net profit. For that reason, he found that provision to be "extravagant and unconscionable" (para 14).

Justice Feehan dismissed the appeal, agreeing with Judge Ingram that the clause was "extravagant and unconscionable" and maintaining that for a party accepting the repudiation, a contract for continuing services with ongoing costs of doing business is different than one with no ongoing services. In the latter, there is no difference between gross income and the net profit after the supply of goods under the contract, but in an ongoing services contract, the loss of income stream (the gross income) is not the same as the damages recoverable at common law (the net income) (paras 2, 30).

Specifically, Justice Feehan maintained that the provision in the Contract claimed the amount of monthly charges plus taxes that would ordinarily become due to Super Save, and that this amount was a measurement of gross income, not a genuine pre-estimate of loss of net profit, making it a penalty clause, not a liquidated damages clause. He noted that there had been no evidence of a marked difference in the qualitative amounts, but that, "qualitatively it is unfair and inequitable to charge a gross income amount, whatever it is, when the loss suffered by Super Save was loss of net profit, whatever it is, on a liquidated damages provision in a contract" (para 30).

Analysis

Gross Profit vs Net Income: No Point of Comparison

The problem in this case is not the final decision, as Super Save did use its gross income to calculate its damages. The problem, rather, is the reference to the clause as being "extravagant and unconscionable" and "unreasonable and oppressive", in spite of having no evidence as to the actual figure of the net profits or damages suffered, and therefore, no point of comparison.

To recap, the Contract provided that in the event of unlawful termination, Shenwei would be liable to pay the amount of monthly charges plus applicable sales tax that would become due for the balance of the contractual term. Super Save claimed $18,303.26, an amount it arrived at by calculating its monthly loss of $363.16 for 48 months, the remainder of the contractual term. Justice Feehan agreed with Judge Ingram's primary reason for dismissing this case when he, too, found that the clause in issue was a penalty clause because it was a measure of gross income, not a pre-estimate of loss of net profit.

In *HF Clarke*, the majority decision explained the difference between gross and net profit: "Gross trading profit… 'means the difference between the net selling prices of the goods and

their laid down cost', the laid down cost being the seller's invoice price plus transportation charges to put the goods on the purchaser's shelves… 'the term "gross trading profit" is profit after cost of sales but before costs customarily deducted to determine net profit'" (at 327).

In the case before us, Justice Feehan found the amount claimed by Super Save to be the gross income amount it lost by Shenwei's repudiation of the Contract. Counsel for Super Save maintained that the difference between gross and net profits was negligible, but did not adduce evidence on the subject (para 15). Despite not having evidence, Judge Ingram, at first instance, and Justice Feehan, on appeal, determined that the clause was extravagant and unconscionable, and Justice Feehan concluded that since the clause was a measure of the gross income, it would be "an unreasonable and oppressive response to the repudiation of the contract, and therefore a penalty, not a genuine pre-estimate of damages" (para 30). Importantly, he went on to note that his conclusion would be the same regardless of the difference in qualitative value between the two figures because "qualitatively it is unfair and inequitable to charge a gross income amount, whatever it is, when the loss suffered by Super Save was loss of net profit, whatever it is, on a liquidated damages provision in a contract" (para 30).

In *HF Clarke*, the clause was denounced as being "a grossly excessive and punitive response to the problem to which it addressed" (at 338) because the court found the difference between the gross trading profits and the net profits over three years to be significant; the amount claimed, the gross trading profits, was $239,449.05 while the actual loss was less than half, at $92,017. In *Dunlop*, Lord Dunedin used the descriptors "extravagant and unconscionable" in the context of comparing the amount of damages with "the greatest loss that could conceivably be proved to have followed from the breach".

In this case, the clause cannot be found to be anything more than a calculation of the gross income, and in principle, "unfair and inequitable" (para 30). Without a figure as to what the net profit or liquidated damages would have been during that period, and a calculation as to the difference between the two figures, it is not possible to assess the impropriety of the clause. A finding of unconscionability in these cases is not necessarily a reference to an unconscionable bargain, but when used as "a synonym for something which is extravagant and exorbitant" (*Imp. Tobacco Co. (of Great Britain and Ireland) Ltd. v Parslay*, [1936] 2 All E.R. 515 (C.A.) at 521), it is important to have a point of comparison. Similarly, a finding of extravagance, unreasonableness or oppression is, by its nature, designed to indict a party that has taken undue advantage of another, again, which is not possible without having the figure of liquidated damages for comparison.

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