FINANCE LEASES AND LOSS OF BARGAIN: JUDICIAL IMPULSES IN THE HIGH COURT

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The High Court decisions on the recovery of damages for loss of bargain by a party who terminates a contract in the absence of a repudiatory breach or breach of an essential term by the other party have been the subject of considerable comment. However much remains unsatisfactory. This paper explores the problem in the context of finance leases.

In the 1980's the High Court departed from existing views and accepted principles on the recovery of loss of bargain damages upon the termination of a contract. This departure began with the decision in *Shevill v Builders Licensing Board*[1] ("*Shevill*") involving a lease of land. Four years later, the High Court held in *AMEV-UDC Finance Ltd v Austin*[2] ("*AMEV-UDC*") that loss of bargain damages are not recoverable by a lessor who terminates a chattel lease under a contractual right where the lessee has not repudiated the contract or breached an essential term under the general law. This is because, the High Court said, the loss is caused by the lessor's election to terminate, not the lessee's breach. But in *Esanda Finance Corporation Ltd v Plessnig*[3] ("*Esanda*"), it upheld a clause that allowed, in effect, recovery of loss of bargain damages even though the hire-purchase contract was terminated

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1. (1982) 149 CLR 620, where a lessor exercised a power of re-entry when the lessee fell into arrears in the payment of rent and sued the guarantors for damages.
2. (1986) 162 CLR 170. In arriving at this decision Gibbs CJ, 175, agreed with *Financings Ltd v Baldock* [1963] 2 QB 104, and Mason & Wilson JJ, 186, cited *The Progressive Mailing House Pty Ltd v Tabali Pty Ltd* (1985) 157 CLR 17, 31. R M Goode "Penalties in Finance Leases" (1988) 104 LQR 25; J W Carter "Chattel Leases: Penalties and Damages" (1987) 1 Com LQ 9.
3. (1989) 166 CLR 131.

under a mere contractual right. In so doing, the High Court accepted an "incongruity in holding that an owner's damages at law for a non-repudiatory breach are limited to losses caused by the breach alone while holding that a clause which imposes a liability on the hirer to pay the losses caused by exercise of a power to terminate a hiring upon breach is not a penalty."[4]

The resulting suggestion that one can, by careful drafting, circumvent the earlier decisions has predictably led to a variety of provisions[5] none of which can inspire much confidence until we understand the operative but unstated ends which lie buried in the thicket of incongruous legal reasoning.

The hypothesis of this paper is that the unstated ends in *AMEV-UDC* and *Esanda* are related to the financing and security functions of finance leases and hire-purchase agreements. More specifically, the impulses in the former decision are to protect an unacknowledged "proprietary interest" of the lessee in a finance lease. But as these impulses are diametrically opposed to the current legal characterisation at common law of all leases as mere contracts of hire, the High Court affected the subterfuge that the loss of bargain is caused by the lessor's election to terminate, not the lessee's breach. Similar impulses are even more apparent in the subsequent case of *Esanda* where members of the High Court were evidently concerned with the expectation interest of the owner, on the one hand, and the "potential proprietary right" of the hirer, on the other. But even in this instance of candour the High Court painfully resolved the issue by applying the rule against penalties. The judicial impulses themselves represent a welcome drift towards the substance of a transaction and away from its form. Unfortunately in taking the course that it did, the High Court left the jurisprudence on loss of bargain damages and penalties vexed,[6] unwittingly confounded the commercial nature of finance leases and failed to distinguish satisfactorily between the finance lease and hire-purchase. Even less delectable is the attempt by some of the judges in *Esanda* to convince us that there is symmetry in the several High Court decisions all of which supposedly respect the perspicuous "meanings" and "intentions" of the parties.

If this hypothesis is right, we should not aim at some magical drafting formula in order to stay clear of *AMEV-UDC*. We should instead overhaul our treatment of leases and hire-purchase agreements by bringing legal

4. Id, Brennan J, 147.
5. See eg J W Carter "Termination Clauses" (1990) 3 JCL 90.
6. Thus in eg "The Liability of Debtors and Guarantors under Contracts Discharged for Breach" (1992) 22 UWAL Rev 338, J W Carter & J C Phillips attempt to return to first principles.

conception into line with commercial reality in order to protect the respective interests of both lessor and lessee effectively. When that is done, it should be possible to restore general contract principles to the pre-*AMEV-UDC* understanding.

THE LEGAL CONCEPTION OF THE FINANCE LEASE

As a first step it is useful to review how commercial reality and judicial perception diverge in the case of the finance lease. With few exceptions, mainly intended to protect consumers, all leases are treated as contracts of hire under which the "hirer obtains the right to use the chattel hired, in return for the payment to the owner of the price of the hiring",[7] the chattel to be returned to the lessor or its order at the end of the lease. The rents are consideration for the use (including sub-lease) and enjoyment of the chattel under a bailment and the lessee does not acquire any equity in it. The rights between the owner and the lessee are determined by bailment principles which also apply to assorted transactions such as pledges, carriage of goods and gratuitous loans.

But there are two fundamentally different kinds of leases: the finance lease and the operating lease. Only the operating lease is a true contract of hire. The finance lease has, as we shall see shortly, financing and security functions which the law does not recognise. In stereotyping all leases as contracts of hire, the common law refuses to acknowledge that the finance lease achieves for the parties, commercially, results which are very similar

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7. *Halsbury's Laws of England* vol 2 (4th edn 1991) ¶1850. In Australia, inroads into this approach are found in the major consumer protection legislation of the States and the ACT: Credit Act 1984 (NSW); Credit Act 1987 (Qld); Credit Act 1984 (Vic); Consumer Credit Act 1972 (SA); Credit Act 1984 (WA); Credit Ordinance 1985 (ACT). See eg *Goddard v Visa Finance Corp Pty Ltd* (1985) ASC 55-449 where the Victorian Small Claims Tribunal found an agreement documented as a lease was in substance a loan contract and mortgage. See also *Hudson v Stateside Credit Corp Pty Ltd* (1988) ASC 55-619. Cf Under Saskatchewan's Personal Property Securities Act 1979 (Sask Stat) ch P-6.1, "leases for a term of more than one year" are deemed to be security agreements for the purposes of perfection (registration), priorities and conflict of laws rules of the Act. They are, however, not treated as security agreements for the purposes of inter partes rights and obligations between the lessor and the lessee. Leases involving lessors who are not in the business of leasing goods are not deemed security agreements and are not governed by the Act unless they are in substance security agreements: The Personal Property Security Act id, ss 2(y), 3(b) and sub-s (1). Alberta and British Columbia have similar legislation: Personal Property Security Act 1988 (Alta Stat) ch P-4.05; Personal Property Security Act 1990 (BC Stat) ch 25. The case has also been made for treating the finance lease as sui generis governed by a statutory scheme "tuned to its unique problems". See eg F Leary Jr "The Procrustean Bed of Finance Leasing" [1981] 56 NYUL Rev 1061.

to those of a conditional contract of sale.[8] Indeed, it distinguishes strictly between them. It ignores the fact that through the retention of title a lessor in a finance lease conserves its interests effectively in preference to all others in the event of the lessee's insolvency and that the attributes and incidences of ownership are made over to the lessee even though legal ownership does not pass to it.

THE FINANCE LEASE IN COMMERCIAL USE

The finance lease is the basic tool of leasing finance even though the leasing packages vary in their structural complexity and may involve multiple parties and different kinds of funding from a number of sources at different stages of the lease package.[9] Finance leases, as their name suggests, are used to finance the acquisition of equipment for use as capital goods.[10] Characteristically, the minimum period of the lease exhausts, or comes close to exhausting, the useful or economic life of the equipment. In Australia, these leases are said to be "rarely" for less than two years. The total rental payable by the lessee represents a sum which, taking into account tax considerations and cash flows, covers capital costs and desired profit for the

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8. Advantages such as tax benefits enjoyed under leases follow from the conceptual distinction between leases and conditional contracts of sale. They are not by any means a justification for the distinction in the first place.

9. Eg in the "wraparound" lease, the lessor of a lease sells the leased equipment to a third party and takes a lease-back for a term typically longer than the initial lease by 2 or more years. The new owner is the "wrap lessor", the original lessor the "wrap lessee", and the initial lease becomes in effect a sub-lease. Frequently the original lessor/wrap lessee would have leverage from borrowed funds for the purchase of the equipment. When leverage is obtained the equipment would already be subject to an existing debt at the time of its sale to its new owner and multiple parties can be involved in the leveraged lease alone through the use of consortium borrowing.

10. Consumer protection legislation in Australia does not concern us in this paper. Incidentally, the reach of this legislation is not determined by the finance function of the transaction. The finance lease is known by various other names. The more common of these names are the "long term lease", "pay-out lease" and "equipment lease". Apart from the fact that finance leases are characteristically for longer terms than operating leases, the epithet "long term" lease is not illuminating. The description "pay-out" highlights the approximation of the aggregate rentals to the price payable if the equipment was purchased under a conditional contract of sale which price in turn reflects the economic life (and hence, worth) of the equipment. The "pay-out lease" is therefore the most suitable alternative designation of the finance lease as it focuses on the lease's function of financing the acquisition in fact, if not at law, of the equipment. Finance leases are mainly equipment leases — hence the name "equipment lease". Like the description "long term lease", the "equipment lease" is not insightful. I R Davies "Equipment Leasing: a Decade of Growth" [1983] LMCLQ 631.

lessor. Rentals may be structured in numerous ways — often to accommodate the needs of the client. Maintenance, repair and insurance are usually the lessee's responsibility. The residual value of the equipment, which is the estimated market value of the equipment at the end of the lease, is usually insignificant. In practice it is often "abandoned" to the lessee, for instance by crediting it to the lessee's future transactions with the lessor. Some lessors may sell the equipment for scrap value or offer it to the lessee at a bargain price at the end of the lease.

In contrast, operating leases have no significant finance function. In these leases the lessee pays a rental for the use and enjoyment of the chattel for a limited period of time. Typically, the rental reflects the use-value of the equipment, the lease is short-term[11] and the lessee is one of a series of lessees of the subject matter which is maintained by the lessor. The lessee's main obligations are to pay the rent and to return the chattel at the end of the lease. Sometimes these leases are called "true" or "pure" leases. Common examples include "fleet management" leases for motor vehicles and leases of office equipment.

THE FINANCE LEASE: COMMERCIAL EXPECTATIONS

From a commercial point of view, the lessor's aim in a finance lease is to secure the lessee's obligation to pay by maintaining in itself a real right in the equipment. If all goes well the value of the equipment to the lessor diminishes as the lessee progressively meets its payment obligation until the obligation secured is fulfilled and the lessor sells the equipment for scrap or abandons it to the lessee. Thus, in the typical finance lease which exhausts the useful or economic life of the equipment the lessee can be regarded as building up "equity" in the equipment. The sum of the lessee's rights to the equipment by the end of the lease is in fact substantially all the incidences of ownership of the equipment. It is noteworthy that in the context of a hire-purchase it has already been observed that it is "more realistic" to acknowledge that there are "two proprietary interests" in the goods — that of the supplier

11. Even on a daily, weekly or monthly basis. *Consumer Credit* (1971) Cmnd 4596 ¶1.2.14 ("the Crowther Committee") reported that the commercial world recognises 3 main types of leases:

- leases, to denote operating and finance leases;
- contracts of hire; and
- rental agreements.

Contracts of hire and rental agreements are generally shorter term leases of particular kinds of goods. The classification is not based on the finance function of the agreements.

diminishing in value while that of the customer increases in value.[12]

The parties to a finance lease contemplate that the lease will commit the lessee to payment of the rental for the primary period. That is why there are express expectations of minimum payment in the typical lease contract. This expectation is reflected in stipulations for arrears of rent and the accelerated payment of all rentals outstanding upon termination, duly discounted, and for the payment by the lessee of any deficiency between the realisable value and the estimated depreciated value of the repossessed equipment (residual value). Indeed the Australian Accounting Standard AASB1008: Accounting for Leases provides by way of guidelines that a lease is a finance lease if (a) it is non-cancellable,[13] and either (b)(i) the lease term is for 75 per cent or more of the useful life of the leased property; or (b)(ii) the present value, at the beginning of the lease term, of the minimum lease payments equals or exceeds 90 per cent of the fair value of the leased property to the lessor at the inception of the lease. Put differently, the expectation of minimum payment restates the purpose of the lease as a finance tool and its design as a security device.

It is therefore not surprising that a finance lease has been described as being in essence a "sale by the lessor of that bundle of rights representing the right to use the equipment".[14] All being well, the lessee is after all more interested in the incidences of ownership, specifically the rights of use, than in physical equipment. Frequently, the equipment decreases in value to the point that at the end of the lease its residual value can be disregarded. Once ownership is "separated temporally",[15] it is evident that the lessor's interest in the lease term is "for security which he can foreclose by selling the term".[16]

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12. *Financings Ltd v Baldock* supra n 2, Lord Denning MR.
13. In AASB 1008: Accounting for Leases, "non-cancellable lease" means a lease which —
    - Can be cancelled only with the permission of the lessor or upon the occurrence of some remote contingency; or
    - The lessee, upon cancellation, would be committed to enter into a further lease for the same or equivalent property with the same lessor or a third party related to the lessor; or
    - Provides that the lessee, upon cancellation, would incur a penalty of a magnitude that, in normal circumstances, would be expected to discourage cancellation.
14. Eg H Kripke in the review of B E Fritch & A F Reisman (eds) *Equipment Leasing — Leveraged Leasing* 2nd edn (New York: Practising Law Institute, 1980), (1982) 37 Bus Law 723. Ownership is widely defined in terms of its legal incidents or the sum of powers inherent in the right of property. See eg A M Honoré *Oxford Essays in Jurisprudence* 1st edn (London: OUP, 1961) 109–118.
15. Kripke id, 729.
16. Ibid.

What he owns, according to this view, is "the temporal residual".[17]

While the above view captures the spirit of the finance lease, it understates the importance of the chattel and raises difficult questions about it. Whose chattel? Third parties often take securities and security interests over the chattel which incidentally can also have realisable values which exceed the estimated residual value significantly. In order to resolve the rights of these parties consistently with the above conception of the finance lease it would be necessary to overhaul existing principles governing those interests. Commercial thinking too would have to change.

LEASES AS A SECURITY DEVICE

To have a commercially realistic legal conception of the finance lease as a security device one needs only to treat it as a credit sale, allow the lessor to sell the chattel upon the lessee's default and apply the proceeds to extinguish the debt owing to it. Indeed, the similarities between conditional contracts of sale and finance leases are so striking that judicial persistence in treating them as completely different kinds of transaction is irrational.[18]

In principle, the distinction between true leases and security devices can be made on the basis of a meaningful residual value. An operating or true lease will have a meaningful residual value at the time of the contract belonging to and to be enjoyed by the lessor. Typical finance leases are not expected to have these meaningful residual values. The absence of a meaningful residual value reflects the "equity" which a lessee can be said to build up over the life of the lease. Conversely, when the asset is "abandoned" to the lessee, or sold at the end of the lease for scrap value, or sold to the lessee at a "bargain" price which is so low that it is commercially certain that the lessee will buy it, one can be confident that the lessor's objective of securing the lessee's obligation to pay has been achieved.

However, the notion of a meaningful residual value has its difficulties. In practice, it would be necessary to estimate it honestly and reasonably in the circumstances at the time of the contract. Account must be taken of inflation, depreciation, maintenance, obsolescence and realistic alternative uses for the

17. Ibid.

18. The Crowther Committee supra n 11, ¶1.3.5, 2.3.5 and 5.5.1 was of the view that finance leases were "implied purchase leases" and should be regulated as far as possible in the same manner as credit sales. I Davies "Absolute Title Financing in Commercial Transactions" (1985) 14 Anglo Am L Rev 71; Kripke supra n 14. Art 9 of the Uniform Commercial Code focuses on function and regulates security interests in personal property. This Act has been used as a model for legislative changes in many jurisdictions.

equipment at the end of the lease. If the realisable value of the equipment should unexpectedly exceed the estimated residual value, this should not affect the characterisation of the lease retrospectively.[19] The quantitative significance of the residual value is considerably more difficult to ascertain. Any attempt to do so is inevitably arbitrary. It really involves accepting the relativity of the residual value to the lease price as a practical indicator of paramount financing and security functions in a lease. To avoid foreseeable difficulties arising from this, it may be preferable to treat all leases as security devices with, perhaps, the exception of leases with terms of less than twelve months.

RAMIFICATIONS FOR THE RULE AGAINST PENALTIES

It is clear from the commercial nature of a finance lease that the lessor expects to recover its capital cost and the desired profit in much the same way as a vendor extending credit. This has significant ramifications for the rule against penalties which has been applied to leases generally. It is submitted that a minimum payment clause, by whatever name, that provides for the payment of arrears, a sum representing the discounted rentals outstanding and any deficiency of the realisable value over the residual value, is not a provision to which the principles relating to genuine pre-estimates of loss and in terrorem penalties are relevant. Such a minimum payment clause is a statement of the real essence of the finance lease as a security device for the acquisition of the asset by the lessee. In other words, it expresses the expectancy value of the lease. Accordingly it should be immaterial that a range of events (whether or not in the nature of a breach) can, at the lessor's option, accelerate the payment of what is otherwise payable over a period of time. For the same reason it should be immaterial that a breach which gives the lessor the option is grave or merely technical. The occasions on which termination and acceleration of payment can occur set out the parameters or reflect the stringency of the credit extended. In this light one can appreciate that the minimum payment clause does not seek to make a sum of money

19. The equipment can exceptionally have a significant realisable value well in excess of the parties' expectations and estimate for a number of reasons (eg, its rarity value can increase). Dramatic changes in foreign exchange rates, some unexpected new and inventive use of the equipment, and the discovery of some unknown potential of the equipment as a result of scientific and technological developments can also increase the realisable value of the equipment.

indiscriminately payable for losses of different magnitudes, however caused.[20] One can also appreciate that it is not a stipulation for "post-termination" payment that may be said to provide legitimately for a "different *kind* of loss" outside the rule against penalties.[21] What obscures this presently is our persistence in stereotyping finance leases as contracts of hire and the lessor's attendant right to repossess upon, usually, the same stipulated events. We shall return to this point shortly.

In *IAC (Leasing) Ltd v Humphrey*[22] ("*IAC*"), the High Court rightly upheld a clause intended to ensure that the capital cost of the equipment in question plus the appropriate profit should be recovered by means of the rent paid and balance outstanding plus any difference between the residual value of the equipment and its realisable value. There was, the Court said, no issue of penalty or a genuine pre-estimate of damages arising in relation to it. Some 38 years before, Street CJ had noted in *Western Electric Co (Aust) Ltd v Ward*[23] that he knew of "no case in which a clearly expressed intention of creating an option such as this has been interpreted as [a penalty]." This "intention", it is submitted, is construed from the commercial substance or reality of the transaction not from the magic of words strung together in any particular fashion. It follows that a minimum payment clause is, strictly

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20. These kinds of in terrorem penalties are subject to the rules laid down in eg *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo Y Castaned* [1905] AC 6 and *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79.

21. The distinction is sought by Professor R M Goode between loss of bargain and a "post-termination" payment for a different kind of loss, namely loss resulting from termination: Goode, supra n 2.

22. (1972) 126 CLR 131.

23. (1934) 51 WN (NSW) 19, 21. Cl 21 in that lease was in these terms:

> In the event of the exhibitor making default in the payment of any instalment of rent due hereunder and such default shall continue for a period of twenty-one days the whole of the moneys outstanding under this agreement and lease shall be at the option of the company exercisable during such default by notice in writing to that effect immediately become due and owing and payable by the exhibitor to the company.

Street CJ noted that *Lamson Store Service Co Ltd v Russell Wilkins & Sons Ltd* (1906) 4 CLR 672 could be applied to the case before him to arrive at the same conclusion. His own reasoning, however, turned simply on the clearly expressed intention of the parties and he did not go so far as to describe as liquidated damages the sum to which the lessor was entitled. See too *Re Mutual (Qld) Knitting Mills Pty Ltd (in liq)* [1959] QDR 357, and *Lamson Store Service Co v Weidenbach & Co's Trustees* (1904) 7 WAR 166. In the latter case the Full Court concluded from the nature and circumstances of the transaction that the realisation of the sum in question was clearly within the "original intention" of the parties and that upon default that sum otherwise payable at a future period becomes forthwith payable.

speaking, unnecessary for the recovery of the loss of the bargain in a finance lease even though it will be important in helping one to decide if the lease is a security device in the first instance. For the same reason, an excessive clause should not prejudice recovery for the expectation interest in a finance lease. The right to repossess — perhaps, more correctly, the fact of repossession translated into the realisable value — becomes an aspect of the expectation interest which is taken into account in estimating the value of the expectation interest.

Esanda subsequently applied *IAC* to allow an owner, who terminated a hire-purchase agreement under a mere contractual right, to recover as liquidated damages an amount equal to the total rent payable under the agreement less deposit, rentals paid, the realisable value of the equipment and a rebate of charges. The total rent payable was made up of the cash price and term charges plus stamp duty. The aim was clearly to ensure, as it was in *IAC*, that capital cost and profit were recoverable, thereby affirming that the transaction was not in substance that of mere hire. The owner was entitled, Brennan J explained, to recoup "the outlays it has made in acquiring the goods — the 'cash price' mentioned in the ... contract — together with interest and other charges up to the time of repossession and the costs associated with repossession and sale."[24] This was because the contract was treated, "in substance if not in form, as a moneylending transaction."[25]

But the decision in *Esanda* was put on the ground that the relevant provision was one for liquidated damages and not a penalty.[26] That put a most unfortunate gloss on *IAC*. The concepts of liquidated damages and penalty, as we have seen, were irrelevant in *IAC*. *Esanda* shifted attention from the expectation interest arising from the substance of the transaction to liquidated damages and penalties. It did this by taking its cue from *AMEV-UDC* that loss of bargain damages may be provided for with a "correctly drawn indemnity"[27] even though such damages cannot be recovered under the general law if termination was pursuant to a mere contractual right. Thus, by treating *IAC* as an instance of veritable draftsmanship, it gave its own previous efforts the appearance of symmetry, if not logic, and put a premium on the "correctly drawn" clause and the "clear intention". But the indicia of intention in

24. Supra n 3, 149; Gaudron J, 157, also affirmed that it was unobjectionable for an owner-hirer to recover the value to him of the performance of the primary obligation according to the terms of the hire-purchase.
25. Id, 150.
26. *AMEV-UDC* supra n 2, Mason & Wilson JJ, 194.
27. Supra n 3, Brennan J, 147.

Esanda are in fact prompted by the commercial substance or reality, not the form.

There is no doubt that the commercial reality or substance of the hire-purchase agreement in *Esanda* was the primary consideration. The owner's losses that could flow from the termination were taken into account and found to approximate the "liquidated damages" claimed. This was done in spite of the acknowledged "incongruity" because such losses do not, according to *AMEV-UDC*, flow from the termination.[28] To uphold the "liquidated damages" clause in the circumstances was to accept that the hire-purchase was in substance, if not in form, a security device for credit extended. Thus Brennan J acknowledged with refreshing candour that:

> If a clause which requires the hirer to pay the owner for losses occasioned by termination for breach under a contractual power is not a penalty provision, the reason must be that the court regards that clause and the clause authorising the owner to terminate the hiring, to repossess and sell the goods and to recover the net losses then outstanding as provisions to secure the owner's interests as a moneylender, as well as to secure the due performance of the hirer's obligations. The right to recover post-termination losses is needed to secure the owner's return of the money lent with interest and the recoupment of the owner's costs and expenses. The owner's rights to terminate the hiring, to repossess and sell the goods and to recover the recoverable amount can hardly be supported as a stipulation for the payment of a genuine pre-estimate of damage caused by any non-repudiatory breach of the hirer's obligations, but they can be seen to be security for the due performance of the hirer's obligations *and* the protection of the owner's interests as a moneylender. In other words, if it be right to uphold a stipulation for the payment of post-termination losses as a stipulation for the payment of liquidated damages, the corollary is that the transaction be treated in much the same way as a chattel mortgage and the contractual power to terminate, repossess and sell be treated merely as security for the payment of the moneys lent with interest and recoupment of the owner's costs and expenses.[29]

DAMAGES FOR LOSS OF BARGAIN AND PENALTIES: THE HIGH COURT'S POSITION

In order to highlight the distortion of contract principles by the highest court in the land, it is useful to reconsider here the one case from which much of the difficulty on recovery for loss of bargain flows. In *AMEV-UDC*, there were two leases of printing equipment for terms of 60 months and 48 months respectively. The lessors sued the defendants who were guarantors of the due and punctual payment of rent and all other sums payable under the leases upon the lessees failing to pay one instalment in each lease within seven days

28. Id, Brennan J, 150–151.
29. Ibid.

of the due date. The lessors had terminated the leases pursuant to a contractual right to do so and repossessed the equipment. They were unable to sell the equipment with an expected residual value of $64 350 but sold the other equipment for $22 500, well in excess of the expected residual value of $9 150. The claim against the guarantors was for $291 857.40 representing (i) arrears of rent as at repossession, (ii) the balance outstanding from the date of repossession to the expiry dates of the leases and (iii) the residual values of the equipment less the proceeds of the equipment that was sold, with interest on the total sum.

The precise nature of the lessor's claim was unclear from the statement of claim. The accelerated sum could not have been claimed as rentals outstanding after the termination — that is, as a debt, because the lessor's right to the accelerated sum abated on termination. It was not argued that there was under the lease contract an express present debt (equal in amount to the total rentals) with an indulgence on the part of the lessor to accept payment by instalments conditional upon due and punctual payment. It would have been unsuccessful in any event. The relevant clauses governing payment, according to Wilson and Mason JJ, were inconsistent with another provision imposing an obligation to pay the whole sum in the event of default. The sum payable was, they concluded, payable on default, as was the sum in *O'Dea v Allstates Leasing System (WA) Pty Ltd*[30] ("*O'Dea*").

The lessors could only have claimed the sum as damages. A provision in the contract supposedly for liquidated damages was struck down as a penalty. It was either considered or assumed by the whole Court to impose additional liability upon breach apparently because it was almost identical to the penalty clause in *O'Dea*. The Court pointed out that the provisions in the two cases exhibited the same following characteristics:

- The contractual right to terminate arose on the occurrence of a number of events including defaults "which, by their nature, could lead only to trifling damage";[31]
- The lessor had the right to recover all rents outstanding in addition to arrears, repossess the equipment and sell it without any obligation to account for any excess of proceeds over the appraisal or residual value;[32]
- The lessee on the other hand had to make good any difference between

30. (1983) 152 CLR 359. In *AMEV-UDC* supra n 2, Dawson J, 209, thought that such a clause which operates upon the premature termination of the lease "can hardly be construed as the withdrawal of an indulgence..."
31. *O'Dea* id, Gibbs CJ, 369.
32. Even though the lessors in *AMEV-UDC* accounted for the excess.

proceeds at disposal and the residual value; and

- There was no rebate for accelerated payment.

The issue, as finally expressed by Gibbs CJ,[33] was the amount of damages (at common law) the lessors were entitled to in the circumstances where the lessee, in breach of the contract but without repudiating it, failed to pay instalments due and the lessor exercised its right under the lease contract to terminate the hiring (and retook possession).

The main propositions of law applicable to this issue can be distilled with varying degrees of certainty from the majority judgment.[34] They are:

- Damages are recoverable at common law where a purported liquidated damages clause is struck down as a penalty. The lessor is in the position of a plaintiff in an ordinary action for damages for breach and is entitled to such damages as it can prove that it has sustained as a result of the breach.
- Damages recoverable by a lessor who terminates a lease pursuant to a contractual right to do so in the absence of a repudiation or the breach of an essential term under the general law by the lessee are different from those recoverable by a lessor in the event of the lessee's repudiation. Thus, loss of bargain damages are recoverable where the breach is repudiatory or of an essential term under the general law but not where the lessor terminates only under a contractual right in the absence of a repudiatory breach or breach of an essential term.[35]
- A lessor who terminates by reason of the lessee's non-repudiatory breach and retakes possession may recover arrears of rent and interest plus damages for any specific breach before the date of termination.[36]
- A lessor who terminates on account of the lessee's repudiation of the lease is entitled to recover arrears of rent and interest on them, damages for any specific breach before the date of termination and damages for

33. *AMEV-UDC* supra n 2, 174–175.

34. Gibbs CJ, Mason & Wilson JJ; Deane & Dawson JJ in the dissent.

35. Where there is a repudiatory breach or breach of an essential term, loss of bargain is recoverable even if termination is pursuant to a contractual right: *The Progressive Mailing House Pty Ltd v Tabali Pty Ltd* supra n 2.

36. As there can be no further breach after termination. *Financings Ltd v Baldock* supra n 2 approved. Cf *Lessors (Aust) Pty Ltd v Westley* [1964] NSWR 2091. It is not clear that damages for capital depreciation by virtue of the lessor having in his hands second-hand goods are recoverable. *Financings Ltd v Baldock* is inclined to deny such recovery. Cf *Universal Guarantee Pty Ltd v Carlile* [1957] ALR 374, which upheld a provision in a hire-purchase agreement for depreciation.

loss of bargain.[37] A lessor's loss of bargain is, in the typical case, approximately the rentals outstanding less a rebate for accelerated payment and less any excess of the realisable value over the estimated residual value.

TENSIONS IN THE HIGH COURT'S POSITION

It is an accepted principle that a party is entitled to recover loss of bargain damages when it terminates its contract for the breach of an essential term under the general law or on the ground of the other's repudiation. There were, however, two views in the cases before *AMEV-UDC* on the basis of recovery where termination is pursuant to a contractual right in the absence of a repudiation or the breach of an essential term under the general law (hereafter, "termination under a contractual right"). According to one view, the right to recover damages for loss of bargain depends on the parties' actual or imputed intention.[38] The other view treats it as being "governed by the ordinary law applicable to the avoidance of contracts for breaches of essential promises ..."[39] This latter view is arguably an unintended gloss on the first.[40] *AMEV-UDC* departs from both views and displays tensions in three aspects of the majority's somewhat contorted legal reasoning. These tensions have arisen because the High Court's approach stereotypes leases and hire-purchase as mere contracts of hire and at the same time attempts covertly to protect the "proprietary interests" of the respective parties with the rule against penalties.

First, the distinction between termination under a contractual right and a repudiation, in the assessment of damages, can lead to unfair and even embarrassing results. An example is provided by *Financings Ltd v Baldock*.[41] In that case the hirer did not pay two instalments and was held liable for damages equal to arrears and interest to the lessor who retook possession. But if the hirer, Lord Denning pointed out, "had been more courteous and had written: "I cannot pay any more instalments," that would have been a

37. This is also the English position. Cf *W & J Investment Ltd v Bunting* [1984] 1 NSWLR 331.

38. Eg *Westralian Farmers Ltd v Commonwealth Agricultural Service Engineers Ltd (in liq)* (1936) 54 CLR 361, 379.

39. Eg *Larratt v Bankers & Traders Insurance Co Ltd* (1941) 41 SR (NSW) 215, 225–226. See too Deane J in *AMEV-UDC* supra n 2. In *Lombard North Central plc v Butterworth* [1987] QB 527 it was suggested that the obligation to pay is a condition breach of which entitled one to recover for loss of bargain.

40. See Carter & Phillips supra n 6.

41. Supra n 2.

repudiation and the damages would have been multiplied tenfold."[42] It is alarming that the extent of a contracting party's liability can turn on a laudable act of courtesy. If one went further and contrasted the consequence of repudiation with that of early termination by the hirer in a hire-purchase, the distinction would be almost comic.

Second, the basis for denying loss of bargain damages for termination under a contractual right is unsatisfactory. The High Court explained that the loss of bargain in these cases is caused by the lessor's election to terminate, not the lessee's breach and hence is not recoverable. Its previous decision in *Shevill*[43] had already put in place what Deane J rightly criticised as a notion which "lie[s] ill with modern notions of causation and remoteness in the law of contract."[44] The upshot of the majority's artificial separation of the lessee's breach from the lessor's election to terminate is to introduce, according to Deane J, a distinction between "legal fault" and "legal liability". That is to say, a further distinction is being made between kinds of breaches in addition to that already made between breaches of different degrees of severity in *Shevill*.

Third, the High Court shed little light on whether a discredited penalty clause can nevertheless provide a basis for the recovery of some or even all of the sum stipulated. It is also unclear whether as a general rule a penalty clause can impose a limit to a party's damages at common law. The dissenting judges were of the view that the penalty is unenforceable only to the extent that the sum exceeds the "damage sustained by the lessor by reason of the termination upon breach, including loss of the bargain."[45] The majority of the High Court coyly abstained from the "wider controversy" of the penalty's demise and considered it "unnecessary" to resolve whether the penal sum posed a limit to recovery. Mason and Wilson JJ doubted the Court's ability to "rewrite" contracts and would not accede to what they considered to be a request to "develop a new law of compensation, distinct from common law

42. Id, 113.

43. Supra n 1. This decision has been severely criticised. Eg, Deane J in *AMEV-UDC* supra n 2, 206–207, thought it confounded long established practice and understanding of real property lawyers in NSW.

44. Deane J in *AMEV-UDC* supra n 2, 206, was of the view that whatever the basis for termination, settled notions of causation, remoteness and mitigation alone should determine the damages recoverable. See too Dawson J's criticisms.

45. *AMEV-UDC* supra n 2, Deane J, 203. In *W & J Investments Ltd v Bunting* supra n 37, Lee J held that a penalty will not influence damages at common law. Cf *Jobson v Johnson* [1989] 1 WLR 1026, 1039: the penalty clause cannot be relied on as an expression of any intention with regard to damages.

damages, which would govern the entitlement of plaintiffs who insist on the inclusion of penalty clauses in their contracts."[46] These reasons are in the circumstances unpersuasive.

It was open to the High Court to endorse one of two views: (i) that a penalty is "unenforceable ab initio" and has no legal effect;[47] or (ii) that a penalty is unenforceable at common law only to the extent that the liability under it "exceeds the true damnification".[48] Both views have judicial support. There is demonstrable historical and recent support for the second view which can also be arrived at by sound analogy with the approach in equity. In *Citicorp Australia Ltd v Hendry*,[49] Kirby P criticised the view that a penalty is void ab initio and put the case forcefully for enforcing a penalty until equity grants relief. The difference between the two views is that the latter allows recovery of the value of the bargain (or possibly a sum approximating it) independently of the common law right of recovery.

Even if a penalty is void ab initio, recovery of, say, the value of the bargain can still be made arguably on the ground of the parties' expressed or implicit intention evident in the penalty to adjust rights between them, for example, by payment for depreciation or capital loss. As a contractual provision it can signal, indicate or express the parties' wishes at the time of the contract. In fact, Rogers J, at first instance,[50] and Deane and Dawson JJ, in the dissent, found that the penalty in *AMEV-UDC* expressed the parties' intention that the value of the bargain was to be recoverable. Indeed, the Law Reform Commission of Victoria was of the view that penalties can put the other party on notice about risks of special loss more effectively than a general notice to support a claim for loss suffered within the contemplation of the parties at the time of the contract within the second rule in *Hadley v*

46. *AMEV-UDC* supra n 2, 193.

47. Eg *Citicorp Aust Ltd v Hendry* [1985] 4 NSWLR 1.

48. Dawson J thought it was even possible to bring an action on the penalty to recover proved damages, recovery for actual loss not being precluded. In *Financings Ltd v Baldock* supra n 2, Diplock LJ, 121 seemed to think that the clause is void only to the extent that it is penal. The issue was not raised. See too *Anglo-Auto Finance Co Ltd v James* [1963] 1 WLR 1042. In *Jobson v Johnson* supra n 45 the English Court of Appeal reviewed the case law on penalties and held that a penalty clause was unenforceable to the extent that it provided for compensation in excess of the innocent party's loss. The very nature of a penalty has come under scrutiny in some of these and related cases. Eg in *AMEV-UDC* supra n 2, Mason & Wilson JJ, 193–194, were of the view that the parties' relationship and any unconscionable conduct in seeking to enforce the provision in question were relevant in determining if the provision was penal. Cf *PC Developments Pty Ltd v Revell* (1991) 22 NSWLR 615.

49. Supra n 47, 22–24.

50. *United Dominions Corp Ltd v Austin* [1983] 1 NSWLR 636.

Baxendale.[51] None of these reasons would have required the Court to "rewrite" the contract or to develop a new law of compensation and more commercially realistic results would have ensued from them, as the parties contemplated.

JUDICIAL IMPULSES

The majority decision in *AMEV-UDC* is an open invitation to speculate on its unstated ends. Why, one is compelled to ask, would the majority of the High Court want us to believe that the loss resulting from a termination under a contract flowed from the lessor's election to terminate, not the lessee's breach? Perhaps they were concerned that a promisee's obligations may be manipulated indirectly by the promisor attaching serious consequences to technical breaches which entitle it, say, to call into account a promisee's obligations in such a way that alters them significantly. This can be a legitimate concern and one which is apparent in the subsequent decision in *Esanda*. In that case, Brennan J was clearly mindful of the need to relieve "against an unconscionable exercise of the power to terminate".[52] His Honour accordingly canvassed the use of the equitable jurisdiction to relieve against forfeiture to protect the "possessory or proprietary interests" of the hirer in a hire-purchase who has not committed a repudiatory breach. For that purpose it would be generally relevant to consider the "deliberation and seriousness of the hirer's breach" and the likelihood of the owner making a windfall profit by exercising its contractual right.[53]

The distinction in *AMEV-UDC* between "legal fault" and "legal liability" was perhaps after all quite intentional, if a little cryptic, and aimed vaguely at minimising the ability of a promisor to manipulate a promisee's obligations. But in the case of a finance lease appropriately treated as a security device, this impulse would be misplaced because the lessor's contractual right to terminate reflects the stringency of credit terms. Consequently the contractual right to terminate should not be seen as an attempt to affect the lessee's obligations adversely. In contrast, a hirer in a hire-purchase agreement has an option to purchase which it can be deprived of by the kind of machinations contemplated.

Perhaps the idea that a loss flows from a lessor's election to terminate,

51. (1854) 9 Ex 341; Vic Law Reform Commission *Liquidated Damages and Penalties* DP No 10 (Melbourne, 1988).
52. Supra n 3, 149.
53. Id, 151–152.

not the lessee's breach, belies concern in the case of a finance lease for the lessee's "lost equity". A finance lease, conceived as it is in the eyes of the law as a mere contract of hire, would mean substantial loss for the hirer against whom loss of bargain damages may be recovered even for technical and minor breaches. This is because a contract of hire does not recognise any equity in the hirer. Could it be that an attempt, albeit an inelegant one, has in fact been made to accommodate or protect a "proprietary interest" on the part of the lessee which the current conception of a finance lease precludes in the first place? In other words, was the majority of the High Court, intuitively at least, moving towards a view of the finance lease which is more in line with its commercial nature? It would appear that it was but was deflected when its line of legal reasoning became inextricably confused with liquidated damages and penalties. In *Esanda*, this impulse is clearly evident in especially Brennan and Gaudron JJ's judgments which openly acknowledged that the hire-purchase agreement is "in substance an agreement for the provision of finance (to which the hiring is merely the formal or legal incident)"[54] and that the hirer-owner is entitled to "the value to [it] of the performance of the primary obligation according to its terms".[55]

CONCLUSION AND POSTSCRIPT

Many attempts have already been made to draft the unassailable provision that *Esanda* seems to say can be crafted.[56] We are witnessing in these attempts confusion between the form and function of words and expressing the same faith in the "rightness" of particular words which Professor Glanville Williams wrote about in "Language and the Law".[57] For instance, the classic example of the penalty-indulgence distinction in our law would be taken to new heights in the idea that one can create a present debt

54. Id, Gaudron J, 158–159.

55. Id, 157. It is also noteworthy that in *O'Dea* supra n 30, the High Court was of the view that the value of the chattel needs to be taken into account when granting relief against forfeiture.

56. The most obvious device is to elevate contractual terms into "essential terms" and to deem any breach of such terms as repudiation. An example is given in R M Goode *Commercial Law* (London: Penguin, 1982) 838:

> 4.4. ... Punctual payment shall be of the essence of the Lease and notwithstanding any other provision in this Agreement or the Lease the Lessee shall be deemed to have repudiated the lease if any payment is overdue for more than 14 days ...

See too the similar suggestion in *Lombard North Central plc v Butterworth* supra n 39.

57. (1945) 61 LQR 71.

and an indulgence under a finance lease to avoid the operation of the rule against penalties.[58] The irony of course is that an indulgence can only have that effect because the law does not recognise the true substance of the finance lease. Given the current legal characterisation of a finance lease as a contract of hire, the various tried but untested devices such as the indulgence will only add another layer of fiction to a transaction already suffering from an identity crisis. Subterfuge in case law also misdirects legal resources and confuses basic principles. There is much to be said for calling a spade a spade.

A few words must now be said about hire-purchase. While the moral of the story is still to call a spade a spade, the hire-purchase transaction is in fact a different "implement" even though at one level of generalisation, a hire purchase, like a finance lease, is a security device. The High Court, however, did not distinguish between them in its application of the rule against penalties. Indeed, in *Esanda*, Wilson and Toohey JJ doubted if "any real significance" attached to the distinction in deciding on penalties.[59]

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58. Provision is made for an indulgence to accept payments by instalments to be withdrawn or to cease upon the occurrence of any of a number of specified events such as a failure to pay promptly in order that a previously accrued debt can revive. This supposedly gives rise to no new or additional liability at the withdrawal or cessation of the indulgence which can offend the rule against penalties. See *The Protector Endowment Loan & Annuity Co v Grice* (1880) 5 QBD 592; *Sterne v Beck* 32 LJ Ch 682 and *Thompson v Hudson* LR 4 HL 1. In *Lamson Store Service Co Ltd v Russell Wilkins & Sons Ltd* supra n 23, Griffith CJ, 683 extended the principle in these cases thus:

> When by a valid contract between parties *sui juris* one party promises to pay the other a sum by instalments, with a stipulation that on default in payment of one instalment all the others shall become due immediately, the nature of the consideration for the promise is immaterial. The only question is whether it is a good consideration. If it is, it matters not whether it was an existing debt, or a grant of an optional privilege, or any other thing that in law is regarded as a good consideration.

Gibbs CJ has since refuted its application to cases where there is no debt accruing before the breach which accelerated the payment: *O'Dea* supra n 30, 374. In the same case Brennan J, 387, pointed to the "commercial unreality in a time of high interest rates to hold that a debt which a creditor is not entitled to recover except by instalments over a period is to be equated with a debt which the creditor is entitled to recover immediately but which he agrees to receive by instalments over such a period." D S K Ong "Chattel Leasing: Indulgences, Liquidated Damages and Penalties" (1986) 60 ALJ 272, 275. In *IAC* supra n 22, the High Court thought that the agreement before it which was drafted in similar terms, could be construed in the same way as was the agreement in *Lamson Store Service Co Ltd v Russell Wilkins & Sons Ltd* id, a case sometimes cited in support of the indulgence. The agreement in question was to lease the equipment for a term of 18 months "at an entire rent equal to the total of the instalments provided in the schedule subject however to adjustment of such rent as provided in Clause 4".

59. Supra n 3, 140. Cf King CJ of the full Supreme Court refused to adhere closely to the

Nevertheless, the hirer's right to early termination in a hire-purchase is unique. It is thus unfortunate that the High Court did not overtly consider what impact, if any, this right to terminate the agreement prematurely may have. One can, however, glean two views on this unique characteristic of a hire-purchase which distinguishes it from a finance lease.

Lord Denning has suggested[60] that a hirer, having a right under a hire-purchase agreement to terminate the agreement prematurely, should not be liable for rentals outstanding even if it repudiates the agreement. The damages should, in short, be the same. In *Esanda*,[61] Gaudron J was generally of the view that an owner is entitled to the cost of the goods less their realisable value. More specifically, it is entitled to the outstanding component of the purchase price at the date of early termination. This is equal to the total instalments paid less the cost of the chattel and term charges referable to the actual period of hire, which is the period not extending beyond the time at which the outstanding component of the purchase price is reasonably to be regarded as available to the finance company. The benefit to the owner on early termination is the possession of the goods freed of the hiring obligation and the hire-purchaser's option to become owner. Accordingly, acceleration and mitigation are irrelevant. These two views converge to the extent that they (one explicitly and the other implicitly) consider it irrelevant that the hire-purchaser's breach is repudiatory or otherwise because the hire-purchaser's right to early termination affects the expectation interest of a hire-purchase.

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criteria in *IAC* supra n 22, on the ground that *IAC* dealt with a lease not a hire purchase: *Plessnig v Esanda Ltd* [1987] ASC 57, 540.

60. *Financings Ltd v Baldock* supra n 2, 113.

61. Supra n 3, 158.