NEWS Release

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PENALTY CLAUSES: DO THEY STICK?

It is common for a commercial lease to contain a provision that obliges a party to pay a pre-calculated amount of money in the event of a default, or a set of circumstances that may be characterized as a "failure". These provisions are either considered to be a penalty or a genuine estimate of damages. At law, most often, penalty clauses are unenforceable (and therefore not payable by the offending party), whereas liquidated damages are enforceable if they are reasonable.

The question inevitably arises as to what factors are needed to characterize a clause as liquidated damages as opposed to a penalty. This characterization can be the difference between the failing party paying nothing versus hundreds of thousands of dollars.

We frequently negotiate clauses stipulating pre-determined amounts of compensation for delays, failed co-tenancy situations, failures to carry on business, and even bounced cheques! We are never certain that the agreed terms will be enforced as written.

The interpretation of these clauses has occasionally been the subject of litigation proceedings.

Court Decisions

The Tenant's Failure to Open

In *J.D.S. Investments Ltd. v. Nino,* the Ontario District Court (now the Ontario Court of Justice), was asked to determine whether a lease clause was a penalty or liquidated damages. The clause provided that if the tenant failed to carry on business in its premises on the required days, the landlord would be entitled to collect an additional charge at the greater of a daily rate of ten cents per square foot of rentable area of the leased premises or $100.00. The Court held that a predetermined amount will be characterized as liquidated damages if it is a genuine estimate of the loss that will be suffered by one party if the contract is broken by the other, but will be a penalty if it is security for the promise that the contract will be performed. It also held that penalties are unenforceable unless the plaintiff proves that they have actually suffered damages in that amount.

The Court concluded that the clause was unenforceable because the amounts were so grossly unreasonable that they could not be defined as a genuine pre-estimate of damages.

Failure of the Landlord to satisfy the Opening Co-tenancy Condition in the Lease

In *Calloway Reit (Westgate) Inc. v. Michaels of Canada*, the lease required the landlord to pay the tenant the sum of $5,000.00 per day for the first five days of delay if the landlord failed to satisfy the co-tenancy requirement by a stipulated date. The Ontario Superior Court of Justice was tasked with determining whether this clause was a penalty. In doing so, the Court concluded that the rule against penalties involves an assessment of the remedy clause at two different junctures: at the time of contract formation, and at the time of the breach. Additionally, the Court must assess whether there was an inequality of bargaining power between the parties in order to determine whether it would be unconscionable for the innocent party to retain the money forfeited.

The Court found that the provision in the lease was not a penalty, as the amounts were not extravagant or unconscionable in comparison with the greatest loss that could conceivably be proved to have flowed from the delay in satisfying the co-tenancy provision. The Court found no inequality in bargaining power between the two sophisticated parties to the lease that would have suggested an "equitable" remedy was appropriate in the circumstances.

The Tenant's Failure to Make Timely Rent Payments

Health Quest Inc. v. Arizona Heat Inc., a recent case from the Newfoundland and Labrador Supreme Court, involved an obligation on the part of a tenant to pay $50.00 per day for failure to pay rent on time. The Court reiterated that the test for determining whether a clause is a penalty or liquidated damages turns on whether the payment is a genuine pre-estimate of damages. In addition, the Court outlined the following guidelines:

1. the sum in question will be a penalty if it is extravagant and unconscionable in comparison with the greatest loss that could follow from the breach;

2. if the obligation of the promisor is to pay a certain sum of money, and it is agreed that if they fail to do so they will pay a larger sum, the larger sum is a penalty;

3. if there is only one event on which the sum agreed is to be paid, the sum is liquidated damages; and

4. if a single lump sum is payable upon the occurrence of one or more events, some of which may occasion serious and others only trifling damage, there is a presumption, but no more, that the sum is a penalty. However, this result may not follow where it is difficult to prove actual loss.

The Court determined in this case that the effect of the $50.00 a day late payment clause was a penalty, as there was nothing to suggest that the amount related to any cost actually incurred by the landlord.

Can Uncertainty be Avoided Through Drafting?

To avoid uncertainty as to the enforceability of penalty/liquidated damages clauses, a lease may provide that the amount is deemed to be a genuine calculation of the cost that would be incurred by the innocent party in the event of a failure. It is unlikely that this phrasing would sway a Court. It is the Court who will assess the legal and economic consequences of the clause, not its characterization by the parties.

Takeaway

Overall, the fact that a lease contains statements of pre-agreed amounts to be paid in the event of a particular failure, is no guarantee that the injured party is entitled to those sums. Agreed upon amounts must *actually be* a genuine pre-calculation of damages in order for the clause to be enforceable. An express statement that a sum is a genuine pre-estimate will not be enough. When the clause is being interpreted, a Court will assess the harm at the time of the failure, at the time the lease was entered into, and whether the amount to be forfeited by the failing party is unconscionable. Regardless of how the parties characterize the provision, if it is not a genuine estimate of the damages that the innocent party will suffer, it will not stick.

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

Our secret for closing files lies as much in what is taken out as in what is put in. By eliminating exorbitant expenses and excess time, by shortening the process through practical application of our knowledge, and by efficiently working to implement the best course of action, we keep our clients' needs foremost in our minds. There is beauty in simplicity. We avoid clutter and invest in results.

Often a deal will change complexion in mid-stage. At this critical juncture, you will find us responsive, flexible and able to adjust to the changing situation very quickly and creatively. We turn a problem into an opportunity. That is because we are business minded lawyers who move deals forward.
The energy our lawyers invest in the deal is palpable; it makes our clients' experience of the law invigorating.

20 Queen Street West, Suite 3000, Toronto, Ontario M5H 3R3 | Tel: 416~597~6888 | Fax: 416~597~8897 | Web: www.dv-law.com

MARY ANN BADON
416-598-7056
mbadon@dv-law.com

FRANCINE BAKER-SIGAL
416-597-8755
francine@dv-law.com

CANDACE COOPER
416-597-8578
ccooper@dv-law.com

DENNIS DAOUST
416-597-9339
ddaoust@dv-law.com

ALLISON FEHRMAN
416-304-9070
afehrman@dv-law.com

SAHISTA FITTER
416-597-5742
sfitter@dv-law.com

GASPER GALATI
416-598-7050
ggalati@dv-law.com

S. RONALD HABER
416-597-6824
rhaber@dv-law.com

MICHAEL HOCHBERG
416-597-9306
mhochberg@dv-law.com

WOLFGANG KAUFMANN
416-597-3952
wolfgang@dv-law.com

LYNN LARMAN
416-598-7058
llarman@dv-law.com

MIMI LIN
416-597-8493
mimil@dv-law.com

MELISSA M. MCBAIN
416-598-7038
mmcbain@dv-law.com

PORTIA PANG
416-597-9384
ppang@dv-law.com

JAMIE PAQUIN
416-598-7059
jpaquin@dv-law.com

BRIAN PARKER
416-591-3036
bparker@dv-law.com

DINA PEAT
416-598-7055
dpeat@dv-law.com

CLAIRE RENNEY-DODDS
416-488-3568
crenney-dodds@dv-law.com

LUCIA TEDESCO
416-597-8668
ltedesco@dv-law.com

NATALIE VUKOVICH
416-597-8911
nvukovich@dv-law.com

DEBORAH A. WATKINS
416-598-7042
dwatkins@dv-law.com