

Court finds 500% “penalty” clause enforceable

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In the law of contracts, a penalty is the payment of a stipulated sum on the breach of the contract, irrespective of the damage sustained. In general, where the penalty is viewed as a genuine pre-estimate of liquidated damages, it will be enforceable. Otherwise, the penalty will be unenforceable.

However, as accepted in the recent decision of *Awad v. Dover*, 2021 ONSC 5437, the law with respect to penalty clauses is shifting toward an unconscionability analysis and the traditional rule set out above is thereby not necessarily absolute.

The relevant facts

In this case, the parties were involved in a lengthy dispute in connection with a joint venture that involved two oil fields in Egypt: Ras El Ush (“REU”) and East Wadi Araba (“EWA”). REU was a producing oil field, while EWA was an exploratory oil field.

The falling out between the parties resulted in the commencement of oppression actions and other proceedings in multiple provinces, including British Columbia, Alberta and Ontario, and eventually, in the Ontario proceeding, a Reference before a Master was ordered for an accounting to determine amounts owing between the parties.

An independent expert engaged on the consent of the parties for the purposes of the accounting calculated that under one scenario that the plaintiff, Dr. Awad, was owed \$1.65 million, plus potentially costs, while under a second scenario, the defendant, Dover, was owed more than \$330,000, plus potentially costs.

The two calculations were based on whether a particular clause in the parties’ Joint Venture agreement (the “JVA”) was enforceable. The clause at issue stated as follows:

For cash calls, the partners will be subject to a penalty of 500% of the costs for exploratory wells, if the funds are not provided in a timely fashion (the “**Penalty Clause**”).

Despite all of the litigation that had taken place between the parties over three jurisdictions, there had been no judicial determination of the Penalty Clause. Master Josefo explained that the closest assessment of the Penalty Clause had been made by Justice Loo of the British Columbia court wherein she stated:

Dover concedes that it has withheld revenues from Dr. Awad since January 2004. I do not know the extent of those revenues. However, Dover has paid Dr. Awad’s share of expenses for the EWA which is currently being litigated in Alberta, and has taken an assignment of Dover Petroleum’s interest in the EWA. The claim against Dr. Awad in the Alberta litigation is for \$708,315 representing his share of the cash calls which he has refused to pay. Under the EWA joint venture agreement, a failure to make a cash call provides for a 500 percent penalty. His potential liability is therefore greater than any REU revenue that is owed to him.

The evidence revealed that the Joint Venture agreement was drafted by Dr. Awad and that the Penalty Clause was his idea. He wanted this kind of clause in the agreement in order to protect his interests from any default by Dover. All of the parties agreed to the Penalty Clause and all of the parties signed the Joint Venture agreement.

However, it was Dr. Awad who defaulted on a cash call for a project on the EWA.

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Master Josefo explained that if the cash calls had not been made, there would have been a loss of an approximately \$4 million cost recovery pool, plus additional millions for well expenses, and the potential for forfeiture of the entire project.

The Law

The seminal decision on penalty clauses was rendered by the House of Lords over 100 years ago in *Dunlop Pneumatic Tyre Co. v. New Garage & Motor Co.* (1914), [1915] A.C. 79. The law was confirmed in Canada by the Supreme Court of Canada in *H.F. Clarke Ltd. v. Thermidaire Corp.*, 1974 CanLII 30 (SCC).

Under these cases, Master Josefo explained that the following principles could be found:

1. While contracting parties may use the words “penalty” or “liquidated damages”, and the parties supposedly mean what they contractually say, the court must determine if the payment is in reality a penalty or liquidated damages.
2. A penalty is stipulating a sum of money as payment in terrorem, while liquidated damages is a genuine pre-estimate of damages.
3. The terms and circumstances of each contract, and each case, are important determining factors, judged as of the time the contract was formed and not at the breach.
4. An amount can still be a genuine pre-estimate of damages even if the consequence of the potential future breach are impossible, at time of contract formation, to quantify. Indeed, that is the situation when the parties wisely run their minds to agreeing on a genuine pre-estimate of damages, which would be the intended bargain that the parties made.

Master Josefo accepted that the Penalty Clause had a purpose other than “*in terrorem*” and that more modern cases arguably were shifting to an unconscionability analysis when assessing the enforceability of these kinds of clauses. These modern cases included *869163 Ontario Ltd. v. Torrey Springs II Associates Ltd.*, 2005 CanLII 23216 (ONCA) and *Birch v. Union of Taxation Employees, Loc. 70030*, 2008 ONCA 809 (paragraphs 34-37).

Although Master Josefo did not determine whether a traditional penalty clause or unconscionability analysis was to be preferred in assessing the Penalty Clause, he found that under each analysis the Penalty Clause was enforceable.

Under the traditional analysis, the Penalty Clause was found to be a pre-estimate of damages, which was reasonable and appropriate given the potentially devastating consequences of a breach of the Joint Venture agreement.

Under the unconscionability analysis, Master Josefo concluded that Dr. Awad should be held to his bargain. He was the creator of the Penalty Clause and the drafter of the Joint Venture agreement, all of the parties agreed to the Penalty Clause and all of the parties signed the agreement. Dr. Awad, although self-represented, was a sophisticated party as well. He had a doctorate degree in the sciences and was astute at trying to protect his own perceived interests.

Lastly, Dover also argued that in any event neither the traditional or unconscionability analysis was needed because the breach was connected to a specific conditional event, the failure to make a cash call payment. Dover relied on *Biddell Equipment LP v. Caliber Midstream GP LCC*, 2020 ABCA 478 for this proposition. In that case, the Alberta Court of Appeal said:

Courts have enforced contract provisions that are a bona fide pre-estimate of damages suffered on breach or non-performance of a contract. These are commonly known as liquidated damages clauses. Conversely, courts have refused to enforce penalty provisions, which are essentially designed to deter a party from breaking a contract, irrespective of the anticipated loss. But a more fundamental issue here is whether this analysis applies at all to the present appeal. We say it does not. This analysis only applies on breach or non-performance of the contract; it does not apply to a conditional event that is governed by the contract.

Master Josefo concluded that if he was wrong with respect to his penalty clause and unconscionability analyzes, that the distinction raised by Dover was worthy of further consideration.

Representation by Gardiner Roberts LLP

Dover was represented by Howard Wolch, a partner and senior litigator at Gardiner Roberts LLP.

Mr. Wolch was assisted in the development and drafting of Dover’s legal argument by Stephen Thiele, a partner and the firm’s director of legal research. A PDF version is available to download [here](#).

If you require any litigation assistance, our **Dispute Resolution Group** lawyers are available to assist you. Please contact **Stephen Thiele** at 416.865.6651 or **Howard Wolch** at 416.865.6669.



Bay Adelaide Centre — East Tower
22 Adelaide Street West, Suite 3600
Toronto, ON M5H 4E3

Phone: 416.865.6600
Fax: 416.865.6636
contactGR@grllp.com

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Authors



Stephen A. Thiele

Partner

416.865.6651
sthiele@grllp.com



Howard Wolch

Partner

416.865.6669
hwolch@grllp.com



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22 Adelaide Street West, Suite 3600
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