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PENALTY

Lawyers, particularly long-in-the-tooth lawyers like us, have known from the time of their first contracts course that penalty clauses, usually for liquidated damages, are unenforceable. They are penalty clauses if there was no genuine attempt to estimate the possible damages from a breach. The clauses are used as a payment threat being held over the head of the other party to ensure that that it does not breach the contract. Could it be that our knowledge is now dated and incorrect? The case of Peachtree II Associates-Dallas LP v. 857486 Ontario Ltd. (2005), 76 O.R. (3d) 362 (C.A.) answers that question – sort of.

Limited Partnership

The general partner (GP) of a limited partnership had received promissory notes from the limited partners (LPs). The notes secured the obligations of the LPs to repay the GP for soft costs that it incurred in purchasing real estate and any funds that the GP advanced to the end of the limited partnership's income guarantee period.

The accountant who had flogged the investment to the LPs had insisted on a clause in the limited partnership agreement stating that if the LPs gave the GP two notices of the GP's default and 30 days had elapsed after each notice without remedy of the default, then the LPs were deemed to have paid the promissory notes in full.

The LPs gave the notices, the GP did not remedy the

alleged breaches, and the matter went to arbitration.

Arbitrator

The arbitrator found that the GP did breach the agreement when it failed to provide a promised line of credit and failed to remit to the LPs \$432,000 in tax refunds. The promissory notes, however, aggregated to several millions of dollars.

The arbitrator determined that the default clause was a penalty because there was no attempt to relate the value of the promissory notes to the value of the breach. However, the arbitrator gave effect to the penalty clause and held that the promissory notes were unenforceable, regardless of the gravity of the breach of the agreement.

The GP appealed on a matter of law and the motions judge upheld the arbitrator's award. The GP appealed to the Court of Appeal.

Streams

The Court signalled its decision would be erudite with the following statement: "*We must turn to history and to the two streams of our legal traditions, common law and equity.*" The courts of common law dealt with attempts to enforce payments of penalties while the courts of equity dealt with pleas for relief from penal forfeitures.

Under common law, the courts would not enforce a penalty on grounds of public

policy. The courts would determine whether there was a penalty by assessing whether, at the date of contract creation, the payment was a genuine pre-assessment of damages.

Under equity, the courts would relieve against a penal forfeiture if its enforcement would be inequitable and unconscionable. The courts would first determine whether the forfeiture was a penalty and then determine, as at the date of the breach, whether the enforcement of it would be unconscionable.

Which One

The GP argued that the clause was a penalty – indeed the arbitrator had found it so – and that under common law, it was therefore unenforceable.

The Court first had to determine what type of clause it was: penalty or forfeiture. Was common law applicable or equity? The Court held that a penalty clause involved payment and noted that there was no payment associated with the clause. The Court held that "*courts should, whenever possible, favour analysis on the basis of equitable principles and unconscionability over the strict common law rule pertaining to penalty clauses.*" The Court felt that "*judicial enthusiasm for the refusal to enforce penalty clauses has waned in the face of a rising recognition of the advantages of allowing parties to define for themselves the consequences of breach.*" Freedom of contract without judicial interference was important to the Court.

Accordingly, the Court

held that the clause was not a penalty clause; rather, it was a forfeiture clause, forfeiting the GP's right to collect on the promissory notes.

Since the Court held that equity rather than the common law rule prevailed, it dismissed the appeal. The arbitrator had correctly applied his discretion to analyse the factors for forfeiture: the conduct of the applicant, the gravity of the breaches, and the disparity between the value of the property forfeited and the damages that the breach caused.

Common Law

Although the Court obviously favoured the methodology and tests under equity over those under common law, the Court did not go so far as to overrule the common law test. It was content to interpret around it. The Court specifically left the question of the applicability of the common law test for another day.

Addendum

In January 2006, the Supreme Court of Canada denied the GP leave to appeal.

DISCLOSURE

Under sections 140-146 of the Business Corporations Act, a corporation must keep specified records. Shareholders have a right to audited statements and to various other basic corporate records, such as a list of directors, articles of incorporation, and minutes of meetings. Directors are entitled to far more information, including detailed financial information. Can a shareholder get more financial information than yearly audited

statements? This question was discussed in Thomas v. Thomas Health Care Corp. [2005] O.J. No. 975 (S.C.J.).

Family

The applicant was no ordinary shareholder. He was one of two siblings, along with two parents, in a family corporation. He was ousted as a director and officer, but was liable as guarantor on a \$17,500,000 debt of the corporation. The rest of the family allowed him access to those records set out in the BCA for shareholders, but nothing else. The applicant wanted more; he wanted ongoing financial disclosure to ensure that his guarantee was not at risk.

The corporation argued that the applicant was entitled only to what the corporation had already given and no more. It agreed that if the ap-

plicant could make a case for an oppression remedy, he could commence an action and obtain the financial information on discovery, but argued that the applicant could not obtain it otherwise. The corporation was unable to give any reason for not delivering the information, other than an unspecified cost.

The judge's view of all of the corporation's arguments, you ask?

"What nonsense. The applicant should be privy to the information to know the direction in which his investment is being taken by the rest of his recalcitrant family and the liability he faces unshielded from their action."

This case is an example of our proposition that most cases are not decided based on black letter law. For most judges, equity rules. In many cases, the smell factor is paramount.

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