

## CONTRACTUAL BREACH: CONSEQUENCES AND MONETARY REMEDIES

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### Introduction

1. The law of contracts requires parties who enter into agreements to stick to them. When a contract is breached, the innocent party has three remedies. It can terminate the contract, and/or claim damages for breach, or it can seek mandatory relief such as specific performance or an injunction to hold the breaching party to the bargain.
2. Termination frees the innocent party of the need to further perform the contract, and also entitles it to damages, but it is only available for serious breaches.
3. This paper looks at damages for breach of contract and is organised into three parts. First, the right to damages. This part looks at causation, remoteness and mitigation of loss.
4. Secondly, the assessment of damages and proof of loss, which considers the nature of damages that may be awarded for contractual breach, their theoretical foundation, and how to calculate and prove those damages.
5. Thirdly, the paper looks at two particular issues in damages: the equitable doctrine of penalties, and the effect of the *Wrongs Act* on damages claims arising under Victorian law.
6. Much of the law of damages for breach of contract is well settled. Most of the concepts are very familiar, and even intuitive. But for these very reasons lawyers need to guard against complacency when running a damages claim for breach of contract.
7. The catastrophe that befell the plaintiff, represented by very experienced practitioners in *NCON Australia Ltd v Spotlight Pty Ltd*<sup>1</sup> provides a salutary lesson – proof of damage requires careful consideration in line with principles of assessment. If a plaintiff fails to prove its loss, it can only recover nominal damages.

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<sup>1</sup> [2012] VSC 604 before Robson J at [296] – [354] and before the Court of Appeal, [2012] VSCA 232.

## **Part I – The Right to Damages**

### **Breach of Contract**

8. To claim damages for breach of contract, there must first be an enforceable agreement. Under the agreement each party has performance obligations, which are the consideration for the bargain. The contract will either expressly or implicitly require performance within or at a certain time.
9. Breach of the contract usually comes about in one of several ways:
  - 9.1. failure to perform on time (or at all);
  - 9.2. failure to perform to an agreed standard or specification;
  - 9.3. refusal or inability to perform before the time for performance has arisen.
10. The first two types of actual breach measure performance against the terms of the contract. Wherever the performance is not strictly in accordance with the contract there will be a breach.
11. The third type of breach is known as anticipatory breach. At the time of an anticipatory breach, if it amounts to a repudiation of the contract, the innocent party may terminate the contract.

### **When does a right to damages accrue?**

12. Damages may flow from any actual breach of contract, regardless of whether the contract remains on foot or has been terminated. By contrast, a party relying on anticipatory breach will usually need to terminate the contract to claim damages.
13. So, a right to some damages (perhaps only nominal) accrues on breach, but to claim more than nominal damages, the innocent party must prove it has suffered loss as a result of the breach. The types of loss recoverable are considered below.

## Identifying the Loss

14. The classic statement is that damages for breach of contract are awarded to an innocent party to place it in the same position as if the contract had been performed.<sup>2</sup> These are known as expectation damages.
15. Instead of an order that the contract be performed, the mechanism used to put the plaintiff in that position is to award it compensation so that it can restore itself to the position it should be in.<sup>3</sup>
16. The compensable loss is measured as the cost to the plaintiff to improve itself from the position it has been left in, to the position it would have been in, after due performance of the contract. Because loss is an essential element in a claim for substantive damages, identifying the loss is a necessary first step.
17. The two limits placed on recoverability of loss are causation and remoteness.

## Causation

18. To result in an award of damages, any claimed loss must have been caused by the breach.
19. The causation test is the same in contract as in negligence.<sup>4</sup> The 'but for' test can be useful in assessing whether event A caused event B, but it can also produce unsatisfactory results. It must be tempered with common sense. As Mason CJ said in *EH March v Stramare (E & MH) Pty Ltd*.<sup>5</sup>

*'The common law tradition is that what was the cause of a particular occurrence is a question of fact which "must be determined by applying common sense to the facts of each particular case".'*

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<sup>2</sup> *Commonwealth v Amann Aviation Pty Ltd* (1991) 174 CLR 64 at 80 per Mason CJ and Dawson J.

<sup>3</sup> *Tabcorp Holdings Ltd v Bowen Investments Pty Ltd* (2009) 236 CLR 272.

<sup>4</sup> *Hardchrome Engineering Pty Ltd v Kambrook Distributing Pty Ltd* [2000] VSC 359 at [446]ff.

<sup>5</sup> (1991) 171 CLR 506 at 515.

### Remoteness of damage

20. The second threshold question is whether the loss is too remote to be recoverable. The two limbs of *Hadley v Baxendale*<sup>6</sup> govern the outer limits of remoteness of loss. A loss will still be recoverable as damages for breach of contract if it:

*'May fairly and reasonably be considered either [as] arising naturally, that is, according to the usual course of things from such breach of contract itself, or...may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.'*

21. Any loss falling within either of these two independent (but overlapping) limbs will be compensable.

22. In the modern restatement adopted by the High Court on *Commonwealth v Amann Aviation*, the focus of the second limb is not on the reasonable contemplation of both parties, but of the defendant:

*'The crucial question is whether, on the information available to the defendant when the contract was made, he should, or the reasonable man in his position would, have realised that such loss was sufficiently likely to result from the breach of contract to make it proper to hold that the loss flowed naturally from the breach or that loss of that kind should have been within his contemplation.'*

23. The High Court has since emphasised that it is not the specific loss that must be foreseeable, but only a loss of the kind sustained.<sup>7</sup>

### Mitigation

24. It is often said that an innocent party has a 'duty to mitigate' its loss, and that loss caused by a failure to mitigate is unrecoverable. An alternative expression of the same principle gaining some acceptance is that there is no such duty to mitigate, but a loss arising after a failure to mitigate will be too remote, in that it does not arise naturally from the breach. That loss would not reasonably have been in the contemplation of the defendant at the time they made the contract.

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<sup>6</sup> (1854) 9 Exch 341 at 354.

<sup>7</sup> *European Bank Ltd v Evans of Robb Evans and Associates* (2010) 240 CLR 432.

25. Whichever form is adopted, the practical result is the same. An injured party cannot expect to recover damages if it lets the consequences of a breach of contract flow without taking any step to protect itself.

## Part II – Assessment and proof of damages

### Exceptional Categories of damages

26. There are two exceptional categories of damages which are not strictly compensation for assessed loss: nominal and liquidated damages.

27. **Nominal damages** are awarded if a breach of contract is proven, but no loss is established. Every breach gives the right to nominal damages. But the weight of authority suggests that a party proving an entitlement to only nominal damages should not recover its costs of the proceeding unless some right of substance is vindicated.<sup>8</sup>

28. **Agreed damages / Liquidated damages** are often provided for in building contracts in the case of delay. The parties agree to a sum that will be fixed and recoverable as a debt by the innocent party on breach.

29. Liquidated damages avoid the need to prove loss when suing for damages for breach of contract. But there is a catch. If the agreed sum for liquidated damages is not a reasonable pre-estimate of the loss that will be suffered for the breach, it will be void as a penalty. Penalties are discussed in detail below.

### Compensatory Damages – Expectation Damages

30. The ordinary form that damages take is compensatory damages, and a number of categories of loss emerge from the authorities. Being able to identify a claim as falling within an existing category helps to overcome the remoteness threshold. Some of the recognised categories are as follows.

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<sup>8</sup> *Nexus Minerals NL v Brutus Constructions Pty Ltd*, unreported, 10 September 1997, Full Court Federal Court of Australia per Spender, Nicholson and Finn JJ (BC9704267); *Alltrans Express Ltd v CVA Holdings Ltd* [1984] 1 WLR 394; *Anglo-Cyprian Trade Agencies Ltd v Paphos Wine Industries Ltd* [1951] 1 All ER 873.

30.1. **Direct losses** from non-compliance are the easiest to identify and assess. For example, a vendor contracts to provide goods and provides something worthless. The replacement cost of the goods is the measure of loss.

More complex to assess are some of the following losses that may be claimed when a contract is terminated for breach.

30.2. **Loss of profits** claims arise from terminated contracts. If the innocent party terminates for breach, it is entitled to claim the profit it would have made in performing its obligations under the contract.<sup>9</sup> That means that the innocent party must prove not only the revenue it would have generated from performing the contract, but also the costs it would have incurred. Without the latter the Court is not in a position to assess the lost profits.<sup>10</sup>

30.3. **Loss of a chance or opportunity** can also result in damages. When a breach of contract deprives the innocent party of a commercial opportunity, even if that opportunity has a less than 50% chance of coming to fruition, that party will be compensated. Examples include loss of the chance to:

- 30.3.1. renew a lease/licence/contract;
- 30.3.2. obtain more favourable terms;
- 30.3.3. extend a contract for service;
- 30.3.4. litigate a claim; or
- 30.3.5. avoid a loss.

As long as the chance is not as low as to be regarded as speculative (< 1% likelihood) or so high as to be practically certain (> 99% likelihood), the Court will take it into account in assessing damages.

This has two sides – although a plaintiff will be compensated for an improbable outcome, its loss will be discounted accordingly.

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<sup>9</sup> *Commonwealth v Amann Aviation Pty Ltd* (1991) 174 CLR 64.

<sup>10</sup> *NCON Australia Ltd v Spotlight Pty Ltd* [2012] VSC 604.

30.4. Damages for **loss of use of money**, also called *Hungerfords v Walker*<sup>11</sup> damages compensate the plaintiff for the loss of the use of money paid away or withheld in breach of contract. It operates in two fields:

30.4.1. where the plaintiff incurs an interest cost in borrowing money that it was entitled to recover from the defendant; or

30.4.2. where the plaintiff suffers an opportunity cost because it is unable to pursue a specific investment or undertaking in the absence of the money it was entitled to recover from the plaintiff.

### Compensatory Damages - Reliance damages

31. There are a further two types of losses which are more akin to tortious damages claims, and known as reliance damages. Rather than putting the innocent party in the position they would have been in if the contract had been performed, they compensate for a loss that was caused by the breach, by undoing harm caused.

32. **Personal damages** for anxiety, mental distress or inconvenience are uncommon, but may be claimed for breach of contract.<sup>12</sup> When an action is brought to recover for damages for breach of contract, any foreseeable inconvenience, anxiety or distress directly attributable to the breach may result in damages. Examples include home owners suing builders for defective building works where the owner has suffered mental distress because of the defective workmanship.

33. **Reliance damages** will be ordered to recover wasted expenditure once it is established that the expense was incurred in reliance on a promise of the party in breach, which it failed to perform. Reliance damages would ordinarily be sought where a contract has been terminated so early that the innocent party would be unable to prove the profits it would have made by performing the contract. In those circumstances the legal onus shifts to the defendant to demonstrate that the plaintiff would not have recovered those costs through the performance of the contract.<sup>13</sup>

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<sup>11</sup> (1989) 171 CLR 125.

<sup>12</sup> *Boncristiano v Lohmann* [1998] 4 VR 82; *Campbelltown City Council v Mackay* (1989) 15 NSWLR 501.

<sup>13</sup> *Commonwealth v Amann Aviation Pty Ltd* (1991) 174 CLR 64.

## Proof of loss

34. Although Courts will do the best they can to quantify damages when it is impossible to call evidence to prove loss with precision, the innocent party still bears the onus of putting all available admissible material before the Court to help it with that task.<sup>14</sup> Anything less would be impermissibly inviting the Court to speculate on the quantum.
35. Whether advising clients on prospects of success, drafting pleadings, discovering relevant documents, or preparing the case for trial, it is critical that lawyers concentrate on the loss that is being claimed and how it will be proven.
36. To identify what losses to claim, some of the relevant matters to consider are:
- 36.1. What is the nature of the breach?
  - 36.2. What did the contract require to be done?
  - 36.3. How was performance deficient?
  - 36.4. What were the consequences of the deficient performance?
  - 36.5. What would be necessary to put the plaintiff in the position as if the contract had been performed?
  - 36.6. Has the contract been terminated?
  - 36.7. Can profits on the contract be proven, or will reliance damages be claimed?
  - 36.8. Did the breach cause an interest cost to be borne or an opportunity to be passed up?
  - 36.9. How will all of these things be proven?

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<sup>14</sup> *McRae v Commonwealth Disposals Commission* (1951) 84 CLR 377 at 411.



## Part III – Particular Issues in Damages

### Penalties

37. The doctrine of penalties is attracted where a contract stipulates that on breach the contract-breaker will pay an agreed sum, but that sum exceeds what can be regarded as a genuine pre-estimate of the damage likely to be caused by the breach.<sup>15</sup>
38. A simple enough statement, but the remedy of relief against penalties has a murky past. As the High Court has recently observed, a proper understanding of the doctrine requires ‘more than a brief backward glance’.<sup>16</sup>
39. Several aspects of the doctrine are unsettled, and in *Ringrow v BP Australia*, the High Court seemed to be inviting an argument that the principles set down in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*<sup>17</sup> were due for reformulation.
40. Some elements of the doctrine are well-enough settled that a conservative contract drafter can avoid getting into trouble by taking the precautionary steps suggested below.
41. Until last year it was thought that only liquidated damages for breach could be void as penalties (by contrast with e.g. bank exception fees or step-up interest rates applying not for breach, but on the happening of events which were permitted under the contract). The High Court’s decision in *Andrews v ANZ Bank*<sup>18</sup> reversed that position.
42. In a promotion of substance over form, the Court unanimously held that:
  - 42.1. There is no limitation that only a contractual obligation that arises from a breach of contract can invoke the penalty doctrine.
  - 42.2. Whether ‘exception fees’ constitute penalties is a matter of substance and not form. The drafting of contractual terms to render ‘exception charges’ permissible cannot oust the penalty doctrine.
43. In *Andrews v ANZ* the Court was limited to answering the specific question of whether the Court could relieve against a payment for a non-breach. The High Court’s decisions in *Ringrow Pty Ltd v BP Australia Pty Ltd*, and the joint judgment of Mason and Wilson JJ

<sup>15</sup> *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 at [10].

<sup>16</sup> *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30.

<sup>17</sup> [1915] AC 79.

<sup>18</sup> [2012] HCA 30.

in *AMEV-UDC Finance Ltd v Austin*<sup>19</sup> remain substantively unaffected by the decision in *Andrews*.

44. Doing the best I can to reconcile those judgments and the statements in *Andrews* the following seems to be a summary of the relevant propositions.

44.1. For non-monetary penalties, an extravagant and unconscionable difference or oppressive disproportion between the value of what is transferred and the price to be received will constitute a penalty.

44.2. A term of a contract requiring the payment of money upon the occurrence of a breach may be held void as a penalty unless the sum payable represents a genuine pre-estimate of the loss occasioned by that breach.

44.3. In determining whether a term stipulating monetary payment on the happening of a breach is void as a penalty, or enforceable as liquidated damages:

44.3.1. It will be held to be penalty if the sum stipulated is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach;

44.3.2. It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid;

44.3.3. There is a presumption (but no more) that it is penalty when a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious breaches, but others only trivial breaches.

### **The *Wrongs Act* and contractual damages claims**

45. The High Court held in *Astley v Austrust Ltd*<sup>20</sup> that contributory negligence would not reduce a defendant's liability for breach of contract. The States and territories moved quickly to legislate away the effect of that decision, and in Victoria we have Part V of the

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<sup>19</sup> (1986) 162 CLR 170.

<sup>20</sup> (1999) 197 CLR 1.

*Wrongs Act 1958* which allows contributory negligence to be raised in reduction of a claim for breach of contractual duty of care.

46. Similarly, under Part IVAA of the *Wrongs Act 1958* some kinds of contractual damages may be apportioned between wrongdoers. As s. 24AF makes clear, Part IVAA applies to:

*'a claim for economic loss or damage to property in an action for damages (whether in tort, in contract, under statute or otherwise) arising from a failure to take reasonable care...'*

47. While the operation of each Part of the *Wrongs Act* is a seminar in itself, it is sufficient to say that a proportionate liability claim inevitably makes a proceeding more complicated and expensive by increasing the number of parties, and increases risks that a claim will not be paid in full. Obviously, a successful contributory negligence claim will reduce the amount of any damages awarded. If either can be avoided, it is usually advantageous to the plaintiff.

48. So it is worth bearing in mind these provisions when pleading damages claims. If a breach can be pleaded in a way that it does not involve a breach of a duty of care (contributory negligence), and does not arise from a failure to take reasonable care (proportionate liability), it may be possible to exclude the operation of the *Wrongs Act*, or at least make it more difficult for a defendant to successfully plead it.

### **Tips on contracting with remedies in mind**

49. Three drafting tips emerge from the above, which may help to ensure that loss suffered is recoverable.

50. First, because the remoteness test is based on the reasonable contemplation of the defendant, it is an objective test. But the extent of what it is reasonable for the defendant to contemplate is dependent on what the defendant subjectively knows. When drafting recitals or negotiating contracts, ensure that the other party understands the possible consequences of breach, so that they are more likely to fall within the limits of allowable remoteness.

51. Secondly, to avoid having an agreed damages clause struck down as a penalty, make a genuine assessment of the highest conceivable loss that could flow from the relevant

breach and document it. Better still, where possible, include that assessment in the contract as an express acknowledgment by the other party. For non-monetary consequences, give proper thought to whether they are being imposed *in terrorem* or constitute a proportionate consequence for breach.

52. Finally, to lessen the possibility of contributory negligence or proportionate liability defences for the breaching party, where possible, draft contracts to include obligations to achieve a rigid outcome, rather than to conduct an activity with care. For example, impose an obligation to construct a watertight building rather than to construct a building with due care and skill.
53. Not only will proof of breach be easier, but if litigation becomes necessary it will be more likely that the breach can be drafted in a way to exclude the operation of the *Wrongs Act*.

## **Conclusion**

54. Most of the principles involved in claiming damages for breach of contract are well-known, which means the capacity for oversight or shallow analysis is increased. It is an area that requires close attention to ensure that clients receive adequate advice before commencing proceedings, and can recover the damages to which they are entitled.

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