# CURRENT DEVELOPMENTS: TERMINATION PROVISIONS IN LEASES POSSIBLE SOLUTION

MICHAEL F MACNAMARA

**Corrs, Pavey, Whiting & Byrne**
**Solicitors, Melbourne**

The cases considered by David Taylor raised two distinct problems which tend to overlap. The first problem which I will call the quantum problem arises where courts hold that liquidated damage or "recoverable amount" clauses provide for the recovery of an excessive quantum either because no credit is given for sale proceeds of the goods recovered in excess of the residual value or no rebate is allowed for accelerated unaccrued rentals. The second which I will refer to as the "causation" problem derives from a line of English hire purchase cases and the decision of the High Court in Shevill's case to the effect that a termination of lease or a non-repudiatory breach on the part of the lessee does not entitle the lessor to damages for loss of the bargain. The argument goes that since it was the decision of the lessor to terminate the lease the bargain is lost by his exercise of the election and not by reason of the initial breach by the lessee. Accordingly, the amount in the liquidated damages or recoverable amount clause is excessive simply because the alleged damage in the loss of bargain was not caused by the defaulting lessee.

What can be done? Attacking the problem at the first level one might ask what the draftsman of a fairly standard form of finance lease such as was in question before the courts in cases such as O'Dea, Hendry or Austin do to ensure that his lessor client would in future be able to at least recover in effect his client's principal outlaid and interest to the date of termination? Addressing the second problem first there would seem to be basically two possibilities. First, one could take the hint given by Gibbs C.J. in Shevill's case where he said that "very clear words" could "bring about the result, which in some circumstances would be quite unjust, but whenever a lessor could exercise a right given by [the lease] to re-enter, he could also recover damages for the loss resulting from the failure of the lessee to carry out all the covenants of the lease - covenants which in some cases, the lessee might have been both willing and able to perform had it not been for the re-entry" (1982) 56 ALJR 793, 796, effectively stipulating that each and every clause of the lease was to be treated as a "condition" or an essential term

a breach of which entitled the lessor to terminate the lease and sue for damages for loss of bargain.

Nevertheless one would have some misgivings. First, his Honour mentioned the possibility of so drafting a lease with a distinct lack of enthusiasm referring to the necessity for "very clear words" and the possibility that such a lease might be "quite unjust". A draftsman would have every reason to expect his clause to be construed very much contra proferentem. Moreover, there has been a strong trend at least in England away from "pre classifying" particular terms as conditions or warranties looking rather to the seriousness of the breach rather than the nature of the covenant breached. See for instance Hong Kong Fir Shipping Co. Limited v. Kawasaki Kisen Kaisha Limited [1962] 2 QB 26; Cehave N v. Bremer Handelsgesellschaft mbH [1976] QB 44, 71; Reardon Smith Line v. Hansen-Tangen [1976] 1 WLR 989, 998.

Another possibility is to select the gravest or most important of the events or defaults upon which it is desired to give the lessor a right of termination and to deem them to be a "repudiation". However, in Financing Limited v. Baldock [1963] 2 QB 104, 123 Lord Diplock made clear that a repudiation which entitled a lessor to obtain damages for loss of bargain was "something which the law regards as wrongful repudiation of the contract". A view thoroughly inimical to "deemed" repudiation.

Despite these difficulties the decision of the High Court in IAC (Leasing) Limited v. Humphrey (1972) 126 CLR 131 has not been over-ruled. That case upheld a lease which provided for payment to the lessor of liquidated damages on early termination of a chattel lease despite the absence of a repudiation as Mason and Wilson JJ. noted in Austin's case:

> "It may no longer be possible to sustain all the steps in the reasoning which led to this court's conclusion in IAC (Leasing). However, there is no reason to suppose that a provision which gives the lessor an indemnity, on his early termination for the lessee's breach, in the form of all unpaid instalments of rent, suitably discounted for early receipt, plus the residual value of the goods adjusted so as to reflect their actual value at the relevant time, would constitute a penalty." ((1987) 68 ALR 185, 202.)

The Justices of the court in O'Dea were at pains to distinguish Humphrey. Nevertheless no draftsman could be happy that he is safe from this point. Priestley J.A. who delivered the principal judgment in the Court of Appeal in Citicorp Australia Limited v. Hendry said that he had "not formed a final opinion" on this point ((1985) 4 NSWLR 1, 34). Clarke J. who heard Hendry's case at first instance appeared to regard the "causation" point as good grounds in itself for striking down a clause similar to the one in Humphrey's case as a penalty independently of the disparity between the high earning rate in the lease (24%) and the low discount rate (10%) ((1985) 4 NSWLR 1, 13-14).

On this causation point, the best which a draftsman can do is to derive confidence from Humphrey's case and the High Court's refusal to over-rule it either in O'Dea or Austin and by rendering his termination - acceleration clause operative only upon more serious breaches such as substantial delays in payment of instalments or breaches which prejudice the safety or condition of the goods or the lessor's ability to recover them.

We now come to the quantum point. It will be recalled that the distinguishing point between Humphrey's case where the recoverable amount clause was upheld and Hendry's case where it was struck down as a penalty was that in Humphrey's case the discount rate to be applied to unaccrued rentals of 10% would have been fairly close to the underlying earning rate on the lease. In Hendry's case it was some 14 per centum per annum less than the earning rate. Of course, there is no reason why the discount rate and the earning rate should be identical. First, the lessor is entitled to a profit margin. Secondly, if interest rates have fallen precipitately from ruling rates at the time the lease was entered into it may not be possible for the lessor's funds to be re-employed at as high a rate of return and the lessor ought to be recompensed for that. Priestley J.A. in Hendry suggested that the discount rate would be non-penal if it were either -

(a) a fixed rate "not so markedly different from the percentage return which the lessor itself was contracting for" or else

(b) a "floating" figure taking account of the movement of market interest rates and the ability of the lessor to put the funds out at a rate incomparable to the one ruling under the lease.

I would favour rebating the earning rate. The lessor may be "short changing" himself to some limited degree but the consequences of asking for too much as evident in Hendry and Austin establish prudence and conservatism as the preferable course. At least one major leasing company has provided for a scheduled rebate rate being 85% of the earning rate thereby avoiding the wide divergence in Hendry.

The rebating of the residual value itself has received little attention in the cases. However the logic of cases such as O'Dea and Humphrey seems to require a rebate of the residual value as well. The conclusion can be reached to two routes. First, the receipt of the residual value can be seen as merely one of a stream of payments which upon acceleration must be rebated to retain their true value. Secondly the finance leases considered in cases such as Austin, Humphrey and O'Dea were structured like principal and interest loans. A lease on this framework for say, five years with a fifty percent residual value at the conclusion of the lease with the cash price of goods at $100,000.00 would be established as a principal and interest loan amortising during the five year term leaving a balloon payment of $50,000.00 at the

expiration to clear all principal and interest. Each of the instalments during the term consists of three components:

(a) The depreciation in the value of the goods - part of the principal sum.

(b) Interest upon the reducing balance of the principal - that is the balance of the depreciating component of the value of the goods from time to time outstanding.

(c) Interest upon the non-depreciating value of the goods - the balloon payment or principal sum of $50,000.00 at the end.

If the transaction were viewed of the principal and interest loan an early payout "without penalty" would entail payment of the principal outstanding and interest due up to the date of repayment. That is the future instalments would be accelerated but the entirety of the interest component would be removed. Translating this back to a finance lease, this result can be achieved only if the residual value itself is rebated because part of the interest component in each instalment is interest upon that fixed residual value of the "loan".

It seems clear from O'Dea and Austin that failure to give credit for surplus of a residual value on sale of the goods would also be regarded as penal and an appropriate clause in that regard must be included.

I would suggest that the Lease provide that upon:

(a) Breach of any of the terms which the Lease defined as essential.

(b) Default is made in the payment of rent for a period exceeding fourteen days.

(c) Any of the usual "automatic" "default" events that is liquidation, receivership etc. occurring "then and in any such event there shall forthwith become due and payable by the Lessee to the Lessor the total (hereinafter called 'the recoverable amount') of:

  (i) The aggregate of the rent instalments not then accrued due rebated to reflect their present value, such value to be ascertained by applying the discount rate (hereinafter defined) to each rental instalment in respect of the period by which the date of payment there is by virtue of this clause brought forward (together with an amount equal to any stamp duty or financial institutions duty payable in respect of such rebate total).

  (ii) The amount of any rentals or other moneys accrued due.

(iii) The costs and expenses of the Lessor in re-possessing the goods (including costs and expenses in satisfying any lien claimed over the goods whether justifiably or not).

(iv) Interest at the rate of — percentum per annum on all overdue amounts payable under this lease.

(v) An amount equal to the residual value of the goods (discounted by applying the discount rate to such amount in respect of the period over which the date for payment of or indemnity against the residual value is by virtue of this clause brought forward)."

The discount rate could be a scheduled rate either fixed or floating so as to meet the criteria laid down by Priestley J.A. in Hendry or (and I would favour this) could be defined as the rate which would "when applied to a future instalment or payment of the residual value ensure that the Lessor would receive the same rate of pre-tax return of profit after such discounting as the Lessor would have received from the Lease if all instalments and payments had been paid on their respective due date and an amount equal to the residual value had been received on the base of the expiration of the lease". The calculation could be made the subject of a certificate by the Lessor which would if given in good faith, be conclusive.

The recent cases have left the law in a most unsatisfactory state. There is little reason for optimism that satisfactory case law reform will take place. In this country the amount of outstandings on leasing finance must run into many thousands of millions. Many of these receivables are owing to public borrowing corporations. Ordinary citizens lend money to these corporations on the face of prospectuses showing the outstandings on leasing agreements as assets. It is clearly in the public interest that the recoverability of these lease outstandings not be under any unnecessary clouds or doubt. In many places in the case law it is acknowledged that the lessors in finance lease are dealers in money and not in goods. The result of cases such as Austin is simply to render irrecoverable part of the principal moneys outlaid by financiers in circumstances where commercial prudence and common sense require them to act to terminate leases.

Regrettably all too often far from seeking to accommodate these commercial realities, the law has seemed to regard leasing finance as a somewhat unsavoury "device" and to take some delight in its practitioners coming undone. Speaking of a hire purchase agreement Lord Diplock said:

> "The business nature of a transaction is that of money lending, and accordingly clauses are inserted by the finance company in the contract of hiring in an endeavour to ensure that upon breach by the hirer of his obligation to pay an

> instalment of hire, the finance company shall be entitled, not only to terminate the contract of hire, but also to recover from the hirer sums which bear no relation to the damages appropriate to a breach of a genuine contract of hire. But hire purchase finance companies cannot eat their cake and have it. If they choose to conduct their businesses by entering into contracts of hire of chattels instead of entering into money lending contracts secured by chattel mortgages, their legal rights will be governed by the terms of the contracts into which they enter and by the general principles of law applicable to contracts of that nature." ([1963] 2 QB 104, 117-8.)

In Austin's case Gibbs C.J. said:

> "It was submitted on behalf of the appellant that the result reached by the Court of Appeal in the present case was unjust. It was said that the leasing agreements were in substance financing transactions. It was pointed out that since the property leased was by its nature likely to fall steeply in value once it had been used, the appellant was likely to suffer considerable financial detriment if the hiring came to an end after a comparatively short period since in those circumstances the right to recover any deficiency below the residual value would probably not recompense the appellant. The answer to these submission is that the appellant chose to enter into an arrangement of that kind, and to determine the hiring, and this its election to do so caused this loss."

Accordingly legislative intervention is essential to provide a certain and satisfactory basis for future leasing transactions. Yet it seems paradoxical that the Hire Purchase Acts - passed as measures of consumer protection - and left in Victoria to deal with commercial transactions dealt with these problems with comparative ease providing for credit for sale proceeds of the goods and a rebate according to the rule of 78 on unaccrued hire instalments. The Victorian Credit Act also employs a formula similar to the rule of 78 (its translation into a formula expressed somewhat differently to the one appearing in the Hire Purchase Act referring to "instalment intervals" rather than months has had an apparently unintentional distorting effect. See Anderson v. HFC Financial Services Supreme Court Victoria Full Court unreported). The South Australian Consumer Transactions Act also has a rebate formula. Any of these rebate provisions ought to be satisfactory and non-penal for commercial leasing if various State Parliaments have thought them fit to employ in consumer protection legislation.

De-regulation is much in vogue in matters commercial. Mason and Wilson JJ. said in Austin:

> "Instead of pursuing a policy of restricting parties to the amount of damages which would be awarded under the general

> law developing a new law of compensation for plaintiffs who seek to enforce a penalty clause, the court should give the parties greater latitude to determine the terms of their contract. In the case of provisions for agreed compensation and, perhaps, provisions limiting liability, that latitude is mutually beneficial to the parties. It makes for greater certainty by allowing the parties to determine more precisely their rights and liabilities consequent on breach or termination, and thus enables them to provide for compensation of situations where loss may be difficult or impossible to quantify or, if quantifiable may not be recoverable at common law." ((1987) 68 ALR 185, 201.)

Legislation should be introduced which does not limit or prescribe what may be recoverable from termination of a commercial lease but rather provides that a lessor will be entitled to recover an amount in accordance with one of the statutory rebate formulae upon the termination of a lease for non-repudiatory breach. It should further be provided that such recovery would not be precluded on the basis of the doctrines of penalty either in terms of the quantum or causation problems which I have discussed.

In applying one of these statutory formulae a problem arises immediately. In consumer transactions it is customary to distinguish between the cash price of the goods financed and the "terms charges" or other corresponding terminology. Commercial leases though generally refer simply to certain instalments and a residual value without nominating a specific earning rate in terms of the per centum per annum and also without isolating a particular part of the amount payable under the lease as "terms charges" or "interest". Nevertheless the use of a definition similar to the definition of "cash price" appearing in the Victorian Credit Act would enable an allocation to be made of the total amount payable under the lease and is between cash price and terms charges. The cash price minus residual value would be deducted from the total lease instalments payable leaving the balance as terms charges. The rebate formula from the South Australian Consumer Transaction Regulation is attached. A liquidated damages clause in terms of the statutory provision would not be mandatory. Lessors could contract for some other scheme but would have to take their chances against the doctrine of penalties.

## ATTACHMENT TO PAPER BY MICHAEL F MACNAMARA

### SOUTH AUSTRALIA - CONSUMER TRANSACTIONS REGULATIONS
### TWENTIETH SCHEDULE
### CONSUMER LEASE - AMOUNT PAYABLE ON TERMINATION

The amount payable by a consumer upon termination of a consumer lease prior to the expiry of its terms (by reason of breach of the provisions of the lease or otherwise) shall be the amount arrived at by the application of the following principles:

1. By application of the following formula:

$$(A + R) - B \times \frac{(C + R)}{D + R} \times (D + R - P) - V$$

in which:

A = the amount of rent payable for the unexpired portion of the lease, plus the amount of any arrears due at the date of termination.

B = the proportion (expressed as a fraction) which the rent due for the unexpired portion of the lease bears to the total rent payable for the full term of the lease.

C = the amount of the rent payable for the unexpired portion of the lease.

D = the total amount of rent payable for the whole period of the lease.

P = the value of the leased goods at the date of the lease together with all charges other than interest and charges arising upon repossession of the goods prior to the expiration of the term of the lease.

R = the estimated or agreed residual value of the goods leased at the end of the full term of the lease.

V = the value of the leased goods at the time of the termination of the lease, which shall be the best price that the lessor could reasonably be expected to obtain from the goods upon sale.

The amount payable by the consumer shall be the amount (if any) calculated by the application of the above formula, plus any of the expenses incurred by the lessor as follows:

(a) any reasonable costs (including legal costs) incurred by the lessor of and incidental to taking possession of the leased goods,

(b) any amount properly and actually expended by the lessor on the storage, repair and maintenance of the leased goods, and

(c) the reasonable cost of selling or otherwise disposing of the leased goods (whether or not the goods have, in fact, been sold or disposed of).