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SETTING AN EXAMPLE:

Tak and Co Inc v AEL Corp Ltd

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CONTENTS

I INTRODUCTION

Traditionally, exemplary damages[1] have not been available for breach of contract. In a startling rejection of this principle, the High Court of New Zealand recently awarded exemplary damages in the case of *Tak and Co Inc* v *AEL Corp Ltd*.[2] This case note examines the background to the decision by undertaking a brief comparative analysis of awards of exemplary damages in contract, and outlining the arguments for and against such awards. It is argued that the decision is a step in the right direction for the future; exemplary damages should be available for breach of contract. However, exemplary damages should not be available on the loose basis of any "outrageous breach" as proposed in *Tak*. An alternative basis for awarding exemplary damages in contract is proposed. While this basis shows the correct decision was reached in *Tak*, it provides a more reasoned framework for the decision, and for future awards of exemplary damages in contract.

II EXEMPLARY DAMAGES

Exemplary damages have their origin in the late eighteenth century. With the large discretion left to juries as to the quantum of damages in tort cases, large awards that obviously exceeded the tangible harm suffered by the plaintiff were common.[3] These large awards of damages were justified in *Wilkes* v *Wood* [4] by Lord Chief

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1 Exemplary damages are sometimes referred to as punitive or vindictive damages. In the United States and Canada the term punitive damages is used. The New Zealand Courts have adopted the English term of exemplary damages.

2 (1995) 5 NZBLC 103-887.

3 D Venour "Punitive Damages in Contract" (1988) 1 Canadian Journal of Law and Jurisprudence 87, 95.

4 (1763) 98 ER 489.

Justice Pratt as "a punishment to the guilty, to deter [them] from any such proceedings in the future, and as proof of the detestation of the jury to the action itself".[5] The case is now famous for the first award of exemplary damages, which have since become commonplace in tort actions.

Exemplary damages enjoyed a flourishing existence until the House of Lords severely limited their ambit in the case of *Rookes* v *Barnard*.[6] In his now famous speech, Lord Devlin first distinguished between exemplary and aggravated damages. Aggravated damages are to compensate the victim for aggravated injury to "the plaintiff's proper feelings of dignity and pride"[7] or, put more simply, are "given to compensate the plaintiff when the harm done to him by a wrongful act was aggravated by the manner in which the act was done".[8] In contrast, Lord Devlin stated the purpose of exemplary damages as being "to punish and deter".[9] His Lordship then explained the long line of cases in which what had been called exemplary damages had been awarded were in fact awards of aggravated damages. According to Lord Devlin, exemplary damages should only be awarded in three situations:

(a) Where expressly authorised by statute;

(b) Where "Oppressive, arbitrary or unconstitutional action by servants of the government" [10] is involved; and

(c) Where "the defendant's conduct has been calculated by him to

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5 Above n 4, 498.

6 [1964] AC 1129.

7 Above n 6, 1121.

8 *Uren* v *John Fairfax & Sons Pty Ltd* (1966) 117 CLR 118, 149 per Windeyer J.

9 Above n 6, 1221.

10 Above n 6, 1226.

> make a profit for himself which may well exceed the compensation payable to the plaintiff".[11]

While Lord Devlin's distinction between aggravated and exemplary damages has largely been accepted around the Commonwealth, his limitation of awards of exemplary damages to the three categories has not.[12] This trend has been followed in New Zealand. In *Taylor* v *Beere*,[13] the Court of Appeal said that the categories of cases in which exemplary damages are awarded in New Zealand are wider than those recognised by the House of Lords.[14] In New Zealand, exemplary damages are awarded where "the injury to the plaintiff is done in such a manner that it offends the ordinary standards of morality or decent conduct in the community in such marked degree that censure by the way of damages is, in the opinion of the court warranted",[15] and the sum of compensatory and aggravated damages will not in itself properly punish the defendant.[16]

In New Zealand the Accident Rehabilitation and Compensation Insurance Act 1992 has replaced the common law right to damages for personal injury with a statutory compensation scheme. However, the situation with regards to exemplary damages has not been materially affected by the legislation.[17] The Court of Appeal has made

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11 Above n 6, 1226.

12 In Australia see *Uren* v *John Fairfax & Son Pty Ltd*, above n 8. In Canada see *Vorvis* v *Insurance Corporation of British Columbia* (1989) 58 DLR (4th) 193, [1989] SCR 1085.

13 [1982] 1 NZLR 81.

14 Above n 13, 92.

15 *Paragon Properties Ltd* v *Magna Envestments Ltd* (1972) 24 DLR (3rd) 156, 167 per Clement JA; as cited by Richardson J in *Taylor*, above n 13, 91.

16 Above n 13, 92 per Somers J.

17 *Brooker's Accident Compensation in New Zealand* (Brooker's, Wellington, 1992) vol 2, Exemplary Damages, para D1-6-24, p 50.

it clear that the statutory restriction on suing in section 14 of the Act does not extend to bar actions for exemplary damages, as these are not compensatory in nature.[18] However, the court did go on to say that a "tight rein" would be kept on such awards, and that "immoderate" awards were to be avoided.[19] The Court of Appeal has also said that exemplary damages take on part of the role of aggravated damages where compensatory damages are unavailable, and that they acknowledge an element of injury to the plaintiff's feelings when faced with high-handed or outrageous conduct.[20]

Academic debate is still intense over the merits of exemplary damages. Supporters argue that they are necessary to punish wrongdoers for reprehensible conduct and to deter similar behaviour in the future. Exemplary damages are seen as a way of ensuring compensation for plaintiffs faced with large legal bills. Further, they argue that exemplary damages prevent unjust enrichment where a defendant's gain from her wrongful act exceeds the compensation payable to the plaintiff. Finally, awards of exemplary damages are seen as an incentive for plaintiffs to pursue litigation they would otherwise forego.[21]

Those opposed to exemplary damages argue that punishment and deterrence belong to the criminal law and have no place in the civil law. They argue that a defendant should not be punished without being afforded the safeguards of the criminal law, such as a higher burden of proof and the presumption of innocence.

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18 *Donselaar* v *Donselaar* [1982] 1 NZLR 97.

19 Above n 18, 107.

20 *Auckland City Council* v *Blundell* [1986] 1 NZLR 732, 738. See also R Harrison *Matters of Life and Death: The Accident Rehabilitation and Compensation Insurance Act 1992 and Common Law Claims for Personal Injury* (Legal Research Foundation, Auckland, 1993) 45.

21 H Street *Principles of the Law of Damages* (Sweet & Maxwell, London, 1962) 33; H McGregor *McGregor on Damages* (15 ed, Sweet & Maxwell, London, 1988) 254; Ontario Law Reform Commission *Report on Exemplary Damages* (Toronto, 1991).

Thirdly, they argue that exemplary damages pose the threat of double jeopardy; namely that a defendant may be punished by both the civil and criminal law for the same act.[22] Exemplary damages are seen as injust as they line the pockets of the plaintiff with money taken from the defendant in the interests of society. Finally, the opponents of exemplary damages argue that the deterrent value of damages remains unproven.[23] However, even in the face of strong criticism, exemplary damages are now well embedded in the New Zealand common law, and rather than being curtailed they are emerging in new areas of the law.[24]

III THE RULE AGAINST EXEMPLARY DAMAGES IN CONTRACT

The traditional rule is that exemplary damages are not available for breach of contract. Some commentators suggest that the rule can be traced back to the origins of exemplary damages.[25] While torts actions often involved large arbitrary awards of damages that needed to be justified on the basis of having a punitive element, contract actions were different. The damages in an action for breach of contract were more readily calculable and verifiable. The plaintiff simply needed to have his expectation interest compensated, and be put back into the position he

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22 However, in New Zealand section 26(2) of the Bill of Rights Act 1990 protects against double jeopardy. In S v *G* [1995] 3 NZLR 681, the Court of Appeal applied the section and refused to award exemplary damages as they would have been a double punishment for the defendant who had already been convicted for sexual abuse.

23 Above n 21.

24 For example see the Court of Appeal's decision in *Aquaculture Corp* v *NZ Green Mussel Co Ltd* [1990] 3 NZLR 299 where it was held that exemplary damages may be awarded in equity for breach of confidence. See also *Tabley Estates Ltd* v *Hamilton City Council* [1996] 1 NZLR 159 for a recent confirmation of the availability of exemplary damages for breach of contract.

25 T Sullivan "Punitive Damages in the Law of Contract: The Reality and Illusion of Legal Change" (1976) 61 Minnesota Law Review 207; L Lee "Punitive Damages in Ordinary Contracts" (1981) 42 Montana Law Review 91.

would have been in had the contract been fulfilled. This usually involved compensating the plaintiff for her pecuniary loss. As a result contract damages became focussed on compensation, and did not need to be justified as having a punitive element like torts damages.

The case often cited as the authority for the traditional rule of no exemplary damages in contract is the House of Lords decision in *Addis* v *Gramophone Co Ltd*.[26] The plaintiff sought what would today be classified as aggravated damages for the manner in which he was wrongfully dismissed. The House of Lords held that damages for mental distress and intangible loss could not be recovered in a wrongful dismissal case. This has sometimes been developed into a general rule that non-pecuniary loss cannot be recovered in a contract action.[27]

The fact that their Lordships seemed to use the terms aggravated and exemplary interchangeably confuses the situation, but the speech of Lord Atkinson is generally seen as providing the authority for the rule of no exemplary damages in a contract action. His Lordship stated that it was his understanding that "damages for breach of contract were in the nature of compensation, not punishment".[28] In a case of breach of contract a plaintiff who was seeking exemplary damages would have to frame his action in tort. If he brought an action in contract "he is to be paid adequate compensation in money for the loss of that which he would have received had his contract been kept, and no more".[29]

The only other member of the House to address the point was Lord Collins. In his

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26 [1909] AC 488.

27 J Burrows et al *Cheshire & Fifoot's Law of Contract* (Butterworths, Wellington, 8th NZ ed 1992) 673.

28 Above n 26, 494.

29 Above n 26, 496.

dissenting speech, he could see no reason to distinguish between torts and breaches of contract committed in a manner that might attract an award of exemplary damages. It was an "arbitrary and illogical"[30] limitation to say a jury could award exemplary damages in a tort action but not in a contract action, where the accompanying circumstances of the wrongful conduct were similar.[31]

With regard to the non-pecuniary loss aspect, discontent with the rule and certain exceptions have developed over time. In New Zealand, judicial disquiet finally came to a head when Gallen J declined to follow *Addis* in *Whelan* v *Waitaki Meats*.[32] Against this background, the New Zealand Law Commission issued a report recommending the legislative reversal of *Addis* in relation to employment contracts.[33] As a result, section 40(1)(c) of the Employment Contracts Act 1991 makes provision for compensation for humiliation, loss of dignity and injury to feelings to employees.

With respect to the rule against exemplary damages change has been more slow in coming. It would be easy to see the recommendations of the Law Commission, and their legislative endorsement in the Employment Contracts Act, as a general expansion of contract damages beyond pecuniary loss and therefore as support for awards of exemplary damages. However, it is significant that the Report did not examine the exemplary damages point. In fact the Report concerned itself with employment contracts, and stated that the rule from *Addis* was valuable for enhancing certainty and efficiency in commercial contracts.[34] The need for both

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30 Above n 26, 498.

31 Above n 26, 498.

32 Unreported, 30 November 1990, High Court, CP 990/88.

33 New Zealand Law Commission *Aspects of Damages: Employment Contracts and the Rule in Addis v Gramophone Co Ltd* (Wellington, 1991).

34 Above n 33, 45.

certainty and efficiency in contract law is seen as one of the primary reasons against awarding exemplary damages. As a result, the Report seems to imply that exemplary damages should not be awarded for breach of contract.

Judicial opinion on the rule against exemplary damages in contract has differed among common law jurisdictions. While the traditional rule as espoused by Lord Atkinson has generally dominated, the more liberal approach of Lord Collins has been gaining in popularity. Particularly in the United States and Canada, the courts have been willing to impose punitive damages in certain contractual situations. These exceptions to the traditional rule show that exemplary damages are appropriate in certain contractual situations, and point the way forward for such awards in New Zealand.

IV A COMPARATIVE ANALYSIS OF EXEMPLARY DAMAGES IN CONTRACT

A England

After *Addis*, the rule against exemplary damages in contract was expressly affirmed in *Perera* v *Vandiyar* [35] and *Kenny* v *Preen*.[36] Both cases involved a landlord's breach of a covenant of quiet enjoyment, and in both cases it was held that exemplary damages were not available in a contract action. A plaintiff seeking exemplary damages would have to bring a concurrent action in tort.

After the decision in *Rookes*, there was debate that instead of limiting exemplary damages, Lord Devlin's three categories might actually have widened their

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35 [1953] 1 WLR 672.

36 [1963] 1 QB 499.

application by including causes of action for which exemplary damages had not previously been available. For example, a breach of contract that is carried out with a view to a profit by the defendant might come within Lord Devlin's "calculated profit" category.[37] However, this possibility was put to rest with the decision in *A.B. v South West Water Services Ltd*,[38] which held that for an award of exemplary damages to be made the action must be one in respect of which such an award was possible prior to 1964.[39] Accordingly, this would seem to rule out the possibility of an award of exemplary damages in a contract action. Furthermore, in a recent decision the House of Lords has stated that in an action for breach of contract "there is no question of punishing the contract breaker".[40]

B The United States

In the United States, awards of punitive damages in contract actions have been more common. The law on the matter is far from uniform, as the common law differs between individual states and federal jurisdictions, and some states have legislation addressing the matter. However, some general observations can be made. The basic principle is that punitive damages are not available for breach of contract.[41] There are several recognised exceptions to this rule.

First, the courts allow punitive damages where the breach of contract is accompanied by an independent tort that is sufficiently outrageous to justify such

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37 McGregor above n 21, 264.

38 [1993] QB 507.

39 Above n 38, 523.

40 *Ruxley Electronics and Construction Ltd* v *Forsyth* [1995] 3 All ER 268.

41 E Farnsworth *Contracts* (2ed, Little Brown, Boston, 1990) 874; *White* v *Benkowski* 155 NW 2d 74 (1967); *Eskew* v *Camp* 204 SE 2d 465 (1974).

an award.[42] There have also been situations where the defendant's conduct does not amount precisely to an independent tort, but instead violates important standards imposed by other areas of law, such as the violation of fiduciary obligations.[43]

Secondly, the courts have imposed punitive damages when a breach of contract is accompanied by fraudulent conduct, even in the absence of an independent tort of fraud that would normally justify such an award.[44]

The exception to the rule that has caused most comment has involved the so-called insurance cases. Beginning especially in California, the courts have implied a duty of good faith and fair dealing into insurance contracts. A breach of this duty can be seen as tortious conduct, and can justify an award of punitive damages.[45] Insurance contracts are seen as a special contractual relationship worthy of such a duty because of the vulnerability of the insured and their dependence on the insurer to perform. In the mid 1980s, the Supreme Court of California suggested that the implied duty and the accompanying tort of bad faith breach might extend beyond insurance contracts to other contractual relationships that exhibited similar characteristics of "public interest, adhesion, and fiduciary responsibility".[46] However, this possibility was dealt a blow by the same court in *Foley* v *Interactive*

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42 *Excel Handbag Co* v *Edison Bro's Store* 630 F 2d 379 (1980); *Club Mediterranee* v *Stedry* 283 SE 2d 30 (1981).

43 J Sebert "Punitive and Non-Pecuniary Damages in Actions Based upon Contract: Toward Achieving the Objective of Full Compensation" (1986) 33 UCLA Law Review 1565; *Palmer* v *Fuqua* 641 F 2d 1146 (1981).

44 *Welborn* v *Dixon* 49 SE 232 (1904); *Edens* v *Goodyear Tire & Rubber Co* 858 F 2d 198 (1988).

45 *Gruenberg* v *Aetna Insurance Co* 9 Cal 3d 566, 108 Cal Rptr 480, 510 P 2d 1032 (1973); *Vernon Fire and Casualty Insurance Co* v *Sharp* 316 NE 2d 381 (1974).

46 *Seaman's Direct Buying Service* v *Standard Oil Co of California* 36 Cal 3d 752, 686 P 2d 1158 (1984).

Data Corporation.[47] The court held that the special relationship analogous to that between insured and insurer should not be deemed to exist in the usual employment relationship, at issue in that case, and thus appears to have limited the ambit of the doctrine and the awarding of punitive damages to insurance contracts.

Nonetheless, while the traditional rule against punitive damages in contract remains in place in the United States, the courts have generally been more willing to make such awards in contractual situations where they believe they are warranted.

C Canada

The Canadian courts have taken a more mixed approach. Until 1976, it was clear that such awards were not available in contract actions.[48] However, in *New Brunswick Electrical Power Commission* v *I.B.E.W. Local 1733*,[49] punitive damages were awarded for the breach of a collective agreement accompanied by tortious acts. *Brown* v *Waterloo Regional Board of Commissioners of Police* [50] threw open the door to punitive damages in contract. The court made it clear that such awards should not be confined to certain causes of action; rather, they should be awarded on the basis of the defendant's conduct. Punitive damages could be awarded where "a contract has been breached in a high-handed, shocking and arrogant fashion so as to demand condemnation by the court as a deterrent".[51] However, rather than a clear cut change in the law, the situation was complicated by the fact that at the

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47 47 Cal 3d 654, 765 P 2d 373, 254 Cal Rptr 211 (1988).

48 *Guildford* v *Anglo-French Steamship Co* (1884) 9 SCR 303; *Dobson* v *Winton & Robbins Ltd* (1960) 20 DLR (2d) 164.

49 (1976) 22 NBR (2d) 364.

50 (1981) 136 DLR (3rd) 49, 150 DLR (3rd) 729.

51 Above n 50, 65.

same time other courts were forcefully asserting that punitive damages were not available for breach of contract.[52] The law remained unsettled until the Supreme Court of Canada's decision in *Vorvis v Insurance Corporation of British Columbia*.[53] Like *Addis*, *Vorvis* involved a case of wrongful dismissal. The majority held that punitive damages could be awarded in contract only if the conduct complained of constituted an actionable wrong, and was deserving of punishment due to its "harsh, vindictive, reprehensible and malicious nature".[54] The subject of much debate, it is probable that *Vorvis* has settled the law in Canada and restricted punitive damages in contract actions to cases where the conduct involved in the breach amounts to an independent tort.[55]

D New Zealand

In New Zealand the traditional rule against exemplary damages in contract seemed to be settled law. The rule was recently affirmed in *Caddick* v *Griff Holdings Ltd* [56] and *Heidenstrom* v *ACC*.[57] However, certain cases have recently raised the possibility of such an award. First, in *McKenzie* v *Attorney General*,[58] another case involving an employment contract, the Court of Appeal stated that the plaintiff could have pursued a claim for exemplary damages. In *Telecom Corporation of NZ Ltd*

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52 *Pilon* v *Peugeot Canada Ltd* (1980) 114 DLR (3rd) 378; *Cardinal Construction Ltd* v *The Queen in Right of Ontario* (1981) 32 OR (2d) 575, 38 OR (2d) 161.

53 (1989) 1 SCR 1085, 58 DLR (4th) 193.

54 Above n 53, 208 per McIntyre J.

55 Ontario Law Reform Commission above n 21, 89. See also J Swan "Now, Can You See Why You Must Start a Contracts Course with Remedies: Extended Damages and Vorvis v Insurance Corporation of British Columbia" (1990) 16 Canadian Business Law Journal 213, 218.

56 Unreported, 15 May 1987, High Court, Wellington Registry, CP 565/86.

57 Unreported, 12 February 1992, High Court, Wellington Registry, CP 223/87.

58 [1992] 2 NZLR 14.

v *Business Associates Ltd*,[59] after stating that the case was one of contract, Richardson J proceeded to evaluate a claim for exemplary damages in a manner that suggested he assumed such an award could be made in a contract action.[60] The only reason that an award of exemplary damages was not made was that the defendant's conduct was not of the nature required. In *Canadian Paints NZ Ltd* v *First City Finance*,[61] Henry J alluded to Richardson J's judgement, saying it "contains observations which seem to indicate the possibility of an award [of exemplary damages] for breach of contract".[62] Thus the situation prior to *Tak* was that while the traditional rule remained in place, the possibility of an award of exemplary damages in contract was certainly not out of the question.

V THE DEBATE OVER EXEMPLARY DAMAGES IN CONTRACT

The growing amount of case law on the matter has sparked academic debate over the merits of exemplary damages in contract. Like the courts, commentators on the matter have been divided.

A The Arguments Against Exemplary Damages in Contract

Tort law has traditionally been the domain of exemplary damages, and it is argued that there are fundamental differences between tort and contract which make an award of exemplary damages suited to tort cases, but not contract.

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59 Unreported, 23 June 1993, Court of Appeal, CA 7/93.

60 Above n 59, 19.

61 Unreported, 2 December 1993, High Court, Auckland Registry, HC 61/93.

62 Above n 61, 3.

First, a tort is seen as being not just harmful to the victim, but also to society. A tort is prohibited and undesirable conduct. As a result punishment and deterrence of such behaviour are seen as valid rationales of tort damages.[63] Where two parties enter into a contract, a breach of that contract is not seen as being harmful to society in the same way. The compensation principle is paramount in contract law; as long as the promisee is compensated no harm is done.[64] Contract law is not morally underpinned in the same way as tort. While people are morally bound in tort not to inflict harm on others, a breach of contract is not totally prohibited behaviour. Along with a freedom to enter into contracts goes a certain degree of freedom to break them. Provided that the promisee is compensated, no harm is done, meaning there is no need for punishment or deterrence in contract damages.[65]

Secondly, the harm in a tort action is said to be of a different nature from that when a contract is breached. Torts involve harm that is often non-pecuniary and uniquely personal. Contract breaches usually involve pecuniary loss which can be easily calculated and compensated.[66]

Further arguments against exemplary damages in contract revolve around the need for certainty in contractual situations. Contract law is said to have developed alongside commercial trade and business. Two parties entering into a contract need to know exactly what the contract is worth and therefore how much the promisee needs to be compensated in the event of a breach. If a better offer should come from a third party, the promisor can then easily calculate whether it is more

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63 N McBride "A Case For Awarding Punitive Damages in Response to Deliberate Breaches of Contract" (1995) 24 Anglo-American Law Journal 369.

64 Great Britain Law Commission *Aggravated, Exemplary and Restitutionary Damages - Consultation Paper No 132* (London, 1993) 76.

65 Above n 64; above n 3, 97.

66 Sullivan above n 25, 217.

beneficial to break the contract off, compensate the promisee, and deal with the third party. This analysis is known as efficient breach theory, as such behaviour is seen to benefit society through a better allocation of resources with no harm to the promisee who is compensated.[67] Under the efficient breach theory there is no place for exemplary damages as they add an element of uncertainty into a contract. They make it impossible for the promisor to calculate whether she is better off breaking the original contract and dealing with the third party, therefore binding her into an inefficient contract.[68]

It is also argued that types of contract breaches are too hard to distinguish. The motive for a breach is not always clear, meaning that it is often impossible to tell whether a breach is innocent or deliberate, and when exemplary damages should be awarded.[69] Furthermore, it is argued that many contract breaches are due to either inability, or a misunderstanding as to the extent of the obligations of the parties, for which it is not fair to punish.[70]

B The Arguments For Exemplary Damages in Contract

The arguments in favour of awarding exemplary damages in contract are based primarily on what has been called the emerging moral view of contract law.[71] Under this view, the distinctions between tort and contract law are removed, making the

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67 R Posner *Economic Analysis of Law* (4ed, Boston, 1992) 117.

68 Above n 3, 98.

69 Above n 64, 138.

70 F Lawson *Remedies of English Law* (2 ed, Butterworths, London, 1980) 137.

71 Ontario Law Reform Commission above n 21, 93.

basis for awarding exemplary damages in contract the same as in tort.[72] A contractual promise is an obligation the promisor is morally bound to perform, and in the event of a breach the promisee is entitled to specific performance if feasible. Contract breaches therefore become prohibited conduct and are harmful to society. Exemplary damages can be justified on the basis of punishment and deterrence, as in tort.

There is also a changing view of contractual remedies.[73] Traditionally damages in contract actions were the norm, and specific performance the exception where damages were not appropriate. However, changes in the law have seen plaintiffs being entitled to specific performance if that is their preference. It therefore follows that a promisor is no longer as free to breach a contract and compensate the promisee.

This change is in direct conflict to efficient breach theory, which is based upon the premise that promisors are free to breach and compensate the other party. The efficient breach analysis is also seen as a fallacy for other reasons. Just because a third party is willing to pay more does not necessarily mean a better use or allocation of resources for society. Secondly, efficiency does not necessarily entail that all the gains should go to the breaching party, as they do under the theory. Thirdly, the transaction costs of securing compensation for the promisee often outweigh any efficiency gains. It is unrealistic to assume that all breaches are automatically fully compensated. Finally, the effect of breaches can often spill outside of the parties to the contract, affecting third parties and having social costs

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72 Sullivan above n 25, 219.

73 Ontario Law Reform Commission above n 21, 94.

that also may outweigh any efficiency gains.[74]

Other arguments in favour of allowing exemplary damages in contract are that the need for certainty and efficiency is relevant to only a small number of contracts;[75] that exemplary damages enlarge the obligations over parties entering into contracts and intensify the sanctity of contract;[76] and that they would stop the growing abuse of bargaining power.[77]

Overall, the place of exemplary damages in contract law depends on whether a traditional view of contract is taken, whereby the compensatory principle is paramount and punishment has no place, or whether a moral view is taken whereby exemplary damages should be available in contract on the same basis as in tort.

VI TAK AND CO INC v AEL CORP & OTHERS [78]

A The Facts

The case involved a contract for the sale of cattle. Tak, a Japanese livestock importer, was looking to acquire and import a plane-load of pedigree Angus heifers

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74 D Friedmann "The Efficient Breach Fallacy" (1989) 18 Journal of Legal Studies 1. P Atiyah "Executory Contracts, Expectation Damages, and the Economic Analysis of Contract" in P Atiyah *Essays on Contract* (Clarendon Press, Oxford, 1986) 150, 158.

75 Above n 3, 98.

76 B Coote "The Changing New Zealand Law Of Damages in Contract" (1996) 9 Journal of Contract Law 159.

77 M Miner "The Growing Availability of Punitive Damages in Contract Actions" (1975) 8 Indiana Law Review 668.

78 Above n 2.

into Japan, for on-sale to a farmers' co-operative. The president of Tak, Mr Terada was told by AEL in New Zealand that they would be able to fill such an order. In the event, AEL was not able to acquire the required number of pedigree animals and made up the numbers with commercial animals with false documentation to make them appear as if pedigree. A second plane-load followed, also containing fake pedigrees. The fraud was discovered when Tak began to deal with a new agent in New Zealand. Tak brought an action for breach of contract against AEL, claiming compensatory and exemplary damages. An action was also brought for compensatory and exemplary damages in tort for deceit against three of AEL's employees.

B The Decision

The first issue before Hammond J was whether Mr Terada was a party to the "scam", or had genuinely expected pedigree animals. Hammond J preferred the evidence of Mr Terada that his understanding was that it would be difficult but not impossible to obtain the required number of pedigree animals, and that he had never abandoned his position that the animals should be truly pedigree. Therefore, it was clear that the contract was for truly pedigree animals, and that AEL had breached the contract by failing to supply the requisite number of pedigree animals in both shipments.[79] Tak was awarded compensatory damages, which included the recovery of the reasonable settlement made with the end buyers of the cattle, contingent liability to the Japanese government for breach of import duty obligations, as well as some damages for loss of business reputation.

Hammond J then turned to the question of exemplary damages. After noting that the Court of Appeal has sanctioned awards of exemplary damages in tort and in equity,

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79 Above n 2, 103-897.

His Honour stated that the position in contract is "less definitive".[80] Hammond J did not start with the traditional rule which would still seem to be good law in New Zealand in the absence of any express authority to the contrary. Instead, the two recent cases of *Telecom* and *Canadian Paints* which raised the possibility of exemplary damages in contract were referred to. Hammond J cited with approval the judgement of Henry J in the latter case, who said:[81]

> More recently there appears to be a movement to allow such an award [of exemplary damages] even in cases of contract. [Authorities cited] It is the latter case *Telecom Corporation of NZ Ltd* v *Business Associates Ltd* which contains observations from Richardson P (pp 19 and 20) which seem to suggest the possibility of an award for breach of contract.

Having found the lack of express authority on the matter in New Zealand, Hammond J looked to overseas authorities for guidance. His Honour started with Canadian awards of punitive damages in contractual situations. *Brown* v *Waterloo Regional Board of Commissioners of Police* [82] held that there was nothing to distinguish tort and contract actions with regards to punitive damages, and that they should be available in contract on the same basis as they are in tort, that being where the defendant's conduct is "high handed, shocking and arrogant".[83]

Hammond J then examined the Supreme Court's decision in *Vorvis* v *Insurance Corporation of British Columbia*.[84] The majority held that punitive damages could only be awarded for an actionable wrong. This has been interpreted to mean that punitive damages may only be awarded where the conduct constituting the breach

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80 Above n 2, 103-901.

81 Above n 61, 3.

82 Above n 50.

83 Above n 50, 65.

84 Above n 53.

also constitutes a tort for which punitive damages are available.[85] This would reaffirm the traditional rule with the independent tort exception. However, Hammond J seemed to ignore this and stated that "The majority did not say that punitive damages could never be awarded, but did say that such a case would be very rare."[86] His Honour then evaluated the language used by the majority to describe the defendant's conduct in those rare cases. It was with this, rather than the limiting of exemplary damages in contract actions, that Hammond J seemed more concerned.

Overall, Hammond J's evaluation of the Canadian position is selective. His Honour ignored the fact that while punitive damages were being awarded in cases like *Brown*, strong criticisms of such awards and reaffirmations of the old rule were being made in other cases like *Pilon* and *Cardinal Construction*.[87] *Vorvis* appears to have severely limited the availability of punitive damages in contract in Canada, and in its recent report the Ontario Law Reform Commission concluded that it would be premature to make recommendations on the matter until the debate over punitive damages in general, and the nature of contractual obligations, had been developed more fully.[88]

Turning to the United States, Hammond J noted that some states allow punitive damages for breach of contract. His Honour referred to *Walker* v *Sheldon* [89] which involved contracts induced by fraud. His Honour cited with approval a passage of the judgement which repeated the idea that exemplary damages should be awarded

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85 Ontario Law Reform Commission above n 21, 89.

86 Above n 2, 103-902.

87 Above n 52.

88 Ontario Law Reform Commission above n 21, 101.

89 10 NY (2d) 401, 179 NE (2d) 497 (1961).

on the basis of the defendant's conduct, regardless of the cause of action.[90]

Hammond J then outlined the policy arguments for and against awarding exemplary damages in contractual situations. None of the arguments appear to have been particularly influential upon His Honour. However, Hammond J then singled out what appears to be the deciding factor in his decision, that being "the relevant institution for the development of the law".[91] In an intriguing passage His Honour said:[92]

> In *Taylor* v *Beere* the Court of Appeal made it quite apparent that, in its view, exemplary damages are sufficiently well embedded in our law that the removal of the same would be a matter for Parliament now, and not the Courts. That general approach is, of course binding on this Court. In conclusion, therefore, it appears to me that exemplary damages in this jurisdiction are a remedy that is sufficiently well established that such would now have to be removed by Parliament; that such are awardable in tort, and to some extent in equity and contract. The test is "Can the conduct concerned be said to be 'outrageous'?" Whatever views this Court might hold, I am clearly bound by the language that has been used to date by the Court of Appeal.

Taylor concerned an action in the tort of defamation, and to say that the case extends to contract actions and binds His Honour to make an award of exemplary damages in an area of the law where they have not previously been awarded in New Zealand is extremely tenuous. With regard to "the language that has been used to date by the Court of Appeal", the only case that comes close to sanctioning awards of exemplary damages in contract is *Telecom*. However, even in that case such an award was not expressly held to be available, but only implied through the language and approach of the court. Again, even with the *Telecom* case it remains very tenuous for Hammond J to say that he is bound to award exemplary damages in a contractual situation.

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90 Above n 2, 103-903.

91 Above n 2, 103-904.

92 Above n 2, 103-904.

Hammond J then evaluated the conduct of the defendant, AEL, to see if an award of exemplary damages was warranted. His Honour concluded that the conduct:[93]

> Falls into a broad category of knowingly deceitful conduct which transcends the formal boundary between contract and tort; and to which the attachment of the term "outrageous" is appropriate.

Exemplary damages of $25,000 were awarded to Tak.

Finally, Hammond J dealt with the claim in deceit against the individual employees of Tak. Section 6(1)(b) of the Contractual Remedies Act 1979 had prevented Tak bringing an action in deceit against AEL itself. The section bars actions in deceit and negligence against the "other party" to a contract which has been induced by a fraudulent or innocent misrepresentation. As AEL was the "other party" to the contract Tak was only able to bring an action in contract. However, the individuals who made the representations were not parties to the contract, and were held to be joint and severally liable in deceit.[94]

The decision in *Tak* is characterised by a desire to depart from orthodoxy and the traditional rule against exemplary damages in contract. Hammond J never mentioned *Addis* and other English authorities that would still seem to be highly persuasive authority for a New Zealand court. His Honour seemed unconcerned about the lack of express authority for such an award in New Zealand, instead he concentrated on awards of exemplary damages in other areas such as tort and equity, and the possibility of an award in contract raised by *Telecom*. The use of overseas case law is selective, and ignores decisions that have criticised awards of exemplary damages in contract.

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93 Above n 2, 103-905.

94 Above n 2, 103-906.

There are several possible motivating factors behind the judgement. It is clear that Hammond J believed that the defendant's conduct in the contractual situation at hand merited an award of exemplary damages regardless of the plaintiff's cause of action. His Honour admitted that he could have founded the award of exemplary damages in the deceit action against the second, third and fourth defendant's alone.[95] It is possible that the availability of exemplary damages against the other defendants in deceit encouraged Hammond J to take the bold step of also making an award in contract against the first defendant. There is also the possibility that the lack of intervention by the Serious Fraud Office and the criminal law into the matter persuaded Hammond J to hand out his own punishment. Whatever the reasons behind the decision, it has the potential to radically reshape the future of contract damages in New Zealand.

VII THE IMPLICATIONS OF TAK v AEL

The decision in *Tak* represents a clear award of exemplary damages in a contractual situation. Hammond J laid down a broad principle that exemplary damages are available where a contract is breached in an "outrageous" manner. Whether future courts will embrace this principle remains to be seen. If the experience from overseas is anything to go by, the law could be entering a turbulent period. It is unlikely that the courts will make a clean break from the traditional rule and unanimously start awarding exemplary damages in contract actions. Future courts could limit the impact of *Tak* by confining it to its facts; namely a uniquely fraudulent breach. The case may also come to be viewed as one where an independent tort was involved; although, strictly speaking this would be incorrect as the tort involved was not brought concurrently against the breaching party, but

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95 Above n 2, 103-906.

against separate third parties who were not parties to the contract.

The most liberal interpretation of the case, and Hammond J's clear intention, is that exemplary damages should be available in contract on the same basis as tort, where the defendant's conduct is outrageous. As if to reinforce this and ensure that *Tak* is not read down, Hammond J has recently restated his view in *Tabley Estates* v *Hamilton City Council*.[96] Dealing with a claim for exemplary damages for breach of an encumbrance, His Honour stated that the approach to awarding exemplary damages in New Zealand is to look not at what category of law the case falls within, but at the nature of the defendant's conduct.[97] It did not matter whether the encumbrance was viewed as a proprietary or contractual interest, as "even in a purely contractual situation exemplary damages can be awarded today in New Zealand".[98]

It is submitted that the decision in *Tak* to allow exemplary damages in contract is a positive step in the direction that future courts should be looking to take. However, the principle in *Tak* of allowing exemplary damages for "outrageous" breaches is too wide and far reaching. The test focuses only on the defendant's conduct, and fails to take into account the surrounding circumstances of the contractual relationship which should be a major factor in an award of exemplary damages. A more refined basis for making such awards is needed which pays closer attention to the motivating factors behind such awards and the contractual situations in which they should be made.

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96 Above n 24.

97 *Tabley* above n 24, 163.

98 *Tabley* above n 24, 165.

VIII WHY ALLOW EXEMPLARY DAMAGES IN CONTRACT ?

Allowing awards of exemplary damages would be consistent with the so-called changing law of contract. Commentators have suggested that contract law is not the neutral domain it once was, and is becoming increasingly morally underpinned.[99] Some have gone further and proclaimed the death of contract and its reabsorption into the main body of tort law.[100] While this is an overstatement, it is hard to deny that contract law is changing. Doctrines such as unconscionability, fair dealing and good faith show that the courts are becoming increasingly willing to intervene in contractual situations to stop what they believe to be immoral behaviour, and to ensure just results. Similar changes are taking place in the law of contract damages. The courts are redefining plaintiffs' expectation interests, and contract damages are becoming increasingly similar to those available in tort. As contract law continues to align itself more closely with tort, and as contract breaches increasingly become regarded as morally culpable acts that are not in the best interests of society, then a blanket prohibition on exemplary damages in contract is unnecessary. While contractual certainty and efficiency may be valid concerns in some contracts, particularly in the commercial world, there are certain contractual situations where breaches should be discouraged. In particular, where there is an imbalance of power and dependency between the parties, and more than just pecuniary loss is at stake. In these situations a breach can be immoral and harmful to society. Exemplary damages should be available in contract for the same reasons as they are in tort: to punish and deter. The existence of exemplary damages would intensify contractual obligations and prohibit immoral behaviour.

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99 D McLauchlan "The New Law of Contract in New Zealand" [1992] NZRLR 436; Coote above n 76. But see L Nottage "Form and Substance in the US, English, New Zealand and Japanese law: A Framework for Better Comparisons of Developments in the Law of Unfair Contracts" (1996) 26 VUWLR 247 who argues that the New Zealand legal system remains more formal, and that the more substantive reasoning invited by a new infusion of moral precepts and redefined notions of efficiency in contract law is likely to lead to slower change than expected by some.

100 G Gilmore *The Death of Contract* (Ohio State Press, Columbus, 1974).

The New Zealand courts should follow the example of their American counterparts, who have awarded punitive damages in an effort to stop bad faith breaches and contractual oppression in these types of situations.

IX A BASIS FOR AWARDING EXEMPLARY DAMAGES IN CONTRACT

It is argued that exemplary damages should be awarded for breach of contract where three criteria are met:

(a) Where there is an imbalance of power and dependency in the contractual relationship;

(b) Where the nature of the contract means more than just pecuniary loss is at stake; and

(c) Where the breaching party abuses their dominant position in a reprehensible manner.

A Power Imbalance

Awards of exemplary damages should depend on the contractual relationship between the parties. In today's society individuals are dealing less with their equals and increasingly with large entities, leading to immense imbalances in bargaining power and contractual dependency.[101] Two categories of cases that illustrate these imbalances and where punitive damages have been awarded in Canada and the United States are the insurance and employment cases. In these types of cases the individual is seen as being highly vulnerable and dependent upon the other party to carry out their contractual obligations. If they do not, then the individual often has

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101 Above n 77, 687.

no one else to turn to, and often lacks the resources necessary to have the contract enforced in the courts.[102] In such situations the availability of exemplary damages would intensify the contractual obligations of the more dominant party and discourage bad faith breaches. Exemplary damages should be used by the courts as a tool to stop contractual oppression and the abuse of bargaining power.

Most contracts in the commercial sector will not involve such imbalances, and in these situations courts should give primacy to concerns of certainty and efficiency. However, the facts of *Tak* itself show how even in commercial contexts with parties of apparently equal power, a situation of vulnerability and dependency can arise. The fact that Tak had already on-sold the cattle in Japan and had secured valuable quarantine space made it totally dependent on AEL. This dependence was intensified by the fact that Tak's former potential supplier had withdrawn at the last minute, leaving AEL as the only supplier capable of filling the order.

B The Nature of the Bargain

In assessing a claim for exemplary damages in a contractual situation the courts should pay close attention to the nature of the bargain between the parties. In a normal business transaction the contract will be for a certain amount of goods, and the parties' expectations will not extend beyond this. However, in certain contracts there is much more involved in the bargain. For example in an employment contract, from the employee's point of view, the contract may extend beyond a simple exchange of wages for labour and include interests of dignity, self esteem and her reputation in the labour market.[103] Likewise insurance contracts involve

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102 Above n 3, 98. See also J Peterson "The Duty of Good Faith in Insurance Relationships: The decision in Gibson v Parkes District Hospital" (1994) 24 VUWLR 189.

103 Above n 3, 100.

elements of emotional as well as financial security.[104] In *Tak* itself the contract involved more than the simple sale of goods. The reputation of the New Zealand breed stock industry was involved, as was Tak's reputation in Japan where business reputation is very important.[105]

In cases such as these certainty and efficiency are not valid concerns. A breach in these circumstances is unlikely to be beneficial to society. Indeed, allowing exemplary damages may have a beneficial effect by deterring breaches that ignore what is really at stake in such contracts.

C Reprehensible Conduct

Once it is established that there is an imbalance in the contractual relationship, and that more than just pecuniary loss is at stake, it should be shown that the dominant party abused their position by breaching in a manner seen by society as undesirable and reprehensible. Awards of exemplary damages should be consistent with their purpose, that being to punish the defendant, and deter similar behaviour in the future. Where the conduct is of this nature, concerns over certainty and efficiency can be outweighed by society's concern over the conduct involved, as *Tak* itself illustrates.

X CONCLUSION

The decision of Hammond J in *Tak* sets a positive example for the future; exemplary damages have a role to play in the law of contract. However, the reasoning of the

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104 Peterson above n 102, 200.

105 Above n 2, 103-900, 103-905.

judgement is strained and not as clear as it could be. This, coupled with the broad and drastic holding that exemplary damages should be available for any outrageous breach of contract may inhibit the long term impact of the case, and the availability of exemplary damages in contract generally. The basis for awarding exemplary damages in contract proposed in this paper provides a more principled framework. It shows that the award was justified in *Tak*. The defendant abused a dominant position in a contract where more than just pecuniary loss was at stake, in a reprehensible manner. Such breaches are undesirable and harmful to society, and should be met with awards of exemplary damages.