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The new law on contractual penalties: what does it mean for commercial contracts?

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1. The Penalty Clause has origins in a far away time, formulated to address a regime which no longer exists. Penalties in English law are contractual terms which are not enforceable in the courts because of their penal character.

2. We are here dealing with a doctrine:-

   1) that can be frustrating from the point of view of a party genuinely seeking to 'iron out wrinkles' before they happen or genuinely to encourage performance; in the sense of having a clear understanding of what precisely will follow from any breach or non-performance;

   2) which the Supreme Court had been invited to abolish because it was outmoded and outdated and should no longer apply.

3. Instead, in Cavendish Square Holding BV v. Makdessi [2015] UKSC 67, [2015] 3 WLR 1373 the Supreme Court has affirmed its place in the law. Their Lordships determines, in summary, that the rule on penalties still had a purpose to serve in relation to non-consumer contracts and it should not be abolished. Nor should it be extended.

4. Its importance is for parties genuinely seeking to draft agreements which reflect a genuine desire to encourage and achieve performance: or to efficiently obtain satisfaction where the innocent party is faced with a de facto breach or non performance, and where it might be considered that it would be commercially advantageous and expedient so to consider likely damages or alternatives in advance.

5. This is often achieved by stipulating that non performance or non agreed performance should result in the innocent party being compensated in specified and agreed monetary terms.

6. Since the beginning of the 19th century, if not earlier, the common law has developed almost entirely in the context of clauses which make provision for the payment of specified sum in place of common law damages. Since they were a substitute for common law damages they could not be regarded as mere security for their payment. Thus the courts developed the well-known distinction between a genuine pre-estimate of loss and a sum out of all proportion to any damages liable to be suffered – hence the label of penalty.

7. There is an understandable desire to encourage performance in any contract and a reminder of the real cost of not doing so is a useful lever. Such a doctrine is of course, in many ways, advantageous. To the employer it gives certainty without having to prove what may often be difficult and complex matters and to the contractor it provides certainty since it defines, and may well limit, his liability.

8. It is thought that by this means, and this is often the case in building contracts, a performance will be encouraged, efficiently or at all.

9. Parties are however generally free to agree terms and be bound by them.

10. This is a recognised tension existing in the moderating jurisdiction of the courts, and it is this apparent resolution which is the interesting part of the Supreme Court's judgement.

11. Chitty on Contracts;

12. "The binding force of contract.

13. A concomitant of the doctrine of freedom of contract is the binding force of contracts, a force which a classical jurist compared to the binding force of the law itself.....however care must be taken in interpreting what is meant by the "binding force" of contracts. Some authors argue that generally speaking the law does not compel the performance of a contract it merely gives a remedy, normally damages for the breach.....".

14. The willingness of courts to interfere in contracts, and strike down clauses is, of course, a blatant interference with the freedom of parties to agree their own terms.

15. But the historical development of the law to protect vulnerable contracting parties remains.

16. Since at least 1720 it has been accepted as a matter of English contract law that if a provision in a contract constitutes a penalty, then that provision is unenforceable by the parties. However, the test for what constitutes a penalty has evolved over time.

17. In Philips Hong Kong Ltd v AG of Hong Kong the Privy Council expressly endorsed the comments of Dickson J in the Supreme Court of Canada in Elsey v J.G. Collins Insurance Agencies Ltd that: ..."the power to strike down a penalty clause is a blatant interference with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression".

18. The law relating to contractual penalties in England has been entirely developed by judges at common law without general statutory intervention. The Supreme Court has noted that "the penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well".

19. However, in addition to the common law rules relating to penalties, there are statutes which make express provision for avoidance of onerous clauses, such as the Unfair Contract Terms Act 1977 and the Unfair Terms in Consumer Contracts Regulations 1999.

20. There is little doubt that in English law it is only engaged on a provision which operates upon a breach of contract. Thus breach of a primary obligation, to complete by the due date, gives rise to a secondary obligation to pay the specified sum.

21. The courts have not sought to regulate the parties' primary obligation; subject to well known exceptions, such as duress; the parties' autonomy to make their own bargains, however one-sided or onerous, has been recognised by the courts.

22. In the context of the interpretation of contracts it has been held: " Experience shows that it is by no means unknown for people to enter into arrangements which are ill-advised, even ignoring the benefit of wisdom of hindsight, and it is not the function of a court when interpreting an agreement to relieve a party from the consequences of his imprudence or poor advice. Accordingly, when interpreting a contract a judge should avoid re-writing it in an attempt to assist an unwise party or to penalise an astute party" Arnold v Britton [2015] UKSC 36.

23. The origin of the common law rules relating to penalties is often taken to be the decision of the House of Lords in the Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd decision in 1914. But the jurisdiction is actually much older. The oldest reported case relating to penalties appears to date from 1720, but even that case is decided on the basis that penalties were already generally considered unenforceable.

24. The rule is one which judges over the years have confessed difficulty with. In Astley v Weldon Lord Eldon admitted ("not for the first time" according to the Supreme Court in Makdessi) to being "much embarrassed in ascertaining the principle on which [the rule was] founded". In Wallis v Smith Sir George Jessel MR similarly confessed: "The ground of that doctrine I do not know". In Robophone Facilities Ltd v Blank Diplock LJ famously said that he would make "no attempt where so many others have failed to rationalise this common law rule".

25. In their decision in Makdessi the Supreme Court reviewed the historical origins of the rule against penalty clauses in contracts. The law originated in the fifteenth century in relation to

"defeasible bonds" (sometimes called penal bonds) which were a contractual promise to pay money, which might be discharged if certain obligations were performed (and if the obligations were not performed, then the payment terms under the bond could be enforced). However the courts of equity regarded these as what they really were - security for performance of the underlying obligation - and were prepared to restrain enforcement of such bonds where the defaulting party paid any damages due at common law. In time the courts of common law began to mirror this approach and stay any proceedings on such bonds where the defendant gave an undertaking to pay damages together with interest and costs. The position of the common law courts was adopted and codified in the Administration of Justice Act 1696 and later the Administration of Justice Act 1705. Accordingly, procedurally relief in relation to such bonds was thereafter administered entirely by the common law courts without intervention by the courts of equity. However, the courts of equity began to develop concurrent remedies for relief from forfeiture. With the decline of the use of defeasible bonds the procedural mechanics became increasingly applied to liquidated damages clauses.

26. However, the decision in Dunlop in 1914 was taken to authoritatively restate the law. That case concerned what was expressed to be a liquidated damages clause. The courts had to determine whether the clause was in fact a penalty. The leading judgment was given by Lord Dunedin, who opined as follows:-

27. "...though the parties to a contract who use the words "penalty" or "liquidated damages" may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages.

28. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre- estimate of damage. It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.

29. It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties...".

30. Although the decision of Lord Dunedin sought to bring greater clarity to the law in 1914, in practice it often proved difficult to apply.

31. Cases continued to come before the courts challenging provisions as a penalty, and the courts continued to wrestle with the issue. In Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd Lord Browne Wilkinson tried to describe the scope of the law of penalties, and noted the slightly anomalous rules in relation to forfeiture of deposits in relation to sales of land: "In general a contractual provision which requires one party in the event of his breach of contract to pay or forfeit a sum of money to the other part)' is unlawful as being a penalty, unless such provision can be justified as being a payment of liquidated damages being a genuine pre-estimate of the loss which the innocent party will incur by reason of the breach. One exception to this general rule is the provision for the payment of a deposit (customarily 10% of the contract price) on the sale of land...".

32. In the course of their exhaustive review of earlier authorities in Makdessi, the Supreme Court sorted through a large variety of obiter dicta relating to penalties, many of which they considered doubtful misinterpretations of earlier decisions, or simply capable of being misconstrued.

33. Before and lastly turning to this decision and examine the guidance given, we will briefly look at a judgement of Lady Justice Arden, giving the judgement of the Court of appeal in Murray v Leisureplay plc setting out a series of five questions which the court should consider in relation to penalties.

34. To what breaches of contract does the contractual damages provision apply

35. What amount is payable on breach under that clause in the parties agreement

36. What amount would be payable if a claim for damages for breach of contract was brought under common law

37. What were the parties reasons for agreeing the relevant clause

38. Has the party who seeks to establish that the clause is a penalty shown that the amount payable under the clause was imposed in terrorem, or that it does not constitute a pre-estimate of loss for the purposes of the Dunlop case, and if he has shown the latter, is there some other reason which justifies the discrepancy between (i) and (ii) above.

39. These wise formulations of factors to take into account when making a decision about an alleged penalty clause are in practise, when taken in combination with the case we are considering, crucially important, and simplifies the whole process; it imports into the equation a commercial dimension and imperative under (v), in the light moreover of what was said in the Makdessi ruling about commercial certainty.

40. The Supreme Court reformulated the common law test for what constitutes an enforceable penalty clause. They held that the validity of such a clause turned on whether the party seeking to enforce the clause could claim a legitimate interest in the enforcement of the clause.

41. ".....The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance.....The penalty rule is an interference with freedom of contract. It undermines the certainty which parties are entitled to expect of the law. Diplock LJ was neither the first nor the last to observe that "The court should not be astute to descry a 'penalty clause': Robophone at page 1447. As Lord Woolf said, speaking for the Privy Council in Philips Hong Kong Ltd v Attorney General of Hong Kong (1993) 61 BLR 41, 59, "'the court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld", not least because any other approach will lead to undesirable uncertainty especially in commercial contracts".

42. Accordingly, the reformulated test has essentially two elements: is any legitimate business-interest protected by the clause; and if so, is the provision made in the clause extravagant, exorbitant or unconscionable?. The Supreme Court also affirmed that the rule against penalties will only apply to secondary obligations, ie. obligations which arise upon breach of a primary obligation. A clause which stipulates onerous provisions in a contract may be onerous, but unless it is triggered by breach it is not a penalty in the eyes of the law. Their Lordships also observed that a penalty clause may often be simple payment of money, but it could also encompass other things, such as the withholding of payments, requirements to transfer assets, or (on the facts before them) a requirement to repay a non-refundable deposit.

43. A clause which provides for a large payment in pursuant of the performance of obligations is not a penalty at law. In Berg v Blackburn Rovers FC it was held that where a football club exercised its right to terminate employment of a manager upon payment out of the remaining salary due under the contract, this was the performance of a term and not a provision designed to constrain breach. Accordingly it could not be a penalty. For English law this position was reaffirmed by the Supreme Court in the Makdessi decision.

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