KEATING CHAMBERS

LIQUIDATED DAMAGES PENALTY DOCTRINE AND RECENT CASE LAW

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Routine Application

- It should not be assumed that clauses providing for payment of a liquidated sum are not struck down as penalties in commercial contracts. They routinely are.

Examples:

- Unaoil Ltd v Leighton Offshore Pte Ltd (2014) 156 Con LR 24
- El Makdessi v Cavendish Square Holdings BV [2014] 2 All ER (Comm) 125 (awaiting judgment on appeal to Supreme Court)
- Lansat Shipping Co Ltd v Glencore Grain BV [2009] 2 CLC 465
- Jeancharm Ltd v Barnet Football Club Ltd (2004) 92 Con LR 26 [CA]

Penalty Jurisdiction Anomalous

- The penalty jurisdiction is regarded as a blatant interference with freedom of contract:

- In McAlpine v Tilebox Jackson LJ said:

> "It is an anomalous feature of the law of contract that the court will strike down penalty clauses".

Penalty Jurisdiction Anomalous

- In Meretz Investments NV v ACP Ltd [2007] Ch 197, Lewison J (as he then was) said:

  "…To characterise a clause as a penalty, with the consequence that the court will refuse to enforce it, is a blatant interference with freedom of contract…".

Penalty Jurisdiction Anomalous

- The Privy Council in Philips Hong Kong Ltd v Att-Gen of Hong Kong (1993) 61 BLR 49 at 58, cited with approval the view of Dickson J in the Supreme Court of Canada 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".

Penalty Jurisdiction Anomalous

- Even Diplock LJ (as he then was) was unable in Robophone Facilities Ltd v Blank [1966] 1 WLR 1428 [CA] to rationalise the rule against penalties:

> "I make no attempt, where so many others have failed, to rationalise this common law rule. It seems to be sui generis":

Traditional Approach

- So how has the jurisdiction traditionally been stated?

Traditional Approach

- Lord Dunedin in Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Company Ltd [1915] A.C. 79 [HL]

Traditional Approach

- "1. Though the parties to a contract who use the word "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 penalty or liquidated damages. This doctrine may be said to be found passim in nearly every case.

Traditional Approach

- 2. 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….

Traditional Approach

- 3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of making the contract, not as at the time of the breach …

Traditional Approach

- Tests for whether penalty include considering:
  - If the sum is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach…

Traditional Approach

- Tests (contd)

  - If 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 and others but trifling damage* "

Traditional Approach

- Tests (contd)

  - Impossibility of pre-estimation does not mean the clause is penal. Indeed that is just when it is probably that the parties intended pre-estimation as their true bargain

Traditional Approach

- Diplock LJ Bernstein v. Liddiate Textiles Ltd 26th June 1962 (Court of Appeal):

> "In the ordinary way a penalty is a sum which by the terms of a contract a promisor agrees to pay to the promisee in the event of non-performance by the promisee of one or more of the obligations and which is in excess of the damage caused by such non-performance."

Traditional Approach

- Diplock LJ (contd):

> "When there is such a stipulation in a contract, then the question arises as to whether provision is a genuine pre-estimate of the damages which will be sustained on a breach, in which case it is enforceable, or whether it is a penalty, in which case the court will grant relief against it and refuse to allow the promisee to recover more than the actual damage which he has sustained."

Emerging Ideas

Lordsvale Finance Plc v Bank of Zambia [1996] QB 752

"whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was **to deter** a party from breaking the contract or **to compensate** the innocent party for breach. That the contractual function is deterrent rather than compensatory can be deducted by comparing the amount that would be payable on breach with the loss that might be sustained if breach occurred".

Emerging Ideas

"… There would … seem to be no reason in principle why a contractual provision the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as **commercially justifiable**, provided always that its dominant purpose was not to deter the other party from breach."

Colman J at 762G and 763g-

Emerging Ideas

- **Cine Bes Filmcilik Ve Yapimcilik v United International Pictures [2003] EWCA Civ 1669**

  "Although the phrase in terrorem has appeared in many cases since Dunlop … [a] more accessible paraphrase of the concept of penalty is that adopted by Colman J in Lordsvale Finance Plc v Bank of Zambia …"

Emerging Ideas

"I have also have found valuable Colman J's further observation in Lordsvale at pp.763g–764a, which indicate that a dichotomy between a genuine pre-estimate of damages and a penalty does not necessarily cover all the possibilities. There are clauses which may operate on breach, but which fall into neither category, and they may be commercially perfectly justifiable."

Mance LJ at [13] and [15]

Emerging Ideas

Murray v Leisureplay plc. [2005] EWCA Civ 963

"The court's reasoning turns on a comparison between the overall amount payable under the agreement in the event of a breach with the overall amount that would have been payable if a claim for damages for breach of contract had been brought at common law. The court proceeded on the basis that, if such a comparison discloses a discrepancy, which can be shown not to be a genuine pre-estimate of damage or to be unjustified, the agreement provides for a penalty."

Arden LJ at [42]

Emerging Ideas

Murray v Leisureplay plc. [2005] EWCA Civ 963

"First, Colman J said no more than that the comparison was a guide to the assessment of a provision as deterrent rather than compensatory. That also, in my view, is as far as this court went in the Cine case itself … The approach that should be applied at trial would be in more general terms than that suggested by my Lady in her paragraph 42…

"I venture to disagree with that approach because it introduces a rigid and inflexible element into what should be a broad and general question. It is also inconsistent with warnings by judges of high authority that, at least in connexion with commercial contracts, great caution should be exercised before striking down a clause as penal;"

Buxton LJ at [113]-[114]

New Orthodoxy?

Makdessi v Cavendish Square Holdings BV & Anor [2013] EWCA Civ 1539

principles:

(i) A sum will be penal if it is extravagant in amount in comparison with the maximum conceivable loss from the breach;

(ii) A sum payable on the happening or non happening of a particular event is not to be presumed to be penal simply because the fact that the event does or does not occur is the result of several breaches of varying severity;

New Orthodoxy?

(iii) A sum payable in respect of different breaches of the same stipulation is not to be presumed to be penal because the effect of the breach may vary;

(iv) The same applies in respect of breaches of different stipulations if the damage likely to arise from those breaches is the same in kind;

(v) But a presumption may arise if the same sum is applicable to breaches of different stipulations which are different in kind;

New Orthodoxy?

(vi) There is no presumption that a clause is penal because the damages for which it provides may, in certain circumstances, be larger than the actual loss; and

(vii) Where there is a range of losses and the sum provided for is totally out of proportion to some of them the clause may be penal

Christopher Clarke LJ at [71]

New Orthodoxy?

Makdessi v Cavendish Square Holdings BV & Anor [2013] EWCA Civ 1539

Further matters to be taken in to account:

(i) The contract must be examined as a whole in the circumstances and context in which it was made;

(ii) It is for the party who claims that it is to establish that. It may be possible to do so by reference to the terms of the clause itself in the context in which it was agreed: Robophone at 1447F–G. It may, however, be necessary to adduce evidence as to its effect or any other matter which is said to render it unconscionable;

New Orthodoxy?

(iii) The court will not be astute to find that a clause contained in a commercial contract is unenforceable because it is penal, especially if the parties are of equal bargaining power and have had high level legal advice. The court recognises the utility of liquidated damages clauses and that to hold them to be penal is an interference with freedom of contract. It is, therefore, predisposed to uphold clauses which fix the damages for breach: per Jackson J in Alfred McAlpine ;

New Orthodoxy?

(iv) To that end it will adopt a robust approach. If the likely loss is within a range, an average figure or a figure somewhere within the range is likely to be acceptable. If the loss is difficult to assess a figure which is not outrageous may well be acceptable. A pre-estimate does not have to be right to be reasonable: per Jackson J in Alfred McAlpine . The fact that it may result in overpayment is not fatal and the parties are allowed a generous margin. Further the fact that a breach may give rise to trifling or substantial damage may not be determinative if the parties can be regarded as having regarded the trifling as unlikely;

New Orthodoxy?

- New orthodoxy headlines
  - Is it a genuine pre-estimate?
  - If it is, the clause is not penal
  - If not a genuine pre-estimate, is there a commercial justification for the clause?
  - If there is, the clause is not penal
  - It need not be a genuine pre-estimate if there is a commercial justification

New Orthodoxy?

(v) But the fact that the clause has been agreed between parties of equal bargaining power who have competent advice cannot be determinative. The question whether a clause is penal habitually arises in commercial contracts, which enjoy no immunity from the doctrine.

Christopher Clarke LJ at [74]

Recent Case Law

- Question: As at what date should the clause be examined in order to see whether it is a penalty?

- Answer: The date of the contract

  - Unless: the contract is amended in “a relevant respect”, in which case it is the date of the amendment.

Unaoil v Leighton Offshore [2014] EWHC 2965 (Comm)

Recent Case Law

- Question: Can the contract be rewritten to avoid the doctrine?
- Answer: Yes.

  - The doctrine applies to sums which are payable (or which cease to be recoverable) by reason of breach of contract

  - The doctrine does not apply to sums which are only payable in the event of compliance with a term

Recent Case Law

Examples:

- If you breach this obligation as to vacating Area X by end of May then:
  - you will not recover £1000 (otherwise due to you)
  - you will pay damages of £1000

= within penalty doctrine

- Conditional on your vacating Area X by end of May then:
  - you will be paid £1000

= not within penalty doctrine

Recent Case Law

- Liquidated damages for replacing key personnel in breach of obligation to seek consent

- Bluewater Energy Services BV v Mercon Steel Structures BV [2014] EWHC 2132 [paras 1207 to 1231]

- Orthodox application of law as to penalties. (Makdessi not discussed.)

Recent Case Law

- MSC Mediterranean Shipping Co v Cottonex Anstalt [2015] EWHC 283 (Comm)

- Demurrage charges began to accrue; defendant in repudiatory breach; claimant elected to affirm and claim demurrage potentially indefinitely

- Were demurrage charges penal?

Makdessi's Companion in Supreme Court

Parking Eye Ltd v Barry Beavis [2015] EWCA Civ 402

"The judge … held that the proper modern approach to deciding whether any particular clause is unenforceable as a penalty requires an examination of its role from a number of different perspectives, including proportionality to actual loss, deterrence and commercial justification. In his view, although the principal object of the charge was to deter overstaying, it was neither improper in its purpose nor manifestly excessive in amount, having regard to the level of charges imposed by local authorities and others for overstaying in public car parks. It was in his view commercially justifiable, both from the point of view of the Pension Fund and Parking Eye and from the point of view of motorists at large … In my view the judge was right to approach the matter in that way."

Moore-Bick LJ at [26]

Questions in the Supreme Court

- Makdessi in the Supreme Court:
  - what is the definition of “commercial contract”?
  - what is a “small business”?
  - what does “commercial justification” mean? (Surely it has a commercial justification if it is in the contract – Lord Mance)
  - “whether the clause was manifestly excessive in achieving the core contractual aims” (Lord Toulson)
  - the rewriting problem – changing a stick to a carrot
  - would small business suffer as a result of abolition: suppliers & subcontractors in the construction industry (Lord Toulson)
  - without consultation how can Supreme Court take informed view of likely fall out

What of the future?

- For the future:
  - Will the doctrine be abolished altogether?
  - Will the doctrine be abolished only for “commercial contracts”?
  - If so, what is a commercial contract?

  - If the doctrine survives for commercial contracts:
    - Will the new orthodoxy prevail?
    - If so, what is “commercial justification”?

The End

THANK YOU FOR LISTENING

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