

Introduction

English law generally recognises the autonomy of contracting parties, particularly outside the context of consumer contracts and contracts based on individual contracting parties' standard contracts.

The English law of contract even allows contracting parties to agree in advance the amount of damages that should be paid if a particular contractual obligation is subsequently breached. The contractual provision which sets such an amount of damages is called "a liquidated damages clause". (Where a liquidated damages clause is in operation, the contractual obligation that has been breached is referred to as the primary obligation, and the payment obligation under the liquidated damages clause is called the secondary obligation.)

Nevertheless, there is a limit to the extent to which the English law of contract would allow enforcement of such clauses. English law does not recognise the enforceability of "penalty clauses", i.e. provisions which are (as objectively interpreted) penal in nature, in the sense that the detriment (such as liquidated damages) imposed by the relevant provisions is disproportionately excessive in comparison with the legitimate interest of the innocent party (such as its monetary loss and, where applicable, any wider legitimate interest) in enforcing those provisions.

The Traditional Understanding of the English Law of Penalty Clauses

It has traditionally been thought that the ultimate test for determining whether a particular "liquidated damages" clause is in fact an unenforceable penalty clause (rather than an enforceable genuine liquidated damages clause), is simply whether the stipulated sum of liquidated damages was a genuine pre-estimate (when judged as at the time of contracting) of the loss that could be caused by breach of the relevant primary obligation. What this traditional test was intended to mean is this: the stipulated sum could not be enforced if (as a matter of interpretation as at the time of contracting) the stipulated sum so greatly exceeds the greatest amount of loss that could be proven to have been caused by breach of the relevant primary obligation, that the stipulated sum can be justifiably said to be extravagant and unconscionable. (As explained in detail below, this interpretation of the penalty rule is now only applicable in straightforward damages situations.)

The New Interpretation of the English Law of Penalty Clauses

As widely publicised recently, the UK Supreme Court, the highest appellate court of the UK, has clarified and shed a new light on the English law of penalty clauses, by its judgment in *Cavendish Square Holding BV v Makdessi; ParkingEye Ltd v Beavis (Consumers' Association intervening)* [2015] UKSC 67 and [2015] 3 W.L.R. 1373.

As clarified by the UK Supreme Court, the most important aspects of the English penalty rule are as follows:

1. The penalty rule is not applicable to contractual provisions which stipulate an obligation to pay a certain amount of money, or to suffer another form of detriment, by way of a primary obligation – it is only applicable to a secondary obligation (i.e. an obligation triggered by a breach of a primary obligation).
2. The distinction between primary obligations and secondary obligations is a matter of substance rather than form or label.
3. The question whether a particular clause is a penalty falls to be decided as a matter of objective interpretation as at the time that it was agreed, and therefore the circumstances in which the relevant clause falls to be enforced are irrelevant.
4. The true test can be explained as follows:
 - a) The general test is whether the relevant impugned clause 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 (emphasis added)" (as per Lord Neuberger and Lord Sumption).
 - b) The general test can be described as "whether the sum or remedy stipulated as a consequence of a breach of contract is *exorbitant or unconscionable when regard is had to the innocent party's interest* in the performance of the contract (emphasis added)" (as per Lord Hodge).
 - c) The traditional test based simply on a comparison between the stipulated amount and the greatest loss that could be proven to have been caused by breach of the relevant primary obligation is no longer suitable, as there may often be a wider interest in enforcing the impugned clause (i.e. the clause the enforceability of which is being challenged) than mere pecuniary compensation.

- d) The words “extravagant” and “unconscionable” usually mean the same thing for the purpose of the aforementioned test.
- e) In the context of liquidated damages clauses, “an inability to ascertain [the measure of damages at common law] can justify an agreement to pay a fixed sum on breach” (as per Lord Mance).
- f) If the innocent party was able to dominate the contract breaker at the time of contracting as to the choice of terms, the courts might take it into account in determining the primary objective(s) of the clause the enforceability of which is being challenged.

Incidentally, the so-called “duty of mitigation” *normally* does not apply in relation to enforceable liquidated damages clauses. (The aforesaid “duty of mitigation” is a reference to the rule that requires the courts, in assessing the amount of recoverable damages, to assume that the innocent party will have taken reasonable steps to reduce losses that would otherwise have been caused by the relevant breach of contract.)

Implications of the New Penalty Rule

The most important feature of the new interpretation of the penalty rule is the recognition that the traditional test based simply on the comparison between the stipulated sum and the greatest amount of loss that could be caused by the relevant breach will usually be inappropriate, and regard may need to be had to the wider interest of the innocent party in enforcing the claim for the stipulated sum.

In many situations, therefore, the new penalty rule means that it is now much more difficult to challenge the enforceability of liquidated damages clauses.

As regards the test of “wider interest”, it remains to be seen how the English courts will normally apply such a test in practice.

Let us consider this in the context of determining the enforceability of (for example) a liquidated damages clause relating to a delay in completion of the construction of items such as a building or an FLNG vessel. In such a situation, if there is evidence that the stipulated amount of the liquidated damages was set entirely with regard to losses that the innocent party might (in the absence of the liquidated damages clause) be able to recover under the relevant contract, it is possible that the court might decide not to apply the test of wider interest.

In considering how to apply the test of wider interest, the court might take into account (among other relevant factors) whether the relevant construction project was a stand-alone project or an important component element in a bigger project. If the latter is the answer, it may well be easier for the court to identify a wider legitimate interest of the innocent party in enforcing the impugned clause than merely the need for pecuniary compensation for loss. Where such an interest is identified (when judged as at the time of contracting), the court might uphold the enforceability of the impugned clause, even if the amount of the stipulated sum is such that in the absence of such consequences the court would have treated the clause as a penalty clause and therefore unenforceable.

In light of the new interpretation of the penalty rule, in situations in which a contracting party is facing a proposal to insert a liquidated damages clause into an English-law governed contract and the proposed amount of liquidated damages appears to be excessive, it is now much more important for such a party to have clear ideas about how the penalty rule works and how to word the relevant clause so as to mitigate the adverse consequences that might arise from accepting the proposed amount of liquidated damages. This is a topic for another day.

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