Paper title: Penalty Clauses – a Game-Changer?

By: David Martin-Clark

Maritime & Commercial Arbitrator and Mediator

Introduction

1. This paper examines the impact on the concept of Penalty Clauses in English law of two recent decisions of the UK Supreme Court in the cases Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis. Both cases were decided together and the judgments are reported at [2015] UKSC 67. They were delivered on 4 November 2015.

2. The issues to be explored are the extent to which these decisions have changed the law's approach to contractual clauses of this type and the likely effect of them if a certain recent decision on penalty clauses in the maritime context was to be revisited.

What is a Penalty clause?

3. A penalty clause in a contract is a clause which sets out in advance what the damages shall be in the event of a breach of contract. It is therefore, a type of liquidated damages clause but one that the law, for reasons of public policy, declines to enforce.

4. The type of liquidated damages clause most frequently encountered in charterparties is the demurrage clause in voyage charterparties, providing that, if laytime is exceeded for any reason other than the 'fault' of the vessel, a fixed sum of money is payable by the charterer to the owner per day and pro-rata, for the period from the moment that laytime expires until the time at which cargo operations are completed. Such a clause is clearly regarded as a liquidated damages clause (as opposed to a penalty clause) as the agreed sum is payable only on one form of breach – the charterers' detention of the vessel beyond the agreed laytime – and is graduated in line with the extent of that breach, since it accrues day by day.[1]

The Origin of the Concept[2]

5. The origins of the so-called 'penalty rule' can be traced to an equitable jurisdiction to relieve from defeasible bonds. These were promises under seal (therefore not requiring any consideration) to pay a specified sum of money, subject to the proviso that they should cease to have effect on the satisfaction of a condition. This condition was usually the performance of some other contractual undertaking of a 'primary' nature [see paragraph 7 below]. The leading judgment in Cavendish states at paragraphs 4 and 5:

> "By the beginning of the 16th century, the practice had grown up of taking defeasible bonds to secure the performance obligations sounding in damages. This enabled the

holder of the bond to bring his action in debt, which made it unnecessary for him to prove his loss and made it possible to stipulate for substantially more than his loss. The common law enforced such bonds to their letter. But equity regarded the real intention of the parties as being that the bond should stand as security only, and restrained its enforcement at common law on terms that the debtor paid damages, interest and costs… The essential conditions for the exercise of the jurisdiction were:

> (i) that the penal provision was intended as security for the recovery of the true amount of a debt or damages, and
> (ii) that that objective could be achieved by restraining proceedings on the bond in the courts of common law, on terms that the defendant paid damages."

6. At paragraph 6, the judgment continued:

"Towards the end of the 17th century, the courts of common law tentatively began to stay proceedings on a penal bond to secure a debt, unless the plaintiff was willing to accept a tender of the money due, together with interest and costs. The rule was regularized and extended by two statutes of 1696 and 1705… The effect of this legislation was… to make it unnecessary to proceed separately in chancery for relief from the penalty and in the courts of common law for the true loss. As a result, the equitable jurisdiction was rarely invoked, and the further development of the penalty rule was entirely the work of the courts of common law."

7. Then, at paragraph 7:

"The penalty rule as it was developed by the common law courts in the course of the 19th and 20th centuries proceeded on the basis that, although penalties were secondary obligations [that is, dealing with the consequences of the breach of another term of the contract – a 'primary' obligation], the parties meant what they said. They [the parties] intended the provision to be applied according to the letter with a view to penalizing breach."

Thus, if the law were to relieve the contract-breaker of the consequences of its breach, as set out in the penalty clause, it was not

"because the objective of the clause could be achieved in some other way, but because the objective was itself contrary to public policy and should not be enforced at all."

8. Continuing at paragraph 8, the judgment said:

"With the gradual decline in the use of penal defeasible bonds, the common law on penalties was developed almost entirely in the context of damages clauses, that is, clauses which provided for payment of a specified sum in place of common law damages. Because they were a contractual substitute for common law damages, they

could not in any meaningful sense be regarded as a mere security for their payment. If the agreed sum was a penalty, it was treated as unenforceable…"

with the result that the innocent party was limited to the common law measure of damages.

9. Concluding this section of the judgment, the Court said in paragraphs 8 and 9 that decisions early in the 19th century:

"introduced the now familiar distinction between a provision for the payment of a sum representing a genuine pre-estimate of damages and a penalty clause in which the sum was out of all proportion to any damages likely to be suffered. By the middle of the 19th century, this rule was well established… The distinction between a clause providing for a genuine pre-estimate of damages and a penalty clause has remained fundamental to the modern law, as it is currently understood."

The Modern Law

10. The judgment then went on to consider, again at paragraph 9? the modern law in these terms:

"The question whether a damages clause is a penalty falls to be decided as a matter of construction, therefore at the time that it is agreed… [A penalty clause] is a species of agreement which the common law considers to be by its nature contrary to the policy of the law. One consequence of this is that relief from the effects of a penalty is… "mechanical in effect and involves no exercise of discretion at all". Another is that the penalty clause is wholly unenforceable… Deprived of the benefit of the provision, the innocent party is left to his remedy in damages under the general law."

11. The Supreme Court in the Cavendish case considered two particular questions in regard to the penalty rule:

a) in what circumstances is the rule engaged at all, and
b) what makes a contractual provision penal?

12. In considering question a), the Court stated at paragraph 12:

"In England, it has always been considered that a provision could not be a penalty clause unless it provided an exorbitant alternative to common law damages. This meant that it had to be a provision operating upon a breach of contract."

It continued at paragraph 13:

> This principle is worth restating at the outset of any analysis of the penalty rule, because it explains much about the way in which it has developed. There is a fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach…

Then it continued:

> "the penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves… it provided the whole basis of the classic distinction made at law between a penalty and a genuine pre-estimate of loss, the former being essentially a way of punishing the contract-breaker rather than compensating the innocent party for [the contract-breaker's] breach."

13. While noting that payment of a sum of money is the classic obligation under a penalty clause, the Court could see no reason why an obligation to transfer assets (as in Cavendish itself) or to pay a sum as a deposit which is forfeited in accordance with the contract terms, should not be capable of constituting a penalty – paragraph 16.

14. In addressing question b) - what makes a contractual provision penal - the Court noted that until relatively recently, this question had been answered by reference to straightforward liquidated damages clauses. Reference was made to two "seminal" cases at the beginning of the 20th century – Clydebank Engineering Co Ltd v Don Jose Ramos Yzquierdo y Castaneda [1905] AC 6 and Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79.

15. The Dunlop case concerned a breach of a price maintenance clause, the contract providing that the contract-breaker would pay Dunlop £5.00 for every tyre, cover or tube sold in breach of any provision of the agreement. In his judgment in Dunlop, Lord Dunedin drew various propositions of law from the earlier cases.

a) "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…

b) The essence of a penalty is payment of money stipulated as *in terrorem*[3] of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage…

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

d) To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:

(i) It will be a 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…

(ii) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated for is a sum greater than the sum which ought to have been paid.

(iii) There is a a presumption (but no more) that it is a penalty when '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'…

(iv) It is no obstacle to the sums 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…"

16. In the view of the Court, at paragraph 22, Lord Dunedin's speech in Dunlop

"achieved the status of a quasi-statutory code in the subsequent case-law. Some of the many decisions on the validity of damages clauses are little more than a detailed exegesis or application of his four tests with a view to discovering whether the clause in issue can be brought within one or more of them. In our view, this is unfortunate."

The Court noted that Lord Dunedin himself acknowledged that the essential question was whether the clause impugned was "unconscionable" or "extravagant".

The Court concluded that the four tests were a useful tool in deciding whether these terms can be properly applied to simple damages clauses in standard contracts but that they are not easily applied to more complex cases. To deal with them, it is necessary to consider what it is that makes a provision for the consequences of breach "unconscionable" and by comparison with what it is that makes a penalty clause "extravagant".

17. Referring back to the judgment of Lord Atkinson in Dunlop and examining later decisions in the High Court and the Court of Appeal, the Court discerned the emergence of a wider criterion: what was the nature and extent of the innocent party's interest in the performance of the relevant obligation? Is there the possibility of a "broader test" in less straightforward cases,

in the context of the supposed "commercial justification" for clauses which might be otherwise regarded as penal?

18. In that event, the Court concluded in paragraph 29:

> "a damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach. This must depend on whether the innocent party has a legitimate interest in performance extending beyond the prospect of pecuniary compensation flowing directly from the breach in question."

The Court's Conclusion

19. In the Court's opinion, at paragraph 31:

> "the law relating to penalties has become the prisoner of artificial categorization… between a penalty and a genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent. These distinctions originate in an over-literal reading of Lord Dunedin's four tests, and a tendency to treat them as almost immutable rules of general application which exhaust the field… The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. 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. In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach…[b]ut compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations."

20. The Court recognized that the penalty rule is an interference with freedom of contract in that it undermines the certainty that the parties are entitled to expect of the law. It is not, therefore, to be lightly inferred.

> "In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach (at paragraph 35)."

The Cavendish Case

21. In the Cavendish case itself, the Court had to consider clauses in a contract by which Makdessi agreed to sell to Cavendish the controlling stake in a holding company which controlled the largest advertising and marketing communications organisation in the Middle East. Both parties recognized that the goodwill of the business was crucial to the deal. The impugned clauses provided that, in the event that Makdessi was in breach of certain non-compete provisions of the contract, he would not be entitled to receive from Cavendish the final two instalments of the purchase price and would be required to sell to Cavendish the rest of his shares in the company at a price exclusive of goodwill. The loss to Makdessi was calculated to be USD44,181,600.00.

22. The Court found that, in reality, the clauses in question were not a liquidated damages clause regulating the measure of compensation for breach of the restrictive covenants. They were not a contractual alternative to damages at law. Rather, they were to be considered as a price adjustment clause and in no sense as secondary obligations. This was of itself enough to dismiss the attack on them as a penalty. But the Court added that, even though the clauses had no relationship, even approximate, to the measure of loss attributable to the breach, Cavendish had a legitimate interest in the observance of the restrictive covenants which extended beyond the recovery of that loss.

> "It had an interest in measuring the price of the business to its value. The goodwill of the business was critical of its value to Cavendish, and the loyalty of Mr Makdessi… was critical to the goodwill…" (paragraph 75). [The clauses] were part of a carefully constructed commercial contract which had been the subject of detailed negotiations over many months between two sophisticated commercial parties, dealing with each other on an equal basis with specialist, experienced and expert legal advice." (paragraph 82)

In consequence, those clauses were enforceable by Cavendish against Makdessi.

The ParkingEye v Beavis Case

23. The facts here were that Beavis was the owner and driver of a vehicle which he had parked in a retail shopping car park for a period of nearly three hours. The car park was managed under contract by ParkingEye to provide a 'traffic space maximization scheme' under which it posted notices throughout the car park advising that failure to comply with a parking limit of two hours would result in a fine of £85.00. Apart from the fine, use of the car park was

free of charge. Mr Beavis contested a claim against him for the fine on the grounds that it amounted to a penalty.

24. His defence failed. The Court held that the amount in question was neither "unconscionable" nor "extravagant" and that ParkingEye had a legitimate interest in charging £85.00 which extended beyond the recovery of any loss, as the charge allowed efficient use of the parking space in the interest of the retail outlets and the users of other vehicles who wanted to find space to park. It also provided an income stream to ParkingEye, enabling it to meet the costs of operating the scheme and to make a profit.

Applying the new test to *The Paragon*

25. Some seven years before Cavendish was decided, the Court of Appeal had been asked to review the decision of Mr Justice Blair at first instance in the case of Lamat Shipping Co Ltd v Glencore Grain BV [2009] EWCA Civ 855. This concerned a particular clause which appeared in a time-charter on an amended New York Produce Exchange Form for the MV *Paragon.* The charterparty was for a period of minimum 3 to about 5 months, with 'about' to mean +/- 15 days, and the daily rate of hire was USD29,500.00. The vessel was delivered on 29 November 2006. Allowing for the plus 15 days margin, the last possible date for lawful redelivery was 14 May 2007. She was in fact redelivered only on 22 May. The charterers paid hire at the contract rate for the period from delivery until 14 May and at the prevailing market rate thereafter.

26. But the Owners claimed hire based on the market rate for thirty days before the latest date for redelivery, amounting to USD471,603.32. Their claim was founded on cl.101 of the charterparty, which read:

> "The Charterers hereby undertake the obligation/responsibility to make thorough investigations and every arrangement in order to ensure that the last voyage of this Charter will in no way exceed the maximum period under this Charter Party. If, however, Charterers fail to comply with this obligation and the last voyage will exceed the maximum period, should the market rise above the Charter Party rate in the meantime, it is hereby agreed the charter hire will be adjusted to reflect the prevailing market level from the 30th day prior to the maximum period date until actual redelivery of the vessel to the Owners."

The Charterers resisted payment under this clause, on the ground that it was a penalty, and were successful, both in the High Court and the Court of Appeal. The arbitration award which had ruled accordingly was therefore upheld.

27. The principal ground for the decision was the disproportion between the damages payable on common law principles for the over-run period of some six days, amounting to USD181,827.00 and the amount payable under the second sentence of cl.101, namely USD 471,603.32, a figure greater by a factor of 2.5. The Master of the Rolls concluded his judgment with these words:

> "Finally, I come to the amount claimed on the basis of clause 101, noting that the award in this case was made by three very experienced maritime arbitrators… They pointed out that if the vessel was redelivered only one hour late, the amount of the claim of $471,602.32 would be payable in full… They were, in my opinion, right to take the view that this would be an "unconscionable" amount within the meaning of the case law, and equally so in the case of a delay in redelivery of just over six days as in the present case. Like the arbitrators, I consider that the primary purpose of the clause was to deter the Charterers from breaching their obligation to redeliver the vessel in time, and whilst such a purpose may in a sense be understandable because of the limits to the Owners' knowledge about the likely length of the final voyage at the time of the order, the clause was in my view a penalty, and not a genuine pre-estimate of damage resulting from a breach of contract. I would dismiss the Owners' appeal, and confirm the Award."

28. Were *The Paragon* case to be re-heard today, in the post-Cavendish era, would the result be different? The test to apply is: is this clause “unconscionable” or “extravagant” in the sense that it 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, namely the redelivery of the vessel within the final termination date of the charterparty?

29. That cl.101 is a secondary obligation is clear, as the clause is relevant only where the charterers are in breach of contract by redelivering the vessel beyond the final termination date of the charterparty. But is it “unconscionable” and “extravagant” in that it imposes a detriment on the charterers out of all proportion to any legitimate interest of the owners in the timely redelivery of the vessel? On a rising market, the owners have a legitimate interest in getting their vessel back as soon as is contractually possible, so that they can start to earn a higher rate of hire at the earliest opportunity. On the other hand, the clause stipulates hire at the higher rate for a period of thirty days prior to the final termination date, a period which the owners sought to justify as the mid-point of the length of an average voyage for the vessel. Was this excessive? Would a period commencing from the start of the final voyage (assuming it was

within the thirty-day period) be more reasonable? Or do such considerations pay undue attention to the issue of a genuine pre-estimate of damage, which is now a discredited criterion? Or is it a discredited criterion in a 'simple' as opposed to 'complex' case, where the issue is just the amount of damages to be paid on breach?

30. If the legitimate interest of the owners lies solely in employing the vessel in the most profitable market as soon as possible and not in any other wider factors, such as reputational loss or defence of market position, is an escalator of 2.5 times to be considered "extravagant" or "unconscionable"? What if the amount involved was greater that the USD500,000 or so in play here, and the 2.5 factor produced a figure of millions of Dollars. Would that be considered "extravagant" or "unconscionable"?

31. And what was the primary purpose of cl.101 in *The Paragon* charterparty? Was it really to protect the owners' legitimate interest in the redelivery of the vessel by the termination date of the charterparty, or was it conceived as a means of punishing the charterers should they redeliver late? And, if the latter, why did the Charterers agree it in the first place? In asking this question, we are entitled to take into account that both parties were sophisticated players in the freight market, had easy access to specialist advice and were of equal bargaining strength. Is this really a case where the Court should interfere in a contract agreed between such parties, particularly when the basic tenet of English contract law is that the parties are to be held to their bargain?

32. The answer to all these questions is not an easy one. Has the de-coupling of penalty clauses from the concept of pre-estimate of loss (however generously interpreted) really achieved a difference, especially in a case such as *The Paragon*? It would be nice to think, after so much intellectual firepower has been applied to the problem in Cavendish, that the answer would be clear. Have we really reached the position where, if it were re-played today, *The Paragon* case would probably be decided differently and the owners would recover the additional damages for which cl.101 provides? That might well be the case but, on the other hand, it very well might not!

David Martin-Clark currently practises as a Maritime Arbitrator and Commercial Disputes Mediator in London, Hamburg, Singapore and Hong Kong. He is a full member of the London Maritime Arbitrators Association, a member of the German Maritime Arbitration Association and a panellist at SIAC and SCMA, CMAC and HKIAC. He also works as a shipping & insurance consultant and as an expert witness.

He was previously engaged for some thirty years in the P&I Club business in the London firm of Thomas Miller & Co. Whilst at Miller's he worked for some years in Hong Kong.

After leaving Millers, he re-qualified as a barrister and was an associate member of Stone Chambers in Gray's Inn between 2006 and 2016.

---

[1]. McGregor on Damages, 19th Edition (2014), Sweet & Maxwell, 15-073

[2] This section is extensively drawn from the judgment of Lords Neuberger and Sumption (with which Lord Carnworth agreed) in the leading cases of Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67, in particular paragraphs 1 to 11. References to the 'Court' are references to this judgment.

[3] Serving or intended to threaten or intimidate.