



White Paper Construction Law: Liquidated damages - the modern test

How do you approach the problem of a "genuine pre estimate of loss" being an inappropriate test for LADs in modern building contracts (because working the figure out is so complex and potentially inaccurate)?

In other words, how should LADs be approached and or calculated?

It starts here - what are liquidated damages?

1. For a very long time students of construction law love writing papers about the distinction between liquidated damages clauses and penalty clauses. Traditionally, it has been relatively firm ground, and in particular, everybody trots out the dicta of Lord Dunedin in *Dunlop v New Garage*.
2. Liquidated damages ("LDs") (also referred to as liquidated and ascertained damages, "LADs") are the damages the parties designate during the formation of a contract as the basis the injured / wronged party may recover compensation upon a specific breach (e.g., late performance, under performance of process plant, and/or failure to provide documentation).
3. The parties often agree that a liquidated (i.e. fixed and agreed) sum shall be paid as damages for a specified breach of a contract. A typical clause provides that if the contractor shall fail to complete by a date stipulated in the contract, or any extended date, it shall pay or allow the employer to deduct liquidated damages at the rate of £x per day or week for the period during which the works are uncompleted e.g. Clause 2.32 of the 2011 JCT Standard Form of Building Contract and secondary option X7 - delay damages (liquidated damages) in NEC3.

2:32.2	Liquidated damages <i>(where completion by Sections does not apply)</i>	at the rate of £ _____ per _____
	Sections: rate of liquidated damages for each Section ^[15]	Section _____ : £ _____ per _____ Section _____ : £ _____ per _____ Section _____ : £ _____ per _____
2:37	Sections: Section Sums ^[15]	Section _____ : £ _____ Section _____ : £ _____ Section _____ : £ _____

Clause 2.32 JCT 2011

4. The benefit of liquidated damages is that in theory they avoid the difficulty of proving and assessing actual loss where a delay occurs. Liquidated damages provisions are always construed strictly *contra proferentem*¹ and usually sensibly. Eleven years ago, in one of the key LD cases of recent times in *Alfred McAlpine Capital Projects v Tilebox Limited*,² which we will look at later, the court considered the question of genuine pre-estimates and held that a pre-estimate of damage does not have to be “right” to be reasonable. There needs to be a substantial discrepancy between the liquidated damage and the level of damage that is likely to be suffered before the pre-estimate can be said to be unreasonable. The test is an objective one. The convention is that the courts prefer to uphold contractual terms fixing the level of damages for breach where possible.

5. The question “*To what extent does English contract law allow parties to a contract to specify for their own remedies in damages in the event of breach?*” has been said³ to be a question laden with jurisprudential tension, rich in judicial commentary and of fundamental legal, practical and commercial significance for construction lawyers and decision-makers.

6. For example, in ‘*Its a lads thing*’ by Tony Bingham in *Building* 28 November 2008 he said:

¹ *Jeancharm Limited v Barnet Football Club Limited* (2003) EWCA Civ 58. Comparatively recently this contract provided for 20% per garment per day for late delivery. And interest at 5% per week for late payment. The claims amounted to 260% of the contract sum. The interest clause was declared a penalty, as it was not a genuine pre-estimate. *Azimut-Benetti SPA v Darrell Marcus Healey* [2010] EWHC 2234 is a more recent example.

² [2005] BLR 271.

³ Dr Hamish Lal in *Exploding the Myths*.

“Lawyers tend to explain what a good thing they are, because they let everyone know the exact sum to be shelled out and allow the contractor to foresee the precise consequences of delay. This is rubbish. Contractors utterly loathe LADs, no matter what unlikely fancy dress you stick them in. They are a sword hanging by a hair directly above their head. Try to persuade any contractor that they are not penalties and you will fail. And knowing that late completion is going to snap the thread leads to all sorts of disputes. I reckon the neon sign of ‘LAD’ does more harm than good.”

As ever, Tony Bingham sees things through his particular telescope, interesting always but not always legally right.

7. A LD provision can, if it “sticks”, result in a considerable saving of costs, because it often happens that “although undoubtedly there is damage the nature of the damage is such that proof of it is extremely complex, difficult and expensive” to establish.⁴ Where there is such a clause and the contractor has failed to complete on time, it is prima facie liable to a claim for the LDs. This can be either by way of action or by deduction (if there is an express power) or by a set-off subject to payless notices etc. and operating the machinery of the contract. There can be no inquiry into the actual loss suffered. Until a certain Supreme Court decision, which I will discuss below, the traditional defence to the claim for LDs was to prove either that the agreed sum is a penalty,⁵ or that it was not a genuine pre-estimate of loss. Should the defaulting party establish such a defence,⁶ it may have left the employer the right to pursue a claim for unliquidated damages (i.e. an ordinary claim for damages) for delay,⁷ as a failed LD clause is usually taken as a cap on what those LDs could be, although there is no direct English authority on the point. In addition, no general rule can be stated as to the date from which such unliquidated damages are recoverable. This depends upon the contract, the particular defence established and the circumstances.

⁴ *Clydebank Engineering Co v Don Jose Yzquierdo y Castaneda* [1905] A.C. 6 at 11, HL.

English contract law requires that damages be proved with reasonable certainty and courts deny damages that are too speculative. This makes proving damages from late completion rather hard in most cases. Take, for example, a project for a new car dealership. The contractor practically completes the work 21 days late. The employer expected to open and operate the dealership during those 21 days and earn profits selling cars to the public. Among other things, the employer will claim as damages the profits they lost during those 21 idle days. But can the employer prove, with reasonable certainty, what their sales volume and profit margin would have been during those 21 days? Can they prove their costs would have been as low as they claim? Can they prove that the cars, accessories and related services they offer *at that location*, during those particular 21 days, would have sold at the prices they claim? Can the owner prove that other factors outside their control, like bad weather, would not have depressed sales during some of those 21 days? Maybe the employer can prove these things, but it’s pretty speculative. And if the employer’s proof is speculative the contractor will oppose, saying it’s not reasonable certain loss. Agreeing in advance on liquidated damages avoids trying to prove things that, at best, are speculation.

⁵ For example in *Braes of Doune Wind Farm (Scotland) Limited v Alfred McAlpine Business Services Limited* [2008] EWHC 426 (TCC) the court concluded that the liquidated damages provisions were punitive because the contractor could be liable for liquidated damages in respect of delays which had been caused by a different contractor.

⁶ Or say an absence of a definitive date fixed by the contract from which damages can run; or any specific contractual procedures, such as giving written notice within specified time limits, that have not been complied with; or the employer has waived the right to deduct or claim LDs; or show the contract is otherwise brought to an end, LDs will still be payable if appropriate.

⁷ See *Elsley v JG Collins Insurance Agencies Ltd* (1978) 8 DLR (3D) 1 Supreme Court of Canada. See *Biffa Waste Services Ltd v Maschinenfabrik Ernst Hese GmbH* [2008] EWHC 6 (TCC) which provides further support for the proposition that liquidated damages clauses are, absent express words to the contrary, likely to act as an exhaustive remedy for all delay-related losses.

8. Partial possession and sectional completion is a more problematic area where LDs often come unstuck,⁸ but that is beyond the scope of this short paper suffice to say that if the clause is overcomplicated, this can jeopardise a claim for liquidated damages. In *Bramall & Ogden v Sheffield City Council* the court found that the Council could not enforce liquidated damages expressed as “£20 per week for each uncompleted dwelling” where partial possession of a housing estate of 123 houses and other works was taken in phases and the building contract did not allow for sectional completion. Again, though this case was decided 30 years ago, it currently remains good law.

Chitty⁹ cautions great care with tapering provisions in that whilst a clause may specify a graduated scale of sums payable according to the varying extent of the expected loss, a sum which is liable to fluctuate according to extraneous circumstances may not be classified as liquidated damage. If we look at a railway construction contract case from over a century ago,¹⁰ it provided that in the event of a breach by the contractor he should forfeit “as and for liquidated damages” certain percentages retained by the Government of the Cape of Good Hope of money payable for work done as a guarantee fund to answer for defective work and also certain security money deposited with the Government. The Judicial Committee held this was a penalty, since it was not a definite sum, but was liable to great fluctuation in amount dependent on events not connected with the fulfilment of the contract. It is obvious that the amount of retained money depended entirely on the progress of those contracts, and that further, as those moneys were primarily liable to make good deficiencies in those contract works, the eventual sum available could not in any way be estimated as a fixed sum.

9. Interestingly, however, graduated damages have been upheld as liquidated damages in building contracts and similar contracts where the sums payable increase in proportion to the seriousness of the breach, e.g. a sum which increases with each week of delay in performance, or proportional to the number of items involved.

The conventional wisdom

10. LD clauses have of course long been a feature of construction contracts since the start of the 18th century. They provide, as we have seen, a pre-determined sum to be paid by way of compensation in the event of a breach of a stipulated contract term.

⁸ See *Brammel & Ogden v Sheffield City Council* (1985) 29 BLR 73 and *Taylor Woodrow Holdings Limited v Barnes & Elliott Limited* [2004] EWHC 275.

⁹ *Chitty on Contracts*, 31st edition, volume 1.

¹⁰ *Public Works Commissioner v Hills* PC [1906] AC.

11. The origins of the penalty rule can be traced back even further to the 16th century, and originate in the concern of the courts to prevent exploitation in an age when credit was scarce and borrowers were particularly vulnerable. Essentially, a penalty is a payment of money stipulated in the contract and is unenforceable against the offending party if it is an exorbitant alternative to common law damages.
12. This prohibition of the penalty clause is said to be consistent with the English law treatment of damages: damages are compensatory and so to allow a clause which provides for recovery of damages in excess of the actual loss suffered or sufferable would be wrong. The damages would be more of a deterrent, designed to discourage breaches of contract or to secure performance by the contractor, rather than provide compensation. This is clear in the statement of Lord Roskill in *Export Credits Guarantee Department v Universal Oil Products Co*:¹¹ “one purpose, perhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant”.
13. The judgment in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co. Ltd*¹² (Dunlop) at the beginning of the 20th century sought to restate the law on the penalty rule by providing **four tests** which were designed to be “*helpful, or even conclusive*” in determining whether or not a clause was an unenforceable penalty. The *Dunlop* judgment distinguished between penalty clauses (which are unenforceable) and “*liquidated damages*” clauses, which are enforceable provided that the specified sum is “*a genuine pre-estimate of loss*” - wording which has since appeared in many English law commercial contracts over the past 100 years.
14. Lord Dunedin's propositions were summarised in his speech to the House of Lords in *Dunlop* and as noted in *Cavendish*, “achieved the status of a quasi-statutory code in the subsequent case-law”: and can be best shown in the table below.

¹¹ 1983] 2 All ER 205.

¹² [1915] AC 847.

"1. 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 ..."

There have been several construction contract cases in which an agreed sum has been held to be liquidated damages although termed a "penalty",¹³ and vice versa.¹⁴

"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."

This formulation has been recast in more modern terms: in summary the question is whether, as a matter of construction, the predominant contractual function of the provision is to deter a party from breaking the contract or to compensate the innocent party of the breach. This may be deduced by comparing the amount which would be payable on breach with the loss that might be suffered if the breach occurred. The principle is not limited to sums of money. It can also apply to a clause requiring a transfer of property as a penalty. However, an agreed sum may be neither a genuine preestimate nor a penalty. This arises where a party is unwilling to run the risk of paying the heavy damages which might result from its breach, and therefore deliberately limits its liability to a smaller sum than that which might be awarded as unliquidated damages.¹⁵ A stipulation for immediate repayment of a loan and all other monies due to the lender if the borrower failed to make instalment repayments on the due dates was held not to be a penalty.¹⁶

"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 of as at the time of the making of the contract, not as at the time of the breach."

The comparison is between the stipulated sum and the range of losses that it could reasonably be anticipated that the sum would have to cover at the time the contract was made.

"Except possibly in the case of situations where one of the parties to the contract is able to dominate the other as to the choice of the terms of a contract, it will normally be insufficient to establish that a provision is objectionably penal to identify situations where the application of the provision could result in a larger sum being recovered by the injured party than his actual loss."

Arguments after the event based on hypothetical possible situations where it is said that the loss might be less than the sum specified: *"should not be allowed to divert attention from the correct test as to what is a penalty ... namely is it a genuine pre-estimate of what the loss is likely to be? ... to the different question, namely are there possible circumstances where a lesser loss might be suffered?"*

However, *"The fact that the issue has to be determined objectively, judged at the date the contract was made, does not mean what happens subsequently is irrelevant. On the contrary it can provide valuable evidence as to what could reasonably be expected to be the loss at the time the contract was made."*

"4. To assist this task of construction various tests have been suggested, which if applicable to the case under

¹³ Clydebank, etc., Co v Yzquierdo, etc. [1905] A.C. 6, HL.

¹⁴ Public Works Commissioner v Hills [1906] A.C. 368.

¹⁵ Cellulose Acetate v Widnes Foundry [1933] A.C. 20, HL.

¹⁶ The Angelic Star [1988] 1 Lloyd's Rep. 122.

consideration may prove helpful, or even conclusive. Such are:

- (a) It will be held to 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."

In practice, this is probably the most important test to be applied. Lord Halsbury in the Clydebank case dealt with it as follows:

"if you agreed to build a house in a year, and agreed that if you did not build the house for £50, you were to pay a million of money as a penalty, the extravagance of that would become at once apparent. Between such an extreme case as I have supposed and other cases, a great deal must depend on the nature of the transaction-the thing to be done, the loss likely to accrue to the person who is endeavouring to enforce the performance of the contract, and so forth."

In applying this test, the unequal financial position of the parties is irrelevant:

"The word unconscionable ... does not bring in at all the idea of an unconscionable bargain. It is merely a synonym for something which is extravagant and exorbitant."

Also irrelevant is any disproportion between the amount of the contract sum and the agreed sum payable on breach. For example, where building works are required for an important exhibition. In such a case, a proper sum for liquidated damages might be so high that after the running of quite a short period of delay it might exceed the contract sum.

- "(b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid. This though one of the most ancient instances is truly a corollary to the last test"

This test is based on the principle that because the exact amount of the loss is known, a greater sum payable cannot be a genuine pre-estimate of the loss.

- "(c) There is a presumption (but no more) that it is 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'¹⁷.

An example of this arose where, in addition to the usual payment of £x per week for delay, there was also a provision that if the contract was not in all things duly performed by the contractors they should pay to the employers £1,000 as liquidated damages. It was held that the latter sum was a penalty¹⁸. But where it was provided that in default of completion by the specified date the contractor should forfeit and pay the sum of £100 and £5 for every seven days of delay it was held that as these sums were payable on a single event only they were liquidated damages¹⁹.

"On the other hand:

¹⁷ Citing Lord Watson in Lord *Elphinstone v Monkland Iron & Coal Co* (1886) 11 App. Cas. 332, HL.

¹⁸ *Cooden Engineering Co Ltd v Stanford* [1953] 1 Q.B. 86 at 98, CA.

¹⁹ *Law v Redditch Local Board* [1892] 1 Q.B. 127, CA.

- (d) 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.²⁰

A calculation based partly on a formula applied to the total value of the contract was held to be a perfectly sensible approach in a situation where it would be obvious that substantial loss would be suffered in the event of delay but what the loss would be would be virtually impossible to calculate precisely in advance. A calculation which produced a genuine pre-estimate as between the employer and the contractor was held not to fail on the ground that it was the product of a formula required of the employer by a funding third party.

The legal ethos is clear

15. This prohibition of LDs amounting to a penalty clause has been consistent with the English law treatment of damages: damages are compensatory and to allow a clause which in turn allows recovery of sums in excess of the actual loss suffered or sufferable would be wrong. In the latter case the sum would be more of a deterrent (designed to discourage breaches of contract or to secure performance by the contractor).
16. However, Her Majesty's Judges have certainly kept abreast of commercial reality over the past 25 years. One can see this from these cases:
17. In *Philips v The Attorney General of Hong Kong*²¹ the Privy Council upheld the decision of the Hong Kong Court of Appeal that the liquidated and ascertained damages clause in a construction contract was valid and enforceable. Emphasis was placed on the leading judgment of Lord Woolf MR who had stated:

*“Except possibly in the case of situations where one of the parties to the contract is able to **dominate** the other as to the choice of the terms of a contract, it will normally be insufficient to establish that a provision is objectionably penal to identify situations where the application of the provision could result in a larger sum being recovered by the injured party than his actual loss. Even in such situations so long as the sum payable in the event of non-compliance with the contract is **not extravagant**, having regard to the range of losses that it could reasonably be anticipated it would have to cover at the time that the contract was made, it can still be a genuine pre-estimate of the loss that would be suffered and so a perfectly valid liquidated damage provision. The use in argument of unlikely illustrations should therefore not assist a party to defeat a provision as to liquidated damages. As the Law Commission stated in Working Paper No 61 (page 30):*

²⁰ Citing the *Clydebank* case, Lord Halsbury; *Webster v Bosanquet* [1912] AC 394, PC.

²¹ [1993] 61 BLR 41.

'The fact that in certain circumstances a party to a contract might derive a benefit in excess of his loss does not ... outweigh the very **definite practical advantages of the present rule** upholding a genuine estimate, formed at the time the contract was made of the probable loss.'

"The fact that in certain circumstances a party to a contract might derive a benefit in excess of his loss does not ... outweigh the very **definite practical advantages of the present rule** upholding a genuine estimate, formed at the time the contract was made of the probable loss'.

'A difficulty can arise where the range of possible loss is broad. Where it should be obvious that, in relation to part of the range, the liquidated damages are totally out of proportion to certain of the losses which may be incurred, the failure to make special provision for those losses may result in the 'liquidated damages' not being recoverable. [See the decision of Court of Appeal on very special facts in Aristón SRL v Charly Records Limited (1990) The Independent 13 April 1990.] However, 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. Any other approach will lead to undesirable uncertainty, especially in commercial contracts.' [emphasis added]

18. After *Dunlop v Selfridge* (which I turn to below) the 'seminal' case is *McAlpine (Alfred) Capital Projects Ltd v Tilebox Ltd*²². In that case, Jackson J (as he then was) conducted a thorough judicial analysis of a number of authorities, distilled the same and formulated a set of 'Rules' or propositions. The learned judge looked at *Robophone Facilities Limited v Blank*²³, where the Court of Appeal by a majority upheld a liquidated damages clause in a hiring contract. It is noteworthy that Jackson J highlighted that *"the relevant clause in this case was subject to closer arithmetical scrutiny than appears to have been applied earlier cases, before a decision was reached that this was a reasonable pre-estimate of the loss."* [emphasis added]

Jackson J then adds *"At the end of his judgment, at page 1449 Diplock said this:*

"I see no reason in public policy why the parties should not enter into so sensible an arrangement under which each knows where they stand in the event of a breach by the defendant, and can avoid the heavy costs of proving the actual damage if litigation ensues. And I see no ground in authority which would permit, much less compel me to hold that this clause is a 'penalty clause' and so unenforceable by the courts ..." [emphasis added].

19. Jackson J in *Tilebox* paid regard to the then widely used dicta in *Philips v The Attorney General of Hong Kong*. Jackson noted that in the authorities then before him only in four cases had the relevant LD clause been struck down as a penalty, these being *Commissioner of Public Works v Hills* [1906] AC 368, *Bridge v Campbell Discount Co Limited* [1962] AC 600, *Workers Trust and Merchant Bank Limited v Dojap Investments Limited* [1993] AC 573,

²² EWHC 281 (TCC), (2005) 104 Con LR 39

²³ [1966] 1 WLR 1428

and *Aristón SRL v Charly Records* (Court of Appeal 13 March 1990). In each of these four cases there was, in fact, a very wide gulf between (a) the level of damages likely to be suffered, and (b) the level of damages stipulated in the contract. Jackson J did not speak solely of a "compensatory model" or focus on the objective mismatch between the sums stated in the contract and the most likely damages recoverable for breach. Instead, Jackson J's analysis and decision was principally focused upon the following:

- public policy of enforcing clauses that fix the level of damages;
- the court's predisposition to uphold such clauses;
- the practical advantages of upholding terms;
- the risk of uncertainty if the above are not followed; and
- the possibility of exploiting the fact there has been domination by one party when the contract was formed.

20. A more "intrusive" approach was advocated slightly later in the next "seminal" case of *Murray v Leisureplay plc.*²⁴ Arden LJ when considering the question of penalties suggested the following "practical step by step guide as to questions which the court should ask":

- (i) To what breaches of contract does the contractual damages provision apply?
- (ii) What amount is payable on breach under that clause in the parties' agreement?
- (iii) What amount would be payable if a claim for damages for breach of contract was brought under common law?
- (iv) What were the parties' reasons for agreeing to the relevant clause?
- (v) 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 genuine 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?

21. In *Leisureplay* Arden LJ considered the question of evidence available to the Tribunal, but *Leisureplay* is not a construction law case; it was concerned with whether a paragraph in a director's service agreement, which provided for payment of a year's gross salary in the event of termination of the director's employment without one year's notice, was unenforceable as a penalty. Nevertheless, until the Supreme Court decision in *ParkingEye*, in many cases *Leisureplay* has been a useful guide. Arden LJ has hypothesised:

"... What happens if there is no evidence about the reasons for the clause? There would in my judgment be no reason why the court could not draw inferences of fact as to the reasons and as to the genuineness of those reasons. What if it appears from the evidence that is given (or

²⁴ [2005] IRLR.

*from the inferences that the court makes from the facts) that the decision to include the damages clause was included on the basis of a mistaken belief that the damages at common law would be assessed on a materially more generous basis than in fact would occur? This would be the case if for example the parties failed to have regard to the fact that a party would have to give credit for a benefit that he obtained on breach, such as a tax saving as a result of the receipt of damages for lost income in the form of a lump sum payment of damages. In my judgment, the good faith belief of the parties is not the deciding factor here. **The court would look at the result and (bearing in mind that the onus is on the party challenging the clause to establish that it is a penalty) ask whether it is satisfied that the parties could not, if they had had the proper information or considerations in front of them, genuinely have considered that the damages payable under the contractual provision were a realistic pre-estimate of the damages payable on breach at common law.**"²⁵ [emphasis added].*

22. Arden LJ appeared to be promoting an intrusive approach whereby the Court, in effect, tests the genuineness of the pre-estimate and is rather less concerned with the public policy reasons for upholding penalty clauses. *Leisureplay* had been criticised because the particular questions set out in the case were too rigid an approach to a question that should be considered in broad general terms. Further, a comparison between the amount stipulated in the contract as payable on breach and what would be awarded at common law could remove one of the commercial advantages that a liquidated damages clause is recognised as achieving - the dispensation with the need to adduce evidence on damages and to calculate them, particularly in cases where proof of the amount of damages suffered may be difficult to achieve to any degree of precision. This was arguably not the correct approach as it focuses on the actual breach found to have taken place and then to compare the damages that might be suffered with the amount of damages stipulated in the contract

23. The opposite thread is the judicial desire to preserve freedom to contract. In *Elsley v JC Collins Insurance Agencies Ltd*²⁶ Dickson J said:

It is now evident 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.

24. Further, in *Philips Hong Kong Ltd v Attorney General of Hong Kong*, Lord Woolf said: *...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. Any other approach will lead to undesirable uncertainty especially in commercial contracts.*

²⁵ *Murray v Leisureplay* [2005] EWCA Civ 963 at [55].

²⁶ [1978] 2 SCR 916, a decision of the Supreme Court of Canada.

25. We have looked above at the leading cases from 1993 to 2005 and I have touched on the Supreme Court's latest, but before we plumb its depths I want to look at key cases between 2010 and 2014, cases which broadly continue the trend of a consistent judicial reluctance to interfere with commercial contracts signed by parties of broadly similar bargaining power.
26. These cases highlight the difficulty of arguing that a clause is a penalty, and the first is *Azimut-Benetti SpA (Benetti Division) v Darrell Marcus Healey*²⁷ where the Commercial Court found that a clause entitling a luxury yacht-builder to retain 20% of the purchase price of the yacht upon termination for late payment,²⁸ was "commercially justifiable" in the circumstances and therefore not a penalty. Caveat emptor for sure! It was held "not even arguably" a penalty clause.²⁹ The clause in question provided Azimut with a right to terminate in the event that the Employer failed to pay "any sum due and owing ... within 45 days after the due date". It further provided that, in the event of lawful termination, Azimut would be entitled to retain and/or recover an amount equal to 20% of the contract price "by way of liquidated damages as compensation for its estimated losses (including agreed loss of profit) [subject to which, Azimut] will promptly return the balance of sums received ... together with Supplies, if not yet installed in the Yacht".
27. Next a 2012 case in *E-Nik Ltd v Department for Communities and Local Government*,³⁰ another Commercial Court case which reignited the debate about "take or pay"³¹ clauses by confirming that such provisions could (but didn't here) fall foul of the rule against penalties.
28. In *E-Nik Ltd v Department for Communities and Local Government*, Burton J of the High Court (citing his own judgment in a 2008 case) confirmed that a take or pay clause could in principle be construed as an unenforceable penalty. On the facts, the clause in question, which required the client

²⁷ [2010] EWHC 2234 (Comm).

²⁸ As the total price was €38m, this equated to €7.6m (quite a chunk of cash).

²⁹ Read as a whole, it represented a commercially justifiable balance between the parties' interests. The 20% figure - while substantial - could not be read in isolation from the rest of the clause; it represented a reasoned balance between the parties' interests. The purpose of the clause is not intended to be a deterrent and the clause itself is commercially justifiable.

³⁰ [2012] EWHC 3027(Comm).

³¹ A rule structuring negotiations between companies and their suppliers. With this kind of contract, the company either takes the product from the supplier or pays the supplier a penalty. See *M & J Polymers Ltd and Imerys Minerals Ltd* [2008] EWHC 344 (Comm), the first occasion the courts have considered whether a take or pay clause can amount to a penalty, despite the fact such clauses are widely used in supply contracts, where the High Court held that as a matter of principle the rules against penalties could apply to a "take or pay" clause. However, in the circumstances, the take or pay clause in question: (1) was commercially justifiable; (2) did not amount to oppression; (3) was negotiated and freely entered into between parties of equal bargaining power; and (4) did not have the predominant purpose of deterring a breach of contract. As such, the clause did not offend against the rules against penalties and the claimant was entitled to recover in respect of the shortfall in purchases as a claim in debt for the price. It has been said its impact is likely to be limited given that most suppliers will be able to demonstrate a commercial justification for including a take or pay clause.

to take a minimum of 500 consultancy days, was commercially justifiable, did not amount to oppression and was negotiated freely - so was not a penalty.

29. Take or pay clauses had generally been seen to give rise to a debt rather than a damages claim for breach of contract, and for this reason it was commonly believed that the rule against penalties (which applies to specified sums payable upon a breach of contract) would not apply. Burton J stated in the *E-Nik* judgment that the client's failure to take the minimum number of days gave rise to a debt rather than a damages claim, but he did not elaborate on why the rule against penalties could still be applied.
30. Next I turn to a decision of Mr Justice Ramsey in *Bluewater Energy Services BV v Mercon Steel Structures BV & Ors*³² in the TCC which was about a Russian oil company, Lukoil, who employed Bluewater Energy Services BV to design, construct and install a soft yoke mooring system (SYMS) for use at an oilfield in the Caspian Sea. Bluewater entered into a contract with Mercon Steel Structures BV to fabricate the SYMS. Mercon, the subcontractor, had undertaken to employ specified individuals as "key personnel" in roles such as the subcontractor's Project Manager, QA Engineer and Transportation & Logistics Manager. Mercon was prohibited from replacing the key personnel without the prior approval of Bluewater, and any replacement was obliged to work with their predecessor for a reasonable handover period. Mercon was liable for LDs of €150,000 following replacement of key personnel. Mercon argued that the level of LDs was intended as a penalty for replacing key staff and did not accurately reflect the resultant losses. The TCC allowed the LDs. Whilst acknowledging the difficulty of quantifying the loss in this scenario, the TCC held that the damages were not unconscionable, extravagant or exorbitant. The court was satisfied from the evidence that the parties had tried to negotiate the level of damages and that the content of those negotiations suggested that the parties had tried to reflect a genuine pre-estimate of the loss that could have been suffered.
31. Now to the essence of this paper: how should LDs be approached and/or calculated in light of the latest authority?
32. Well to understand that question it should be first understood that the double whammy case a year ago,³³ in *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Limited v Beavis*³⁴ of the Supreme Court, the highest court in the land shifted away from the test of liquidated damages being a "genuine pre-estimate of loss" but declined to abolish the rule against penalties!³⁵ The court stated that the underlying rationale of the rule in English law has been misunderstood and that as a result the rule has been applied in many situations where it is both unnecessary and unjust.

³² [2014] EWHC 2132 (TCC).

³³ Judgment in the case was handed down on 4 November 2015 by Neuberger, Lord Mance, Lord Clarke, Lord Sumption, Lord Carnwath, Lord Toulson and Lord Hodge. The definitive version of the judgment is that which appears on the Supreme Court website <https://www.supremecourt.uk/cases/docs/uksc-2013-0280-judgment.pdf>.

³⁴ [2015] UKSC 67.

³⁵ The foundation of relief in equity against penalties is expressed in Story, *Equity Jurisprudence* (14th edn) as follows:

"Where a penalty or forfeiture is designed merely as a security to enforce the principal obligation, it is as much against conscience to allow any party to pervert it to a different and oppressive purpose as it would be to allow him to substitute another for the principal obligation."

33. The Supreme Court thereby rejected the traditional test of whether a clause that takes effect on breach is a “*genuine pre-estimate of loss*” and therefore compensatory, or whether it is aimed at detering a breach and therefore penal. The essentially binary position had been:
- it is an enforceable requirement to pay liquidated damages if the amount concerned is regarded as a genuine pre-estimate of loss; or
 - it is an unenforceable penalty - when the amount concerned is not a genuine pre-estimate of loss but in the nature of a deterrent against breach (*in terrorem*).
34. The true principle, as established in the judgment, is whether the LD clause is out of all proportion to the innocent party's legitimate interest in enforcing the counterparty's obligations under the contract. If so, it will be penal (an exception to the general principle of English law that a contract should be enforced in accordance with its terms) and therefore unenforceable.
35. The Supreme Court judgment sets out a new, progressive test for determining whether or not a contractual provision will be considered penal and therefore unenforceable. The judgment re-calibrates the application of the penalty rule and potentially gives drafters greater scope to deter certain types of behaviour and impose contractual penalties for certain types of breaches.

The law restated in a new light - *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Limited v Beavis*

36. Perhaps I could say forget all the above, it is mere historical baggage, but I cannot go that far! In the conjoined appeal decisions of *El Makdessi* and *ParkingEye*, which I discuss in more detail below, the Supreme Court noted that the *Dunlop* tests had taken on the status of a “*quasi-statutory code*”, which was never the intention! The *Dunlop* test has been applied too rigidly, particularly in cases where there is a clear commercial justification for including a penalty clause, or where there may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden.
37. In these conjoined decisions, the Supreme Court re-focused the long-established test for identifying a penalty clause, but frustratingly declined to abolish the rule against the unenforceability of penalties altogether. The decision is consistent with the general trend of the courts in recent years to

The operation of this relief in the fact of contrary agreement by the party is also explained in this section:

“If it be said that it is his own folly to have made such a stipulation, it may equally well be said that the folly of one man cannot authorize gross oppression on the other side.”

become more reluctant to interfere with the parties' freedom of contract and particularly so in a commercial context. This is highlighted by an acknowledgement in the lead judgment by Lords Neuberger and Sumption that:

“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”.

What were these cases about?

38. The *El Makdessi* case concerned the sale of a Middle Eastern media business and the contents of a share purchase and shareholders' agreement. The agreements provided certain restrictive covenants that if the seller was in breach of certain non-competition restrictions, then he lost his entitlement to deferred consideration that would otherwise have been payable, and he must sell his remaining shares at a price that excluded the value of the goodwill (which would have been diminished by his breach of the covenants). Mr Makdessi breached the restrictive covenants and then subsequently challenged the clauses in question on the grounds they were unenforceable penalties. The Court of Appeal held that these provisions were penal, as their purpose was to deter an act rather than to compensate for the loss suffered by the innocent party.
39. The *ParkingEye* case is remarkable for the trivial amount in issue as it related to a £85 parking fine imposed after a driver (chip-shop owner) overstayed the two-hour limit in a privately-run car park. ParkingEye managed the car park and displayed numerous notices throughout, clearly stating that a failure to comply with the two hour time limit would “*result in a Parking Charge of £85*”. Mr Beavis argued that the £85 charge was unenforceable as a penalty (as the owner of the car park had not suffered any clear loss) and therefore unenforceable (and/or unfair and unenforceable by virtue of the Unfair Terms in Consumer Contracts Regulations 1999).
40. The Court of Appeal disagreed but granted Mr Beavis permission to appeal, and it is testament to the integrity and impartiality of the English court system that the Supreme Court gave such a detailed judgment on a case involving a £85 fine.
41. In this case ParkingEye did not incur any loss from an parking overstay. But the Supreme Court ruled that the fine was not a penalty as the charge authorises the company to control access to the car park in the interest of customers and the wider public.

42. Lord Neuberger and Lord Sumption ruled that the charge was not unfair, and that overstaying penalties are a ‘normal feature of parking contracts’. The ruling was agreed on by six out of the seven justices while Lord Toulson dissented on the regulations point in *Parking Eye*³⁶.
43. The judgment said fines were beneficial to motorists themselves as they make parking spaces available to them which might otherwise be clogged up by long-stay users.
44. “The risk of having to pay [the fine] was wholly under the motorist’s own control. All he needed was a watch,” the judges said.
45. The case sets a new test for “take it or leave it” consumer contracts as the law was last considered at this level 100 years ago. Until this decision charges which had been agreed in advance, payable on breach of contract, were disallowed as unlawful penalties unless they could be justified as a genuine pre-estimate of loss. The judgment sweeps away that rule and says that deterrent charges will be allowed if there is some commercial justification for them.

The Supreme Court decision

46. The Supreme Court upheld the validity of the disputed clauses in both appeals; albeit for different reasons. In *Cavendish*, the Supreme Court distinguished between “*primary obligations*” (i.e. those obligations that are required to be performed by the terms of the contract) and “*secondary obligations*” (i.e. obligations that are triggered by a breach) and held that the clauses in that case were in the nature of primary obligations and therefore not susceptible to the rule against penalties.
47. In *ParkingEye*, the Supreme Court found that although the parking charge did potentially engage the penalty rule, the level of the charge was not such as to constitute a penalty. The Supreme Court stated that “*deterrence is not penal if there is a legitimate interest in influencing the conduct of the contracting party which is not satisfied by the mere right to recover damages for breach of contract*”. In that case, the legitimate interest was ensuring the efficient use of the car park by seeking to prevent users overstaying the two hour time limit which, in turn, benefitted ParkingEye.
48. Therefore, the Supreme Court has in effect shifted the focus from the loss that could conceivably have resulted from the breach as being the key question in identifying whether a contractual provision is penal. Rather, even where a damages clause imposes a liability in excess of that which the innocent party might suffer by reason of the breach, the clause may properly be justified by other considerations. This will depend on whether the

³⁶ Lord Toulson (dissenting) would have allowed the appeal, on the grounds that the clause infringes the 1999 Regulations, which reflect the special protection afforded to consumers under the European Directive on unfair terms in consumer contracts. The burden is on the supplier to show that the consumer would have agreed to the terms in individual negotiations on level terms. It is not reasonable to make that assumption in this case, and in any event ParkingEye had not produced sufficient evidence to that effect [309-315].

innocent party had a “*legitimate interest*” in performance of the contract extending beyond the damages it would otherwise be entitled to receive from the contract breaker.

49. Following this decision, the question so far as enforceability of the relevant provision is concerned will be whether it is penal, not whether it is a genuine pre-estimate of loss. Therefore, a clause may require a payment that significantly exceeds a pre-estimate of loss but that will not necessarily make it penal.
50. The true test is whether the relevant provision imposes a detriment on the contract breaker that is out of all proportion to any legitimate interest of the innocent party in enforcement of the primary obligation. While the various Lord Justices take slightly different approaches, essentially the key questions are:
 - whether there is a legitimate business interest served and protected by the clause; and
 - whether the contractual provision to protect that interest is extravagant, exorbitant or unconscionable.
51. If the clause satisfies a legitimate business interest and is not extravagant, exorbitant or unconscionable, it will be enforceable. In order to fail the latter part of the test, the provision would effectively require a detriment to the contract breaker out of all proportion to the legitimate interest of enforcement by the innocent party.
52. Consequently, when considering whether a clause is penal, it is not just the financial loss that would have been suffered as a result of the breach that is relevant. Potentially relevant factors in applying the test would be: whether others in the same industry impose similar charges; the indirect business cost to the innocent party of breaches of the relevant obligation; and whether the secondary obligation was brought to the contract breaker’s attention in an appropriate manner.

The new test

53. The judgments of the Supreme Court have moved the law on contractual penalties away from the narrowly applied tests in *Dunlop* and re-cast the test as follows: “*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*”.

54. Lord Hodge expanded on this, stating that the *“correct test for a penalty is 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 [see 255]”*.
55. In *El Makdessi*, the Court determined that the provisions in the agreements protected the buyer’s legitimate interest in enforcing the non-competition covenants so that the goodwill of the business was secure. The goodwill of the business was critical to its value to the buyer. The provisions therefore did not surpass protecting the buyer’s legitimate interests.
56. In *ParkingEye*, it was clear that whilst the £85 charge may have been perceived understandably by visitors to the car park as a deterrent from over-staying the two-hour limit, there were also clear legitimate commercial interests that it was seeking to protect by imposing the charge. These included preserving the traffic management system and efficient use of parking space in the surrounding outlets and their users by deterring long-stay parking. The charge was also relied upon to generate the income needed to run the scheme. As a result, the charge was held not to be *“out of all proportion”* to those interests and therefore not penal.
57. Over and above the principles of primary versus secondary obligations, proportionality and the legitimacy of a deterrent, the Supreme Court in respect *El Makdessi* also referred to the significance of considering the circumstances in which the parties entered into the contract - *“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 [35]”*. This is relevant to construction contracts, which can appear across the spectrum depending on whether it is say a contract between a main contractor and subcontractor, or a major infrastructure contract between a contracting consortium and a department of state.

What are the practical implications?

58. The Supreme Court has fixed a new test which recognises that a contractual party will often have a legitimate interest which can be protected by a contractual penalty which does not have to be a genuine pre-estimate of loss.
59. Provided that a contracting party can demonstrate that it is using a penalty clause to protect a legitimate interest and the penalty is not exorbitant or unconscionable, the following principles now apply:
- It is no longer necessary for the penalty to be a genuine pre-estimate of loss.

- A party relying on the penalty clause does not have to suffer a loss.
- The predominant purpose of a clause can be to act as a deterrent against a certain breach of contract.
- The penalty does not just have to be a specified financial amount. A party can, for example, withhold deferred consideration or require the transfer of certain property as the consequence for breach.
- Generally, parties have a greater freedom to contract for the consequences of breach.

Also avoid inserting “£nil”, “n/a” or “none” in the appendix/contract particulars. This can preclude any claim for delay as it may be interpreted as specifying LDs at a rate of £zero thereby limiting any claim for unliquidated damages to £zero. This was the case in *Temloc Ltd v Errill Properties Ltd*.³⁷ In order to preserve the right to claim unliquidated damages Employers should specify that “unliquidated damages are to apply” or delete the relevant liquidated damages provisions completely.

The way in which the LD figure is expressed should reflect the way in which the works are to be carried out/handed over under the contract.

Express LDs as a daily rate where practicable or per week, “pro rata”, as opposed to “or part week”, or “or part thereof”. When seeking to levy LDs comply with any procedural requirements for doing so in the contract.

60. It is also worth noting that the penalty rule only operates on and regulates against breaches of “*primary obligations*”. For example, if the contract provides that Party A shall perform an act (the primary obligation) and goes on to state that if Party A does not perform that act, Party A is obliged to pay Party B a specified sum of money, then the obligation to pay is a “*secondary obligation*” and is capable of being a penalty. If an obligation to pay a penalty can be expressed as a primary obligation, then this would circumvent the application of the penalty rule. However, the Supreme Court judges had differing views on what constituted a primary and a secondary obligation, so clever drafting will not always guarantee that the penalty rule can be avoided by framing a penalty as a primary obligation.

³⁷ (1987) 39 BLR 30.

What does this mean for English law construction contracts?

61. Construction contracts typically fall into two categories:

- those which are issued on a “*take it or leave it*” basis, which is common in domestic contracting between parties new to each other, when the parties are not of comparable bargaining position and the weaker party may not even take proper legal advice; or
- those which are negotiated freely between well-advised parties of comparable bargaining strength, which is common in larger-scale contracting.

62. It therefore seems like a fair assumption that the greater freedoms conferred by the Supreme Court will have most impact on English law large scale domestic and international construction contracts, as opposed to smaller scale domestic agreements.

63. This judgment has been comforting news for employers, who may have previously hesitated from including deterrents and specified financial consequences for certain breaches. There may be more scope now to charge LDs for repeated breaches, breaches of say sectional completion dates that might facilitate a factory to start production for example.

64. However, the new test does set a number of hares running which will no doubt be tested in the courts in the years to come. At what point does a specified sum become exorbitant? In *ParkingEye*, £85 was proportional, but would the court take the same view to a fine of £500? There is a degree of uncertainty over what constitutes a primary and secondary obligation and the extent to which it is therefore possible to “*draft around*” the whole issue of contractual penalties.

65. The Supreme Court has without doubt provided a welcome update of the law in relation to penalties. Parties must now have a greater expectation that provisions agreed by commercial parties on an equal footing will be enforced by the courts, providing the innocent party can show that the clause protects its legitimate business interest. Greater consideration will now be required at the drafting stage as to whether an obligation should be drafted as a primary obligation (which would avoid engagement of the rule against penalties) or a secondary obligation, and the distinction between the two is likely to provide fertile ground for disputes. The court emphasised that the classification of terms for the purposes of the penalty rule depends on the substance of the term and not mere form.

66. Further, although the payment of money is the classic obligation under a penalty clause, the Supreme Court says there is no reason the rule should not apply to an obligation to transfer assets (either for nothing or at an undervalue). Lord Mance and Lord Hodge also consider that the rule applies

equally to clauses withholding payments on breach, and could apply alongside relief against forfeiture³⁸. Lord Neuberger and Lord Sumption leave that latter question open.

³⁸ Which raises the interesting but still speculative notion that some time bar provisions, which contain particularly onerous notice provisions, might be circumvented by the equitable doctrine of relief from forfeiture. As Robert Fenwick Elliott one of my former partners has rightly I think stated, for many construction lawyers, the concept of relief from forfeiture is a land law thing, learned at law school but largely forgotten since then. Our eye has been taken off the ball that the doctrine might have anything much to do with penalties. But consider a tenant who is late paying the rent. Or perhaps is in breach - perhaps a minor breach - of some covenant in the lease. The lease (probably drafted by the landlord's lawyers to be as aggressive as legal ingenuity can devise) gives the landlord the right to forfeit the lease in these circumstances. We know that equity used to offer relief to the tenant in appropriate cases. As it did to mortgagors. And that statute subsequently codified that relief. And that is because forfeiture would be an extravagant and disproportionate remedy. The concept is not a million miles from that of penalties.

And this is what the Supreme Court has now drawn vivid attention to. The first speech of Lords Neuberger and Sumption (Lord Carnwath agreeing) set the scene:

"...The relationship between penalty clauses and forfeiture clauses is not entirely easy. Given that they had the same origin in equity, but that the law on penalties was then developed through common law while the law on forfeitures was not, this is unsurprising."

The House of Lords Supreme Court picked up and ran with a concept rolled out in *BICC plc v Burndy Corpn* [1985] Ch 232, namely that the court's approach is first to look at the penalty issue, and then, if not satisfied that the clause is penal, to then consider whether to grant relief from forfeiture. Lord Hodge said:

*"There is no reason in principle why a contractual provision, which involves forfeiture of sums otherwise due, should not be subjected to the rule against penalties, if the forfeiture is wholly disproportionate either to the loss suffered by the innocent party or to another justifiable commercial interest which that party has sought to protect by the clause. If the forfeiture is not so exorbitant and therefore is enforceable under the rule against penalties, the court can then consider whether under English law it should grant equitable relief from forfeiture, looking at the position of the parties after the breach and the circumstances in which the contract was broken. This was the approach which Dillon LJ adopted in *BICC plc v Burndy Corpn* [1985] Ch 232 and in which Ackner LJ concurred. The court risks no confusion if it asks first whether, as a matter of construction, the clause is a penalty and, if it answers that question in the negative, considers whether relief in equity should be granted having regard to the position of the parties after the breach."*

There are a number of interesting things about this.

First, we have not hitherto been going down this track in construction law. The idea of the twofold test is new.

Secondly, the second ground may be, at least in some cases, wider than the first. The passage is predicated on the possibility that a clause might clear the penalty hurdle, but fall at the relief from forfeiture hurdle.

Thirdly, this second hurdle involves a wider enquiry. The traditional view is that the penalty issue is judged as at the time of the contract, not the time of the breach, and this bit of Dunlop appears to survive. But the relief from forfeiture issue requires the court to look at what has actually happened (if anything) as a result of the breach. Think about the case of a bridge crossing a river as part of a new road through some virgin forest. The bridge contractor is late. The liquidated damages clause in the bridge contract may well not be penal; at the time of the making of the bridge contract, it might have been perfectly reasonable. But suppose the road either side of the bridge, being constructed by another contractor, is even later? The owner suffers no loss at all as a result of the bridge being late; until the road is built, the bridge is useless. Should the bridge contractor still forfeit the liquidated damages in these circumstances? Or should the courts give relief against that forfeiture? We do not know how this will pan out.

Fourthly, look at the passage again in the context of a notice provision, whereby a contractor forfeits their right to extensions of time, or loss and expense, or payment for variations, unless they give notice in a specified form by a specified time. That looks, at first blush, well within the doctrine. And even though the court might decide that such a time bar is not penal, it might nevertheless conclude that the failure to give notice was in the event of no practical consequence whatsoever, since the owner knew perfectly well of the relevant event, of its likely impact on time and cost, and that the contractor would be making a

67. Thus, pure concepts of “deterrence” and “*genuine pre-estimate of loss*” are unhelpful. 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.
68. For industry not having to “compute” “*a genuine pre-estimate of loss*” in calculating liquidated damages (LADs) and apply fourfold tests involving subjective judgments as to whether LADs are “*commercially justified*”, extravagant or oppressive, and whether they were “*negotiated on a level playing field*” may be endless fun for lawyers, but how can anyone else hope to know what to do?
69. Although a factual issue, rather than a point of legal principle, the distinction between primary and secondary obligations as discussed in the judgments is one of the most controversial aspects of the decision. The importance for those drafting commercial contracts is clear.
70. So, where is all this going? Are the courts shutting down challenges, applying black letter law? Or widening the grounds of challenge? It is some of each, it seems.

Lords Neuberger and Sumption said:

“...*the courts do not review the fairness of men’s bargains either at law or in equity.*”

claim for it. And so all of the legitimate purposes of the notice provision are otherwise satisfied. Should the court grant relief from forfeiture in these circumstances? It looks arguable, but again we will have to wait and see what courts do with the argument.

So, how had we all missed this? Partly, it is because it was widely assumed for a long time that the equitable doctrine of relief from forfeiture had been entirely subsumed by the statutory codification of the doctrine in the case of forfeiture of mortgages and leases. But in *Shiloh Spinners Ltd v Harding* [1973] AC 691 the House of Lords had said, “Oh no. The old equitable doctrine still applies in other contexts”. That case was highlighted recently by the Privy Council in *Cukurova Finance International Ltd & Anor v Alfa Telecom Turkey Ltd* (British Virgin Islands) [2013] UKPC 2. This is how Lord Wilberforce had put it in *Shiloh*:

“*There cannot be any doubt that from the earliest times courts of equity have asserted the right to relieve against the forfeiture of property. The jurisdiction has not been confined to any particular type of case...I would fully endorse this: it remains true today that equity expects men to carry out their bargains and will not let them buy their way out by uncovenanted payment. But it is consistent with these principles that we should reaffirm the right of courts of equity in appropriate and limited cases to relieve from forfeiture for breach of covenant or condition where the primary object of the bargain is to secure a stated result which can effectively be attained when the matter comes before the court, and where the forfeiture provision is added by way of security for the production of that result. The word ‘appropriate’ involves consideration of the conduct of the applicant for relief; in particular, whether his default was wilful, of the gravity of the breaches, and of the disparity between the value of the property of which forfeiture is claimed as compared with the damage caused by the breach.*”

And the speeches were particularly reticent about interfering with commercial bargains on a level commercial playing field negotiated with the assistance of lawyers. Nevertheless, there perhaps a dose of salt should be taken with this, as in the previous breath, they said:

“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.”

71. They spoke about “the true test” in these terms:

72. *“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.”*

73. Or, as Lord Mance put it:

“What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable.”

74. For many in the commercial field the concepts of fairness and legitimate business interest might be hard to separate. Usually, where it is possible to say of a provision in a commercial construction contract: “That provision is unfair!” it will be equally possible to say: “That provision serves no legitimate business interest!”

75. In the case of liquidated damages clauses, the net effect of *Cavendish* is probably going to be to make challenges easier. Certainly, a clause is not going to be declared penal unless it is way beyond the pale of what is commercially appropriate, but that was pretty much the situation anyway following cases like *Philips v Attorney General of Hong Kong*.

76. However, the second wave of attack - in the form of relief from forfeiture - might well succeed in those cases, by no means uncommon, where the liquidated damages are way in excess of the loss, if any, actually suffered by the owner due to the late completion.

77. What about time-barring notice provisions? The new attention to relief from forfeiture raises a number of interesting and difficult questions. For example, is it within the jurisdiction of an adjudicator to afford relief against the forfeiture of contractual rights for failure to give notice? To what

extent will the courts put unbending enforcement of notice provisions in onerous “hard money” contracts into the “rapacious and unconscionable” pigeonhole? Time will out.

Finally, I think the question of when the doctrine of penalties will and won’t apply ultimately requires refinement and clarification through case law!

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