Penalty Clause
(Relevant to AAT Examination Paper 6 – Fundamentals of Business Law)

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Introduction

The common law remedy for breach of contract is payment of damages. The purpose of an award of damages is to compensate an innocent party who has suffered a loss, due to a breach of contract, in monetary terms. Candidates of AAT Examination Paper 6 — 'Fundamentals of Business Law' should not confuse the word 'damage' (singular) with the word 'damages' (in plural). The everyday word 'damage' simply means a harm, a loss or an injury, whereas *damages* is a specific legal term that refers to monetary compensation for the harm, loss or injury suffered by some party and that is awarded by the court.

The common law basis for this compensation is laid down in the earlier case of *Robinson v Harman* (1848), which stated that:

> 'The rule of the common law is, that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed.'

Even where there is a breach of contract, a plaintiff may not be able to claim full compensation for his loss. There are, broadly speaking, two types of damages: *liquidated damages* and *unliquidated damages*. In brief, liquidated damages are the ascertained sum of money for compensating the loss due to the breach of contract. A contractual term may provide in advance that in the event of a breach, the defaulting party will pay an agreed fixed sum. Such a clause is known as a 'liquidated damages clause' or 'agreed damages clause'. Unliquidated damages, on the other hand, are the sum of money that cannot be ascertained or fixed at the time of the loss. They are awarded by courts, and the judge will consider the circumstances in determining the amount, such as whether the plaintiff has a duty to mitigate his loss but does not do so, or whether the loss is too remote to be compensated. In this article, we will explore some rules and recent changes in the law relating to liquated damages.

Liquidated damages clause

A *liquidated damages clause* or *agreed damages clause* is very common in commercial contracts, as a means of dealing with matters such as a delay in performance or delay in delivery. The purpose of these clauses is to relieve the innocent party from the burden of proving the details of his losses and to avoid the costs of litigation. On the other hand, the other party entering into a contract knows well beforehand the extent of his risk if he does not perform his duties under the contract properly.

Liquidated damages must be a genuine attempt to pre-estimate the loss that will be suffered in the event of a breach. In *Cellulose Acetate v Widnes Foundry* (1933), the clause allowed the plaintiff to be compensated 'by way of penalty £20 per working week' if there was any delay beyond the contractual period. In the case, there was a delay of 30 weeks and the actual loss suffered by the plaintiff was £5850. However, since the clause was a genuine attempt to pre-estimate the loss, the compensation would only be £600 (£20 × 30), which was far less than the actual loss.

Penalty clause

On the other hand, if the court rules that the agreed sum is a *penalty*, the court will not award the agreed sum and will itself consider the proper measure of damages. Just because a clause is stated to be a 'penalty clause' is not determinative that it is in fact a true penalty. In contrast, a *penalty* is by definition oppressive and deters the party from breaching the contract under the threat of imposition.

In *Shum Kit Ching v Caesar Beauty Centre Ltd* (2003) (HCSA 38/2002), there was a clause stating that money paid by the customer (full payment for the beauty treatment) could not be refunded by the beauty centre whenever the treatments were cancelled regardless of the circumstances or reasons that lead to the cancellation of the treatments. So, if the customer had refused to perform the contract by not rendering herself present to receive the treatment, then the beauty centre could forfeit the full payment as compensation. However, the court held that in the normal course of the event, the only loss suffered by the beauty centre was the loss of profit. Thus, the non-refunding provision was not a genuine pre-estimate of loss but a penalty, and hence it was unenforceable.

On a side note, this case was a Court of First Instance case. The case number HCSA 38/2002 stands for a High Court (HC) case (i.e. the Court of First Instance of the High Court) and is also a Small Claims Tribunal Appeal (SA) case. It was the 38th case to be heard in 2002.

Distinguishing between liquidated damages and penalty clauses

In *Cellulose Acetate v Widnes Foundry*, the court held that despite the word 'penalty' in the clause ('by way of penalty £20 per working week'), the clause was a genuine attempt to pre-estimate the loss.

In *Phillips Hong Kong Ltd v Attorney General of Hong Kong* (1993), the Privy Council held that:

> '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 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 leading authority on the topic of penalties is the decision of the House of Lords in *Dunlop Pneumatic Tyre Co Limited v New Garage and Motor Co Limited* (1915). In its judgment, the court provides some rules for distinguishing a liquidated damages clause from a penalty:

> '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.
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> 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.
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> 3. 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 breach.
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> 4. 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:
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> (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.
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> (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. …
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> (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."'

The UK Supreme Court in *Cavendish Square Holding BV v Talal El Makdessi* and *Parking Eye Ltd v Beavis* (2015) laid down a new formulation for testing whether a clause is a penalty clause or not. Following this decision, instead of looking at whether there was a genuine pre-estimate of loss, the court in future would look at whether the clause is penal or not in nature. To this end, the court regarded the concepts of 'deterrence' and 'genuine pre-estimate of loss' as being unhelpful.

The court distinguishes between primary and secondary obligations under a contract. The penalty rule is applicable only upon breaching the primary obligation under a contract. According to the judgment, in short, according to the judgement, 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, … But compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations.'

As the case law from the highest court in UK is only a persuasive authority, or a highly persuasive authority, for the courts in Hong Kong, it remains to be seen whether the Hong Kong courts will follow the new formulation or the old genuine pre-estimate of loss test in assessing the award of damages.