

Is it a Penalty?

Introduction.

In the world of football the cry of “It’s a Penalty!” (normally together with a few expletives) is often made when it is claimed that a foul has been committed within the penalty box.

In the less emotive world of contracts, the cry of “It’s a Penalty” is also made from time to time, but in this case it is where it is claimed that the contract incorporates a clause that should be construed as being a penalty, and, as such is invalid and unenforceable.

The recent case of *Alfred McAlpine Capital Projects Limited v Tilebox Limited* [2005] EWHC 281 (TCC): 25th February 2005, revisited the question of penalty clauses in contracts.

Penalty Clauses.

In the case of *Dunlop Pneumatic Tyre Co. Ltd. v New Garage & Motor Co. Ltd.* [1915] A.C. 79 at 86., it was noted that a clause is penal if it provides for “a payment of money stipulated as *in terrorem* of the offending party”, (i.e. a payment of a sum of money intended to frighten or intimidate the offending party).

A clause that is found to be penal (i.e. a penalty clause) is generally invalid, and it is an unusual feature of the law of contract that the court will strike down penalty clauses, whilst (usually) permitting other clauses which have been freely agreed between the parties even if those clause are unduly harsh.

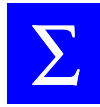
The Law Relating to Penalty Clauses.

In the case of *Commissioner of Public Works v Hills* [1906] AC 368, Lord Dunedin formulated the test for Penalty clauses as follows:-

“The general principle to be deduced ...is ...that the criterion of whether a sum -- be it called penalty or damages -- is truly liquidated damages, and as such not to be interfered with by the Court, or is truly a penalty which covers the damage if proved, but does not assess it, is to be found in whether the sum stipulated for can or can not be regarded as a 'genuine pre-estimate' of the creditor's probable or possible interest in the due performance of the principal obligation”

In the above noted case of *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited*, Lord Dunedin set out a series of propositions in respect of Penalty clauses, which have often been cited and relied upon for the last 90 years. These propositions being:-

1. Even though the parties may use the word ‘penalty’ or ‘liquidated damages’ in respect of a clause, it is for the Court to find out whether the payment stipulated is in truth penalty or liquidated damages.

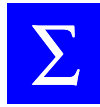


2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party.
3. The essence of liquidated damages is a genuine covenanted pre-estimate of damage.
4. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of making the contract, not as at the time of the breach.
5. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration, may prove helpful, or even inclusive. Such tests being:-
 - (a) It will be held to be a penalty if the sum stipulated is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.
 - (b) There is 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.'
 - (c) 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. On the contrary, that is just the situation when it is probable that pre-estimate damage was the true bargain between the parties

Thus, in the case of *Campbell Discount Co Ltd v Bridge* [1962] AC 600, the House of Lords struck down as a penalty a clause in a hire purchase agreement requiring the hirer to pay compensation for premature termination. The objectionable feature of this clause was that it provided a sliding scale which operated in the wrong direction. The less the depreciation of the vehicle, the greater was the compensation payable.

Whilst, in *Philips v The Attorney General of Hong Kong* [1993] 61 BLR 41. 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. It was held that 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 background to the recent case of *Alfred McAlpine Capital Projects Limited v Tilebox Limited*, was that on 27 April 2001, *Tilebox* and *McAlpine* entered into a written building contract. Clause 24 of the contract conditions provided that



McAlpine should pay liquidated and ascertained damages for delay at the rate at the rate of £45,000 per week or part thereof. The Contract Completion Date was 14 August 2002, but building works were not completed by that date, and the works were not expected to be complete until June 2005 (i.e. some 2½ years late).

Against this background, *McAlpine* became concerned about its potential liability (of something approaching £6 Million) to liquidated and ascertained damages under clause 24 of the contract conditions. *McAlpine* took legal advice and, having done so, formed the view that the rate of liquidated and ascertained damages specified in the building contract was excessive, and was a penalty clause and was therefore invalid. *Tilebox* denied that clause 24.2 was a penalty clause.

The parties referred this matter to court, and in the court case Mr Justice Jackson, considered the authorities and made the following general observation:-

1. There seem to be two strands in the authorities. In some cases judges consider whether there is an unconscionable or extravagant disproportion between the damages stipulated in the contract and the true amount of damages likely to be suffered. In other cases the courts consider whether the level of damages stipulated was reasonable. Mr Justice Jackson came to the view that a pre-estimate of damages does not have to be right in order to be reasonable. There must be a substantial discrepancy between the level of damages stipulated in the contract and the level of damages which is likely to be suffered before it can be said that the agreed pre-estimate is unreasonable.
2. Although many authorities use or echo the phrase "genuine pre-estimate", the test does not turn upon the genuineness or honesty of the party or parties who made the pre-estimate. The test is primarily an objective one, even though the court has some regard to the thought processes of the parties at the time of contracting.
3. Because the rule about penalties is an anomaly within the law of contract, the courts are predisposed, where possible, to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power.
4. Looking at the bundle of authorities provided in this case, Mr Justice Jackson noted only four cases where the relevant clause has been struck down as a penalty.

Based upon the above, and the circumstances of this case, Mr Justice Jackson formed the view that the liquidated damages clause in question was not a penalty clause, and therefore would be enforced.



Conclusion.

The courts are normally pre-disposed where possible to uphold contractual terms that have been freely agreed between the parties. Thus, other than in the most exceptional of cases, the courts are unlikely to find a liquidated damages clause to be a penalty clause. Consequently, other than in the most blatant of cases, it would be foolish to rely on overturning a liquidated damages clause on the basis that it was indeed a penalty clause, after the contract has been entered into.

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