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# Liquidated Damages and Penalties: the New Approach

***By Peter Sheridan***

A comprehensive review of the rule against penalties was undertaken recently in the Supreme Court, with seven judges participating in what is now the leading case, *Cavendish Square Holding Bv v El Makdessi* (2015). For the previous 100 years, the leading case had been *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* (1915).

Where parties provide in their contract for what the consequence of breach may be, often in construction contracts for payment of a sum of money for delay, that provision will be either a liquidated damages provision (valid) or a penalty (invalid). In *Dunlop*, Lord Dunedin (seeking to summarise the existing case law) stated that a liquidated damages provision is justified where it provides a genuine pre-estimate of the loss caused by the breach; that a penalty provision is one where the court takes the view that the clause is oppressive, extravagant or unconscionable; and that a penalty clause is one which is *in terrorem* of the offending party (which modern courts interpreted as meaning 'intended to deter breach').

Before the recent Supreme Court case, the courts had refined the approach over the past 20 years, to the effect that a clause which provides for payment exceeding a genuine pre-estimate of the loss caused by the breach may yet be valid, if it has a proper commercial justification, provided that the primary purpose is to compensate and not to deter: see *Lordsdale Finance v Bank of Zambia* (1996), *Cine Bes Filmcilik v United International Pictures* (2003) and *Murray v Leisureplay Plc* (2005).

The rule against penalties has been described as anomalous, an interference with contractual freedom and in *Cavendish* as "an ancient, haphazardly constructed edifice which has not weathered well". However the Supreme Court declined to abolish the rule against penalties; it is well established and a major change in the law should be left to legislators. The Supreme Court also declined to extend the principle to clause which is not concerned with the consequences of a breach, as has been done in Australia in *Andrews v ANZ Banking Group* (2012).

The Supreme Court drew a distinction between a primary obligation, an example of which would be to complete by a particular date, and a secondary obligation, which would arise following breach, an example of which would be an obligation to pay liquidated damages for delay. The rule against penalties applies only to secondary obligations, so, as the court, recognised, it may be possible to avoid the rule by framing the obligation in a different way. For example, if payment of part of the contract sum is conditional on completion by a particular date, that is a primary obligation. However, in standard construction contracts at present there is normally a secondary obligation to pay liquidated damages on breach of the completion obligation. The rule against penalties is therefore engaged; the tribunal then considers whether the clause is valid or if it offends against the rule.

The test applicable now 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 has no proper interest in punishing the defaulter. In the case of a straightforward damages clause (as in many construction contracts' liquidated damages provisions), that interest will rarely extend beyond compensation for the breach. To that extent, the Lord Dunedin approach in *Dunlop* will still be adequate to determine validity. But compensation is not necessarily the only legitimate interest that the innocent party may have. One of the cases before the Supreme Court illustrates this: it concerned a shoppers' car park where parking was free for two hours and there was then a charge of £85 for overstaying. This was upheld on the legitimate interest ground, although the sum did not reflect loss caused by the breach. *Dunlop* itself is a further example, where Dunlop had a legitimate interest in keeping prices of its products globally at or above list price, although its charge for breach did not reflect its loss for a single sale below list price.

It follows that deterrence is not penal if there is a legitimate interest, so it would be unsafe now to regard deterrence as a key issue; the real issue is whether the charge seeks to punish or is out of proportion to the legitimate interest so that the innocent party is in effect profiteering.

The Supreme Court also made the point that in a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption is that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach.

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