

Concluding Comparative Remarks in Relation to UK Supreme Court Cases on Penalty Clauses

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1. Introduction

The previous case notes offer extensive information on the way eight European legal systems approach penalty clauses. In this short concluding comparative analysis, I will not summarize these different approaches, but will only analyse whether the two cases brought the law in England and Wales closer to that of other European jurisdictions, and where still some important differences exist.¹

As Paula GILKER's case note demonstrates, the UK Supreme Court did not abolish the rule on penalty clauses, nor did it restrict it to non-commercial cases where parties do not have equal bargaining power. In this sense, the rule that penalty clauses are not valid still stands and deviates from the majority of the European legal systems.² However, the law on penalties is amended or specified in two ways.

In the first place, the UK Supreme Court specified the scope of the law on penalties. It made clear that, for the qualification of a penalty or liquidated damages clause, it is not important whether the 'payment' is expressed in money or in some other form. Furthermore, only clauses that are considered as a contractual remedy for breach of contract fall within the scope of the law on penalties. Clauses that are not activated in case of a breach and/or those that are considered as a primary obligation fall outside the scope of the rule against penalties.

In the second place, the test for deciding whether a clause is an invalid penalty clause or an enforceable liquidated damages clause is amended in comparison with the Lord Dunedin test: it must now be assessed:

*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.*³

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1 This analysis only sketches the outlines in respect to the main issues on which the UK Supreme Court gave a decision. Only the definition of a penalty clause and the way penalty clauses are being controlled by courts are briefly discussed.

2 Except for Belgium; see the case note on Belgian law by Françoise AUVRAY and Sanne JANSEN in this issue.

3 UKSC 4 November 2015, *Cavendish Square Holdings BV v. Makdessi; ParkingEye Ltd v. Beavis* <http://www.bailii.org/uk/cases/UKSC/2015/67.html> at para. 32.

This test provides a court in England and Wales presumably more leniency in deciding whether a clause is permitted or not. It is no longer decisive whether the clause is, at the time of contracting, a genuine pre-estimate of the likely loss, but the test seems to be shifted to the question whether the amount is exorbitant and unconscionable, given the interests of the creditor to demand payment of the amount.

This last shift seems to bring English law closer to the other European approaches in relation to penalty clauses. However, I will argue that some important differences still exist. First, I will comment on the first aspect of the UK Supreme Court Decision: the definition of a penalty clause (sec. 2). This will be followed by some remarks on the question of when a court is allowed to interfere with the principle of freedom of contract in relation to penalty and liquidated damages clauses (sec. 3) and by an analysis of the legal consequence of unfair clauses (sec. 4).

2. What is a Penalty Clause?

The UK Supreme Court made it clear that a clause also falls within the scope of the rules on penalty clauses if it not only requires payment of *money* in case of breach of contract but also on performances *not expressed in money*, such as the transfer of property or shares. This is the situation in the majority of jurisdictions discussed in this issue of *European Review of Private Law (ERPL)*.

On the other side, the UK Supreme Court also decided that the rule on penalties only applies to a secondary obligation that imposes a detriment, thereby excluding primary obligations. The case notes demonstrate that this approach is not followed all over.⁴ It should be noted that jurisdictions that do not consider the performance of a *primary* obligation in case of a breach as a penalty clause, usually accept another form of control on these clauses.⁵ In these jurisdictions the qualification of a clause as a penalty clause is not as important as it is under English law.

In other words, this aspect of both cases (the scope of the rule on penalty clauses) is not treated unanimously the same in the European jurisdictions discussed in this issue.

4 It is not accepted in Dutch law, but is adopted in French law. In some other jurisdiction it is not clear; in Italy, for instance, it has never been discussed whether the rule against penalty may be applied to price adjustment clauses. See the analysis by Francesco Paolo PATTI in his case-note on Italian law.

5 See, for instance, the situation in Polish law as described by Ewa BAGINSKA and Paulina SLUFINSKA in their case note in this issue: a court would either consider as a conditional price that is not always allowed, or qualify it as covert liquidated damages clause. Dutch and German law also provide for another form of control (for instance, the boundaries of reasonableness and fairness), should a clause not be qualified as a penalty clause. See the case note on Dutch law and the analysis by Florian FAUST on German law, who also addresses the question, which was not addressed in the UK Supreme Court cases, of whether the penalty clause was actually agreed on.

3. The Test for Judicial Control

Paula GILIKER's case note demonstrate that the key test in English and Welsh law is now whether the clause imposes a detriment on the contract-breaker that is exorbitant and unconscionable or out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The time of reference is the time of contracting. The old test of Lord Dunedin in the *Dunlop* case seems to be abandoned and the new leading cases in this respect are now *Cavendish v. Makdessi* and *ParkingEye v. Beavis*. The new criterion to control penalty clauses seems to be more flexible and shifts the control to exorbitant and unconscionable clauses instead of assessing whether the clause was a genuine pre-estimate of the likely damages.⁶ The gap between UK law and other jurisdictions seems to have been narrowed.

However, even though it is likely that penalty clauses will be upheld more easily under the new rules and with a more flexible and broader test than before, there are still some important differences between the law in England and Wales and some other European jurisdictions. The first difference is that even though the test to reveal penalty clauses has been changed, as a matter of principle the law in England and Wales still do not accept clauses that have a deterrent and 'penalizing' character. In most jurisdictions, except for Belgian⁷ law, the law accepts penalty clauses as such and is only concerned with whether these penalties appear to be manifestly unreasonable. In other words, the validity of the clause is generally accepted, but the law only reacts if the application of the clause causes unacceptable consequences. This also means that English and Welsh law still treat penalty clauses differently than liquidated damages clauses and also makes a distinction between the two clauses. This is different from Dutch and Polish law, for instance, where parties are allowed to agree on any payment irrespective of whether it is to repair damage or only to induce performance,⁸ subject to the possibility of reducing penalty clauses if it is evident that equity so requires (Dutch law) or if the obligations have been performed to a great extent or when the liquidated damages are disproportionately high (Polish law). The same holds true for Article 9:509 PECL and 7.4.13 UNIDROIT Principles for International Commercial Contracts, neither of which make a distinction, and both of which treat each and every

⁶ See P. GILIKER, in her case note on English law in this issue.

⁷ See the case note on Belgian law by Françoise AUVRAY and Sanne JANSEN. In Sweden, there is no specific regime to control penalty or liquidated damages clauses. However, when an agreed payment exorbitantly exceeds the estimated future damage, it will be reduced on the basis of a general article in the Swedish Contract Act (s. 36) that limits all unreasonable contract clauses; see Christina RAMBERG in her case note from a Swedish perspective.

⁸ This means, for instance, that under Dutch and Polish law, a *pure* penalty that allows the creditor to claim both the contractual penalty and statutory damages is perfectly valid as long as parties expressly stipulate that both the penalty and statutory damages can be claimed. See the case notes on Dutch (by Harriet SCHELHAAS) and Polish law (by Ewa BAGINSKA and Paulina SLUFINSKA).

clause in which parties agree on a payment in case of non-performance the same: the claimant is awarded that sum irrespective of its actual loss, unless the agreed payment is ‘grossly excessive in relation to the loss’. For this last test, regard should be taken to the situation *ex post*; that is, not at the time of contracting but once the non-performance has taken place and the court has to evaluate whether the agreed payment is grossly excessive. Other jurisdictions that (unlike English law) also accept the validity of penalty clauses in general, such as German law, make a distinction between the two types of clauses. Unlike English law, this distinction is not used to separate valid liquidated damages clauses, but only to be able to exercise judicial control.⁹ This control is only possible if a clause qualifies as a penalty clause. In sum, the control on agreed payment clauses does not aim to invalidate penalty clauses but to protect contracting parties if it appears afterwards that a clause is unfair.

This marks a second important difference in this respect. The enforceability of the clause under English law has to be assessed as of the time when the parties concluded the contract. Almost¹⁰ all other European jurisdictions under study consider the facts and circumstances until the day of the enforcement of the penalty clause¹¹ or the moment a judgment is rendered as relevant. This, for instance, means that subsequent behaviour and the actual amount of damages may be relevant factors in the majority of the European jurisdictions, where this is not the case in English and Welsh law.

4. Legal Consequence

Another difference between the English approach and the approach of the other discussed European systems is related to the legal consequences. Under English and Welsh law, the consequence of a clause being characterized as a penalty clause is its invalidity: the clause cannot be invoked at all. Therefore, the English rules on penalty clauses still adopt an all-or-nothing approach. It appears that this rigid legal consequence is unknown in the specific provisions on penalty clauses in the other European jurisdictions that are discussed in this issue.¹² Even Belgian law,

9 See Florian FAUST in his German case note in this issue.

10 The exception seems to be Belgian law, where a comparison of the contractual penalty and the likely damage (*‘dommage potentiel’*) at the time of the conclusion of the contract needs to be made. See the case note on Belgian law by Françoise AUVRAY and Sanne JANSEN in this issue.

11 See, for instance, Italian law, where the situation was unclear until recently, but recent case law by the Italian Supreme Court suggests that circumstances until the enforcement of the penalty clause may be taken into account: see Francesco Paolo PATTI in his case-note on Italian law.

12 However, the control of penalty clauses in general conditions that fall within the scope of the European directive on Unfair Terms in Consumer Transactions is different and results in the invalidity of an unfair penalty clause. See for the interaction of the authority of the court to reduce penalty clauses and the invalidity prescribed by the European directive, including the Dutch, German and Italian case note in this issue and ECJ 30 May 2013, C-488/11, ECLI:EU:C:2013:341 (*Asbeek Brusse v. Johani*).

which like English and Welsh law does not accept penalty clauses as such, reduces these clauses rather than invalidating them.

5. Conclusion

All of the jurisdictions examined in this issue agree on the necessity of judicial control on unfair agreed damages clauses and thereby accept exceptions to the principle of freedom of contract. However, the specific manner in which these clauses are restricted differs.

The new English criterion to control penalty clauses has become less strict than the old Dunlop rules and seems to narrow the gap between the different European approaches. In this sense, the *Cavendish* and *ParkingEye* cases mark, in the words of GILIKER, ‘an important turning point in the treatment of penalty clauses in England and Wales’.¹³ However, the case notes in this issue also make it clear that there are still some important differences in the treatment of penalty clauses throughout Europe.

13 See P. GILIKER in her case note on English law in this issue.