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Landmark UK Supreme Court Decision on Penalties – No Change in Hong Kong (yet)

Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67

The UK Supreme Court has confirmed that the centuries-old doctrine of penalties still has a place in the modern commercial world of contracts, in spite of calls for its abolition, but revised the test as to when a sum stated in a contract might be considered a "penalty". Until the Courts in Hong Kong choose to revisit the topic, however, the existing principles will continue to apply.

The Supreme Court's decision is the first of the Supreme Court (and its predecessor, the House of Lords) on the scope and application of the penalties doctrine since the seminal cases of *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* (in 1905) and *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*[1] (in 1915). It is particularly significant as it revises the principles to be derived from those cases in re-evaluating the law on contractual penalty clauses (i) in relation to commercial contracts (in the appeal between *Cavendish v Talal El Makdessi*) and (ii) at a consumer level (in the appeal between *ParkingEye Ltd v Beavis*).

The two appeals were heard together over three days in July 2015 culminating in five separate judgments. The Court, consisting of Lords Neuberger, Mance, Clarke, Sumption, Carnwath, Toulson and Hodge, was unanimous that the doctrine of penalties should not be abolished, but was divided on the scope of the doctrine and the relevant test to be applied. Clifford Chance acted for Mr Makdessi in the case.

It is clear from the majority judgment (of Lord Neuberger and Lord Sumption, with whom Lord Clarke and Lord Carnwath agreed) that in the UK there is a shift in focus from the classic test of *"genuine pre-estimate of loss"* and concepts of extravagance, unreasonableness and deterrence, and a greater emphasis on *"legitimate interests"* and punishment.

Given the close ties between English law on the one hand, and the law of other common law jurisdictions on the other, the decision is expected to resonate globally. In Hong Kong, however, until the courts decide otherwise, the position remains as it is. This article examines the differences between the approach now adopted in UK and the traditional approach that for now will continue to hold sway in Hong Kong.

Key issues

- The UK decision in *Cavendish* revises the test as to when a stated sum may be considered a *"penalty"*.
- The test under English law is no longer whether there is a *"genuine pre-estimate of loss"* but rather whether the clause in question *"imposes a detriment...out of all proportion to any legitimate interest"* of the innocent party.
- In **Hong Kong**, however, the existing principles continue to apply.
- Liquidated damages are a genuine pre-estimate of the loss which would occur if the term is breached.
- A penalty is a stipulated payment of money meant to frighten or deter a party from breaching a term and is unenforceable.

[1] [1915] AC 79

Key lessons for commercial parties under English law arising out of the Supreme Court's decision

1. The scope of clauses which can fall within the penalty doctrine has been clarified. Clauses which constitute primary obligations are not capable of being a penalty in contrast to clauses that regulate those primary obligations upon breach.
2. The Supreme Court has moved away from the traditional test of whether a sum of money stated in a clause that takes effect upon a breach of contract is a "genuine pre-estimate of loss", and therefore enforceable, or whether it is more properly aimed at holding a threat over a party's head with a view to compelling it to perform, (so called "in terrorem"), and is therefore unenforceable as a penalty.
3. Indeed, the Court has provided guidance that "[t]he fact that the clause is not a pre-estimate of loss does not ... at any rate without more, mean that it is penal".[2]
4. The true principle, according to the Supreme Court, is whether the clause "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] Or as Lord Hodge and Lord Toulson stated: "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."[4]
5. In circumstances in which the parties were properly advised and were 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."[5]

The Hong Kong Position

The Supreme Court's decision in *Cavendish* will have little practical application in Hong Kong at present. Hong Kong courts have traditionally upheld the bargain made by the parties. In *Philips Hong Kong Ltd v A-G of Hong Kong* [1993] 1 HKLR 269, Lord Woolf was at pains to point out that *"the courts have always avoided claiming that they have any general jurisdiction to rewrite the contracts that the parties have made*", an approach found in other Commonwealth jurisdictions such as Canada.

In *JG Collins Insurance Agencies Ltd v Elsley* (1978) 83 DLR (3d) 1, the Supreme Court of Canada described the courts' powers to strike down penalty clauses as a *"blatant interference with freedom of contract"*, which was *"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."*

In the later Hong Kong case *Re Mandarin Container* [2004] 3 HKLRD 554, Waugh J also noted that *"the court should be slow to find terms agreed by the parties to be "in terrorem" rather than genuine agreement providing for fixed formula of loss."* The Court described the *"modern approach to penalty clauses"* as being *"whether the disputed provision could be said to be unconscionable or oppressive by reason of its being extravagant, exorbitant or excessive."* The court's finding that an *"additional default interest rate"* on a judgment debt did not constitute a penalty was however still made in relation to the *"range of* ***losses*** (emphasis added) *that could reasonably be anticipated at the time the contract was signed".*

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2 *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis* [2015] UKSC 67, paragraph 31.
3 *Ibid*, paragraph 32.
4 *Ibid,* paragraph *255* (Lord Hodge); paragraph 293 (Lord Toulson).
5 *Ibid,* paragraph 35.

Until the courts in Hong Kong decide otherwise, the principles of *Dunlop Pneumatic Tyre Co Ltd* will continue to apply. These are:

1. A penalty is a stipulated payment of money meant to frighten or deter a party from breaching a term. Liquidated damages on the other hand are a genuine pre-estimate of the loss which would occur if the term is breached.
2. The question of differentiating between them is one of construction. This is to be decided upon the terms and circumstances of each particular contract, judged as at the time of making the contract, not at the time of breach.
3. Though the parties may use terms such as "penalty" and "liquidated damages", these terms are not conclusive.
4. If the sum is extravagant or unconscionable in comparison to the greatest loss conceivable from the breach, it is a penalty.
5. There is a presumption that when the payment is by a single lump sum, on the occasion of one or more events, some of which may be trifling, then it is a penalty.
6. It will be held to be a penalty if the breach concerns the non-payment of a sum of money due under a contract, and the sum stipulated is greater than the sum which ought to have been paid.
7. Simply because the consequences of the breach are difficult to estimate, this does not mean it is a penalty. Rather, there is a presumption that it is a liquidated sum.

It remains to be seen whether the Hong Kong courts will follow in future the revised test set out in *Cavendish* or whether they will continue to prefer the existing principles derived from the decision in *Dunlop*. Clients may wish to consider provisions in their Hong Kong law governed contracts that might stray into penalties territory to take into account the possibility that the Hong Kong courts may choose to follow *Cavendish*.

We have previously commented on this decision in a global briefing and Singapore briefing.

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