

SCOTTISH LAW COMMISSION  
Discussion Paper No 103



# Discussion Paper on Penalty Clauses

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**This Discussion Paper is published for comment and criticism and does not represent the final views of the Scottish Law Commission**

The Commission would be grateful if comments on this discussion paper were submitted by 31 March 1998. All correspondence should be addressed to:

Mrs D F Barbirou  
Scottish Law Commission  
140 Causewayside  
Edinburgh  
EH9 1PR

(Tel: 0131 668 2131)  
(Fax: 0131 662 4900)

## NOTES

1. In writing a later report on this subject, the Commission may find it useful to be able to refer to, and attribute, comments submitted in response to this paper. If no request for confidentiality is made, the Commission will assume that comments on the paper can be used in this way.
2. Those who wish copies, or further copies, of this Discussion Paper for the purpose of commenting on it should contact the Commission at the above address.

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# Part 1 Introduction

## Background to Discussion Paper

1.1 The need to consider reform of the law on penalty clauses was first brought to our attention by the Faculty of Advocates. There are two main problems in the existing law. One is that some contractual provisions which are not in any way oppressive or unreasonable may be struck down as unenforceable penalty clauses because they fall on the wrong side of the line which the law draws between penalties and liquidated damages. The other is that some contractual provisions which are of the nature of oppressive and unreasonable penalty clauses may escape the normal judicial control over penalty clauses because they are drafted in such a way as not to arise on a breach of contract. Judges have from time to time expressed concern about this area of the law and have suggested that its defects may need to be remedied by legislation.<sup>1</sup> Problems with the current law on penalty clauses were mentioned in our seminar on Remedies for Breach of Contract organised with the University of Edinburgh on 21 October 1995.<sup>2</sup> We decided to include this topic in our Fifth Programme of Law Reform as part of our work on the law of obligations,<sup>3</sup> and engaged Professor William W McBryde of the University of Dundee as a consultant. We gratefully acknowledge Professor McBryde's substantial contribution to this discussion paper.<sup>4</sup> The responsibility for its final form and content is however ours alone.

## The European and international context

1.2 The Council of Europe published a report on penalty clauses in 1978.<sup>5</sup> The Committee of Ministers recommended that the governments of the member states took into consideration the principles in the appendix to their Resolution when preparing new legislation on this subject. In 1983 UNCITRAL adopted *Uniform Rules on Liquidated Damages and Penalty Clauses*, for international contracts<sup>6</sup> and the General Assembly of the United Nations recommended that States should give serious consideration to the rules and, where appropriate, implement them in the form of either a model law or a convention.<sup>7</sup> UNIDROIT has produced *Principles of*

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<sup>1</sup> See eg *Campbell Discount Co Ltd v Bridge* [1961] 1 QB 445 at 458-459; *Mercantile Credit Co Ltd v McLachlan* 1962 SLT (Sh Ct) 58 at 59. See also, in relation to penal irritancy clauses, *CIN Properties Ltd v Dollar Land (Cumbernauld) Ltd* 1992 SC (HL) 104.

<sup>2</sup> See Professor William W McBryde's paper "Remedies for Breach of Contract," revised and published in 1996 ELR Vol 1 p 43 (hereafter "Remedies") at pp 74-77. Professor Andrew Burrows of The Law Commission also commented on the reform of this area of law in "Legislative reform of remedies for breach of contract: the English perspective," 1997 ELR 155 at 175-176; see also H MacQueen, "Remedies for breach of contract: the future development of Scots law in its European and international context," 1997 ELR 200 at 223.

<sup>3</sup> Scot Law Com No 159 (1997) Item 4. paras 2.21 and 2.22. Under this item we intend to produce during 1998 a further discussion paper or further discussion papers on remedies for breach of contract.

<sup>4</sup> Professor McBryde produced a complete first draft of the paper, the bulk of which has been unaffected by subsequent amendments.

<sup>5</sup> *Penal Clauses in Civil Law*, Resolution (78) 3 Adopted by the Committee of Ministers of the Council of Europe on 20 January 1978 and Explanatory Memorandum (Strasbourg 1978) (hereafter "Council of Europe"): reproduced in the Appendix.

<sup>6</sup> *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance and Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance* (hereafter "Uncitral"). See *Official Records of the General Assembly, Thirty-eighth Session, Supplement No 17 (A/38/17, annexes 1 and 2)*.

<sup>7</sup> Resolution No 38/135 of the 101st plenary meeting 19 December 1983.

*International Commercial Contracts*<sup>8</sup> which incorporate an article on penalty clauses.<sup>9</sup> The Commission on European Contract Law under the chairmanship of Professor Ole Lando has recently produced a text with a clause on "Agreed Payment for Non-Performance".<sup>10</sup> The issue has been considered by law reform commissions in England,<sup>11</sup> California,<sup>12</sup> Canada<sup>13</sup> and Australia.<sup>14</sup>

### The problem of definition

1.3 One of the difficulties with this area of law is to define a penalty clause. The first problem is that in the United Kingdom,<sup>15</sup> the term "penalty clause" is used with both a wide and a narrow meaning. The law makes a distinction between an unenforceable penalty clause, in the narrow sense of that term, and an enforceable liquidated damages clause. But in normal speech many lawyers and lay persons would probably refer to a penalty clause intending to mean the clause which is usually a liquidated damages clause but which might, exceptionally, be unenforceable because it is penal. We use the term "penalty clause" in its wider sense.

1.4 That, however, is not the end of the problem of definition. What may be the typical type of penalty clause can be illustrated by the terms of the Council of Europe Resolution:<sup>16</sup>

"A penal clause is, for the purposes of this resolution, any clause in a contract which provides that if the promisor fails to perform the principal obligation he shall be bound to pay a sum of money by way of penalty or compensation."

This identifies the normal features of a penalty clause. It provides for a money payment in the event of a failure to perform. A similar approach to definition is taken in the Uncitral text<sup>17</sup> and the Unidroit rules.<sup>18</sup> In the Scottish context the typical penalty clause provides for payment of a sum of money on a breach of contract.<sup>19</sup> For the purposes of this Discussion Paper we have to use a broader approach. This is because much of the concern with this area of law has been with clauses which may be penal in operation but which do not arise on a breach of contract eg a payment due if a contract is terminated when one contracting party becomes insolvent or exercises an option to terminate the contract early, or forfeiture of a deposit which was paid

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<sup>8</sup> Rome 1994 (hereafter "Unidroit").

<sup>9</sup> Art 7.4.13.

<sup>10</sup> *The Principles of European Contract Law: prepared by the Commission on European Contract Law, chairman, Ole Lando, edited by Ole Lando and Hugh Beale, Netherlands 1995* (hereafter "Lando Commission"), art 4.508.

<sup>11</sup> *The Law Commission Working Paper No 61, Penalty Clauses and Forfeiture of Monies Paid* (1975) (hereafter *Penalty Clauses*).

<sup>12</sup> California Law Revision Commission, *Recommendations Relating to Liquidated Damages* (1975), appendix XIV to the Annual Report for 1975 and (1976), appendix X to the Annual Report for 1976 (13 Cal L Rev Comm Rep) (hereafter *Recommendations*).

<sup>13</sup> Ontario Law Reform Commission: *Report on Amendment of the Law of Contract* (1987) ch 7 (hereafter *Contract*).

<sup>14</sup> Law Reform Commission of Victoria: *Discussion Paper No 10: Liquidated Damages and Penalties* (1988) (hereafter *Liquidated Damages*).

<sup>15</sup> A constant problem with agreement on international texts has been that other legal systems do not make the distinction between penalty clauses, in the narrow sense, and liquidated damages clauses. In most Civil Law countries a stipulated payment clause is enforced whether or not its purpose is to have a genuine pre estimate of loss. The control is over excessive payments. See, for example, the Lando Commission, Notes to article 4.508.

<sup>16</sup> Council of Europe, art 1.

<sup>17</sup> Uncitral, art 1 "These Rules apply to international contracts in which the parties have agreed that, upon a failure of performance by one party (the obligor), the other party (the obligee) is entitled to an agreed sum from the obligor, whether as a penalty or as compensation."

<sup>18</sup> Unidroit, art 7.4.13 - "Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance ...".

<sup>19</sup> As we note later there are differences between breach and failure to perform which may be significant in this context. See paras 4.12 to 4.24 below.

before there was any breach of contract. Also a clause may be penal when it involves forfeiture or transfer of property, instead of payment of money;<sup>20</sup> or when it involves the withholding of a sum of money. It is arguable that clauses of all these types ought to be within the rules on the control of penalty clauses, although of course not all would be regarded as unenforceable.

1.5 The fundamental problem is that the courts rightly do not wish to interfere in the terms of a commercial contract. This reluctance was illustrated long ago in Scots law by cases on agricultural leases where the tenant had to pay additional rent in the event of miscropping. If the court would not interfere in the amount of rent agreed, why should it be concerned with the possibility that additional rent was payable in certain circumstances? We discuss the case law later. There is a tension between the refusal to enforce a penal provision, and a desire to enforce what was agreed. In Professor Treitel's words: "What is at stake here is the perennial conflict between certainty and justice; and in fact some degree of compromise is to be found in all the legal systems under consideration."<sup>21</sup> This problem remains central to the question of what, if any, controls are needed for penalty clauses, and in what circumstances any controls should operate.

### Scope of paper

1.6 This paper is concerned with penalty clauses in the wider sense identified above. It seeks views on whether the right test is used to identify unenforceable penalty clauses and on whether control should be extended to certain clauses having an effect essentially similar to that of the classic penalty clause. It also seeks views on various consequential problems which might arise if the law were to be changed in these respects.

1.7 It would be possible to adopt a different approach and to begin with the proposition that there ought to be a wide statutory power to control all types of extortionate or oppressive contractual provisions. On this approach, penalty clauses would be seen as just one example of oppressive clauses. There is a certain logic and attraction in this approach. For one thing, it avoids some of the problems of definition which are inevitable on the narrower approach. However, there are also dangers and disadvantages. The greatest danger is that contracts would be exposed to unacceptable uncertainty. Any contractual term would be potentially open to review by judges on the ground that it was grossly oppressive (or that it failed to pass whatever other test was used). If some attempt were made to limit the scope of judicial review of contracts then problems of definition would simply present themselves in another form. It would be unwise to rule out for all time the possibility of a wider approach, whether based on a fresh start or on an extension of the existing rules on unfair contract terms,<sup>22</sup> but it would require the most careful consideration and would be a very big exercise. We have not been made aware of any demand for such an approach at present. On the other hand we have been made aware of dissatisfaction with the present Scottish law on penalty clauses. It is safer and more manageable to deal with that narrow topic rather than adopt a more radical approach.

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<sup>20</sup> Eg *Watson v Noble* (1885) 13 R 347; *Jobson v Johnson* [1989] 1 WLR 1026. These cases are discussed at paras 5.4 to 5.7.

<sup>21</sup> G H Treitel, *Remedies for Breach of Contract: A Comparative Account* (1988) (hereafter *Remedies*) p 213.

<sup>22</sup> See the Unfair Contract Terms Act 1977 and the Unfair Terms in Consumer Contracts Regulations 1994 (SI 1994/3159).

## Comparative law

1.8 There was at one time a pronounced difference of approach to penalty clauses in the countries whose law was heavily influenced by the English common law and in the countries whose law was heavily influenced by the Napoleonic code.<sup>23</sup> The common law approach was to regard all penalty clauses as unenforceable: it was not for private parties to punish each other. The approach in many civil law countries, influenced by the Napoleonic code, was to regard penalty clauses as fully enforceable: they were seen as an efficient stimulus to performance and a way of avoiding litigation: it was not for the courts to modify a provision agreed between the parties unless there was another ground for challenging the contract, such as the existence of a vice of consent.

1.9 More recently there has been an element of convergence. The common law distinction between penalties and liquidated damages can be used in a flexible way to allow recovery of many sums which the parties have agreed should be payable in the event of non-performance. French law now allows the courts to modify contractual penalties.<sup>24</sup> Other countries within the civil law tradition often adopt a similar intermediate approach.

"In Germany, a distinction is drawn between the Civil Code and the Commercial Code. Whereas the latter enacts the 'efficient model' [i.e. penalties fully enforceable] (section 348), BGB section 343 states that 'if a penalty is disproportionately high the Court may, upon the obligor's request, reduce it to an appropriate amount.'

Article 161 of the Swiss Code of obligations clearly states: 'The forfeited penalty may be recovered even though the obligee has suffered no damage.' The BGB approach is then followed by stating that 'an excessively high penalty is to be reduced by the Court at its discretion.'

The same intermediate approach is adopted by the Italian Civil Code of 1942, which states at art. 1382 that 'the penalty may be reduced if ... its amount is manifestly too high.'

The new Dutch Civil Code adopts the same principle by devoting four provisions to the subject (arts. 91, 92, 93, 94)."<sup>25</sup>

1.10 It appears that most modern or recently revised civil codes envisage the possibility that excessive penalties can be modified. There is still, however, a difference in starting point between the common law and the civil law systems. There is also a difference in technique because in common law systems an unenforceable penalty is not modified. The penalty clause

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<sup>23</sup> See Mattei, "The Comparative Law and Economics of Penalty Clauses in Contracts," 43 Am J Comp L (1995) 427.

<sup>24</sup> Law No. 75-597 of 9 July 1975.

<sup>25</sup> See Mattei, "The Comparative Law and Economics of Penalty Clauses in Contracts," 43 Am J Comp L (1995) 427 at p 438.

falls completely and the person for whose benefit it was inserted is forced back on the remedy of damages.<sup>26</sup>

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<sup>26</sup> We discuss this question further at paras 5.41 to 5.47 below.

# Part 2 Origins and devolution

## Introduction

2.1 In this Part we consider the history of the Scottish law on penalty clauses. This demonstrates why the law has reached a position which has been described as creating difficulties "because nowadays the courts do not ask whether the contractual provision produces a result which is penal in the circumstances of the case. Instead there is the application of technical, narrow and unsatisfactory rules to determine whether the clause is penal."<sup>1</sup>

## The early law

2.2 The early law was concerned with sums payable by borrowers and was affected by attitudes to usury<sup>2</sup> ie the demand for an exorbitant rate of interest. According to Stair it was part of the *nobile officium* of the Court of Session to modify exorbitant penalties:

"They modify exorbitant penalties in bonds and contracts, even though they bear the name of liquidate expenses, with consent of parties, which necessitous debtors yield to: these the Lords retrench to the real expenses and damage of parties."<sup>3</sup>

The control exercised by the court went beyond payment of money. It applied to irritancy clauses, ie clauses which resulted in forfeiture of property, usually land.<sup>4</sup> The time allowed to purge an irritancy was given as an example of the power to modify an exorbitant penalty.<sup>5</sup>

2.3 Stair would have been familiar with penalty clauses because three clauses were in his contract dated 26 March 1681 for the printing of his *Institutions, Acts of Sederunt, Decisions* and a treatise on Human Knowledge and other matters. The printer had to keep copies of the treatises under lock and key until they had been fully printed under a penalty ("the pain") of £100 Scots for each copy found out of the printer's custody. The printer was bound to deliver 12 leather copies, half of them gilded, to the author "under the pain of £40 Scots money as the liquidate price thereof by consent". Both parties had to perform the contract "under the pain of 1000 merks Scots money, by and attour<sup>6</sup> performance of the premises".<sup>7</sup> Penalty clauses have a long history in Scots law.

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<sup>1</sup> McBryde, *Remedies*, p 75.

<sup>2</sup> *Home v Hepburn* (1549) Mor 10033; McBryde, *The Law of Contract in Scotland* (1987) (hereafter *Contract*) para 20-127.

<sup>3</sup> Stair, IV.3.2; see also I.10.14, III.2.32, IV.5.7, IV.51.11.

<sup>4</sup> I.10.14.

<sup>5</sup> IV.18.3.

<sup>6</sup> Above, in addition to.

<sup>7</sup> G Dallas, *System of Stiles* (1st ed 1697) p 152. There was also a penalty in Dallas' style of a charterparty: "with the sum of - money foresaid, each day the said AB his said ship and mariners shall remain at either of the said ports (attour the ly-days above specified, in default of the said CD)." The style and spelling has been slightly modernised in the quotations.

2.4 According to Kames it was only an *exorbitant* penalty with which the court would interfere. "If exorbitant, it is so far penal, and will be mitigated by the court. But unless the excess be considerable, the court will not readily interpose."<sup>8</sup> There was a very common provision in bonds for repayment of loans that the borrower should pay the principal sum and interest and a fifth part more of liquidate expense. This fifth part was in effect damages arising from non payment of money, additional to interest. The courts would modify the creditor's claim to the actual loss, such as the expenses of litigation.<sup>9</sup> The Debts Securities (Scotland) Act 1856 section 5 now provides:

"and in all cases where penalties for nonpayment, over and above performance, are contained in bonds or other obligations for sums of money, and are made the subject of adjudication, or of demand in any other shape, it shall be in the power of the court to modify and restrict such penalties, so as not to exceed the real and necessary expenses incurred in making the debt effectual."

2.5 Another example of the use of penalty clauses was in indentures for apprentices. In the event of absence by the apprentice, or other breach of contract, the apprentice or a cautioner might have agreed to pay a certain sum. The courts restricted a penalty for non performance to the actual loss suffered by the master.<sup>10</sup>

2.6 The area of law which gave rise to much litigation, and which could be said to have been primarily responsible for developing Scots law on penalties, was miscropping by tenants under leases.

### The miscropping cases

2.7 An example of a miscropping problem is *Stratton v Graham* in 1789<sup>11</sup> in which tenants bound themselves "to pay the sum of £2 sterling additional rent as herein before particularly mentioned, for each acre they, in consequence of the said liberty, may alter in their management from that particularly before expressed; which additional rent is not to be looked on as a penalty but as pactional rent ...". The Court of Session modified the amount of additional rent claimed. On appeal to the House of Lords Lord Chancellor Thurlow observed:<sup>12</sup>

"It was not the words used in the lease, but the sense of it, which a court ought to consider, and here it seems impossible but the parties must have understood the additional rent (which so far exceeded the real value of the land, however cultivated) as a penalty, whatever it might be called in the lease; and it is against the principles of equity to allow any person to take from another, what bears no proportion to the loss he has actually suffered."

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<sup>8</sup> Kames, *Principles of Equity* (1825 ed) (hereafter *Principles*) p 379.

<sup>9</sup> *Smith v McLean's Trs* 3 June 1800 FC; *Inglis v Renny* (1825) 4 S 113 (ne 114); *Ramsay v Goldie* (1826) 4 S 737 (ne 744); *Jamieson v Beilby* (1835) 13 S 865; *Orr v Mackenzie* (1839) 1 D 1046; and see discussion in *Bell Commentaries* 1, 700-702; cf Kames, *Principles* at pp 379,380. A recent example of a similar provision concerning rent in a lease being a penalty is *The Council of the Borough of Wirral v Currys Group plc* (OH) Lord Hamilton 29 April 1997, unrep, but see 1997 GWD 19-900.

<sup>10</sup> *Sibbald v Fletcher* (1758) Mor 588; *Wright v McGregor* (1826) 4 S 434 (ne 440); *Watson v Merrilees* (1848) 10 D 370. In *Mitchell v Allardyce* 1915 2 SLT 398 a charge for the liquidate penalty was suspended.

<sup>11</sup> (1789) 3 Pat 119. The treatment of miscropping in W M Gloag, *The Law of Contract* (2nd ed 1929) (hereafter *Contract*) p 672 does not fully reflect the complexities of the case law.

<sup>12</sup> At 124.

As well as being an early example of a House of Lords decision on the Scots law of penalties, the case also decided that the court should look at the substance rather than the form of the contract.

2.8 While it was established that an additional rent might be struck down as a penalty, this was not always the result.<sup>13</sup> An additional rent was not by itself a penalty, even if the rent was excessive. "The landlord is entitled, if the tenant agrees, to ask an excessive additional rent, just as much as an excessive original rent."<sup>14</sup> It was important that in some cases the penalty was enforced because it avoided an investigation of actual loss.<sup>15</sup> The tenant did not have the option to violate the terms of the lease on payment of the additional rent.<sup>16</sup>

2.9 After the middle of the nineteenth century most of the reported case law on penalties was concerned with other problems such as the supply of goods or services, including building contracts. But it was recognised that the cases on pactional rents were one of the main, if not the principal, example of the development of the law in Scotland.<sup>17</sup> Penalties in leases were controlled by the Agricultural Holdings Act 1900, section 6<sup>18</sup> and the Agricultural Holdings (Scotland) Act 1908, section 22<sup>19</sup> and subsequent legislation. Now the Agricultural Holdings (Scotland) Act 1991 section 48 prevents a landlord obtaining more than his actual loss in the event of a breach of the lease, notwithstanding any provision to the contrary in the lease of an agricultural holding.

### **The nineteenth century and early twentieth century law**

2.10 The principles evolved by the courts were (1) the courts may modify an exorbitant amount of penalty, with a jury making the decision in a complicated case;<sup>20</sup> (2) the use of the term "penalty" or "liquidated damages" did not affect the result because the courts looked to substance not form;<sup>21</sup> (3) whether a provision was exorbitant (or unconscionable) was determined at the time the parties made their stipulation;<sup>22</sup> and (4) a clause which applied to any type of breach was not likely to be proportionate to the loss, and so might be unenforceable.<sup>23</sup>

2.11 There were some areas of doubt. The relevance of English law was uncertain. Lord President Inglis had refused to consider English law because the history was different.

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<sup>13</sup> Eg *Hunter v Clark* 1810 Hume 852.

<sup>14</sup> *Fraser v Ewart* 25 Feb 1813 FC at 228 per Lord Pitmilley.

<sup>15</sup> *Henderson v Maxwell* (1802) Mor 10054, argument in answers; *Mackenzie v Gilchrist* 13 Dec 1811 FC and see opinion of Lord President Hope for a valuable history of these provisions in leases; see also *Morrison v Blair* (1823) 2 S 241 (ne 242); *Lawson v Ogilvy* (1832) 10 S 531, (1834) 7 W & S 397.

<sup>16</sup> *Mackenzie v Craigies* 18 June, 1811 FC; *Mackenzie v Gilchrist*; *Gold v Houldsworth* (1870) 8 M 1006; *Dalrymple v Herdman* (1878) 5 R 847 (a case on a duplicand in feu duty).

<sup>17</sup> *Johnston v Robertson* (1861) 23 D 646 at 654 per Lord Cowan; *Forrest and Barr v Henderson, Coulborn & Co* (1869) 8 M 187 at 194 per L P Inglis, at 197 per Lord Deas - "Perhaps the most numerous class of cases in our books..."

<sup>18</sup> The abolition of penal rents by this provision was controversial. On the one hand there was a control in penal rents which landlords could use. On the other hand there was the argument, which won, that tenants should have freedom of cultivation and penal clauses could be unjust, particularly if the tenant had improved the land. See *Parliamentary Debates* (4th ser) vol 85 (1900) cols 1337 to 1344.

<sup>19</sup> See J Rankine, *Law of Leases* (3rd ed 1916) pp 460 to 467 for a general discussion.

<sup>20</sup> *Forrest and Barr v Henderson, Coulborn & Co* (1869) 8 M 187.

<sup>21</sup> *Johnston v Robertson* (1861) 23 D 646; *Forrest & Barr v Henderson, Coulborn & Co*.

<sup>22</sup> *Forrest & Barr v Henderson, Coulborn & Co*.

<sup>23</sup> Contrast *Johnston v Robertson* with *Craig v McBeath* (1863) 1 M 1020.

The English courts had, he claimed, less power to alter penalties than the Scottish courts.<sup>24</sup> On the other hand Lord Justice Clerk Moncreiff was not so reticent in the use of English authority.<sup>25</sup> The issue was probably influenced by the decision of the House of Lords in *Lord Elphinstone v Monkland Iron and Coal Co Ltd*<sup>26</sup> in which Lord Fitzgerald in his speech said:<sup>27</sup>

"...the law of Scotland, which we are now administering, seems in this respect to agree in principle with the law of the rest of the United Kingdom; or it would be more correct to say that the law of Scotland in this respect existed in full force and equitable effect whilst we were struggling against the hard and technical rules of our common law."

He decided the case by reference to five English cases and one Irish case. English law was then adopted by the Second Division in *Commercial Bank of Scotland Ltd v Beale*,<sup>28</sup> the respondents having argued that since *Elphinstone* there was no difference between Scots and English law. This may have had a significant effect. At least it leads to one of the issues which has inspired this Discussion Paper. *Commercial Bank of Scotland Ltd v Beale* decided that the rules on penalty clauses did not apply to forfeiture of a deposit, following English cases. There were no Scots cases on the point. If the view had been taken that there was a general control of exorbitant payments, beyond any loss which could have been sustained, a different result might have been reached. By the time of the classic case of *Clydebank Engineering and Shipbuilding Co Ltd v Castaneda*<sup>29</sup> Lord Chancellor Halsbury could say:<sup>30</sup> "It is, I think, not denied now that the law is the same both in England and in Scotland."

2.12 Nevertheless some caution must continue to be used in the application of English authority, particularly in cases which involve forfeiture. Sheriff Substitute Allan G Walker observed:<sup>31</sup> "It is difficult for a Scottish lawyer to be certain that he understands the procedure whereby the Courts applied their equitable jurisdiction in these cases...". Lord Keith referred to "English principles of equity which are not familiar in Scotland".<sup>32</sup>

2.13 If the sum was an unenforceable penalty the claimant could seek damages. But could the damages exceed the penalty? It seemed to have been decided that the damages were limited to the amount of the penalty.<sup>33</sup> This was fair to the extent that a party who had inserted an invalid provision would otherwise benefit from the successful challenge of the clause. But in *Dingwall v Burnett*<sup>34</sup> the Second Division reinterpreted the law and held that a landlord's claim for damages of £300 was not limited by an unenforceable penalty of £50.

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<sup>24</sup> *Forrest & Barr v Henderson, Coulborn & Co* at 195, 196. See the history in McGregor, *Damages* (15th ed 1988) paras 435 to 438 and the review of the law by the High Court of Australia in *AMEV-UDC Finance Ltd v Austin* [1986] 162 CLR 170 at 186 to 195.

<sup>25</sup> *McElroy v Tharsis Sulphur and Copper Co* (1877) 5 R 161 at 167 (see cases cited by the pursuers which were followed); on appeal (1878) 5 R (HL) 171.

<sup>26</sup> (1886) 13 R (HL) 98.

<sup>27</sup> At 108.

<sup>28</sup> (1890) 18 R 80.

<sup>29</sup> (1904) 7 F (HL) 77.

<sup>30</sup> At 77.

<sup>31</sup> *Reid v Campbell* 1958 SLT (Sh Ct) 45 at 46.

<sup>32</sup> *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296 at 298.

<sup>33</sup> *Johnstone's Trs v Johnstone* 19 Jan 1819 FC; *Hyndman's Trs v Miller* (1895) 3 SLT 170; *Lord Elphinstone v Monkland Iron & Coal Co Ltd* at 108 per Lord Fitzgerald.

<sup>34</sup> 1912 SC 1097.

## The classic cases

2.14 There are two House of Lords decisions at the beginning of this century which are often taken as encapsulating the present law; one a Scottish appeal and the other an English appeal.

2.15 *Clydebank Engineering and Shipbuilding Co Ltd v Castaneda*<sup>35</sup> did not really alter Scots law. It was observed that the courts had to look at the substance of transactions. If a sum was proportionate to the rate of non performance it was prima facie liquidate damages. But an extravagant or unconscionable or exorbitant (all these terms were used) provision would not be enforced. The interesting feature was that the facts showed the value of an enforceable penalty.

2.16 The *Clydebank* case arose out of the second war against Spain for Cuban independence which started with a rebellion in 1895.<sup>36</sup> By two contracts in 1896 the Spanish Government contracted with a Clyde yard for the building of four torpedo boats. The time of delivery was very important to the Spanish navy. Between 6 1/2 and 7 3/4 months were allowed for delivery. The vessels were delivered from 20-46 weeks late. There was a penalty of £500 for each week of late delivery of each vessel. This sum was held to be an enforceable penalty clause. The Clyde yard had to pay £67,500, which was slightly more than the price of one torpedo boat.<sup>37</sup>

2.17 It is possible that if the Spanish government had been in a position in 1897 to establish a blockade around the coast of Cuba, the Cuban insurrection might have been crushed and American intervention avoided.<sup>38</sup> As it was America did intervene in 1898 and Spain, at the end of that year, relinquished its sovereignty over Cuba by the Treaty of Paris. But how would the loss arising from the late delivery of four ships be proved at common law?

2.18 As Lord Chancellor Halsbury commented:<sup>39</sup>

"Supposing there was no such bargain, and supposing the Spanish Government had to prove damages in the ordinary way without insisting upon the stipulated amount of them, just imagine what would have to be the cross examination of every person connected with the Spanish Administration such as is suggested by the commentaries of the learned counsel: 'You have so many thousand miles of coast line to defend by your torpedo-boat destroyers; what would four torpedo-boat destroyers do for that purpose? How could you say you are damaged by their non-delivery? How many filibustering expeditions could you have stopped by the use of four torpedo-boat destroyers?'

I need not pursue that topic. It is obvious on the face of it that the very thing intended to be provided against by this pactional amount of damages is to avoid that kind of minute and somewhat difficult and complex system of

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<sup>35</sup> (1904) 7 F (HL) 77.

<sup>36</sup> Some of the facts in this narration about the history of Cuba are not to be found in the case reports. See L A Perez, *Cuba Between Empires, 1878-1902* (Pittsburgh, 1982); L E Aguilar, "Cuba c 1860 - c 1930" in L Bethell (ed), *Cuba: A Short History* (1993). See also the facts as set out in the report of the *Clydebank* case at the time of its being considered by the Second Division (1903) 5 F 1016 at 1017-1018.

<sup>37</sup> Interest was also due for about four years from the date the action commenced in 1900. Cuba had been under American occupation and it became a Republic, in 1901, before this litigation was concluded.

<sup>38</sup> See *Clydebank* case (1903) 5 F 1016 at 1023 per Lord Ordinary (Lord Kyllachy). Whether this speculation is correct is, of course, part of the problem surrounding proof of loss.

<sup>39</sup> (1904) 7 F (HL) 77 at 78,79.

examination which would be necessary if you were to attempt to prove the damage. As I pointed out to the learned counsel during the course of his argument, in order to do that properly and to have any real effect upon any tribunal determining that question, one ought to have before one's mind the whole administration of the Spanish Navy - how they are going to use their torpedo-boat destroyers in one place rather than another, and what would be the relative speed of all the boats they possessed in relation to those which they were getting by this agreement. It would be absolutely idle and impossible to enter into a question of that sort unless you had some kind of agreement between the parties as to what was the real measure of damages which ought to be applied."

This clearly demonstrates the difficulties of proof, after the event. But it also may illustrate a fallacy in the present law. How could there have been a genuine pre-estimate of loss prior to the contract? The strong arguments about the difficulty of proof when the facts were known, suggest that an estimate of loss at the time of signing the contracts was impossible. It would have been even more difficult to predict the effect of late delivery than in the scenario considered by Lord Chancellor Halsbury. Yet the touchstone of the enforceable penalty clause is said to be its use as a genuine pre-estimate of loss and the *Clydebank* case has been cited as authority for that proposition.<sup>40</sup>

2.19 In the second case, *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*<sup>41</sup> part of Lord Dunedin's speech has been treated as describing the law in both England and Scotland. The terms of what he said are well known to those familiar with this area of law, but it is thought useful to repeat them here. He said:<sup>42</sup>

"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. This doctrine may be said to be found *passim* in nearly every case.

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 (*Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda*<sup>43</sup>).

3. 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 of as at the time of the making of the contract, not as at the time of the breach (*Public Works Commissioner v Hills*<sup>44</sup> and *Webster v Bosanquet*<sup>45</sup>).

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<sup>40</sup> See para 2.19.

<sup>41</sup> [1915] AC 79.

<sup>42</sup> At 86-88.

<sup>43</sup> (1904) 7 F (HL) 77.

<sup>44</sup> [1906] AC 368.

<sup>45</sup> [1912] AC 394.

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:

- (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. (Illustration given by Lord Halsbury in *Clydebank* case.)<sup>46</sup>
- (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 (*Kemble v Farren*<sup>47</sup>). This though one of the most ancient instances is truly a corollary to the last test. Whether it had its historical origins in the doctrine of the common law that when A promised to pay B a sum of money on a certain day and did not do so, B could only recover the sum with, in certain cases, interest, but could never recover further damages for non timeous payment, or whether it was a survival of the time when equity reformed unconscionable bargains merely because they were unconscionable, a subject which much exercised Jessel MR in *Wallis v Smith*<sup>48</sup> - is probably more interesting than material.
- (c) There is a presumption (but no more) that it is a penalty when 'a simple 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' (Lord Watson in *Lord Elphinstone v Monkland Iron and Coal Co*<sup>49</sup>).

On the other hand:

- (d) 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 the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties (*Clydebank Case*, Lord Halsbury<sup>50</sup>; *Webster v Bosanquet*, Lord Mersey<sup>51</sup>)."

## Recent developments

2.20 There have been three significant developments in Scottish cases this century. (1) The reaffirmation that the rules on penalty clauses do not apply to forfeiture of deposits; (2) clear decisions that the rules on penalty clauses apply only when there is a breach of contract; and (3) doubt about the application of the rules to hire purchase contracts when the hirer terminates early.

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<sup>46</sup> At 78.

<sup>47</sup> (1829) 6 Bing 141.

<sup>48</sup> (1882) 21 Ch D 243.

<sup>49</sup> (1886) 13 R (HL) 98.

<sup>50</sup> At 79.

<sup>51</sup> [1912] AC 394 at 398.

## Forfeiture of deposits

2.21 If a buyer pays a deposit of a purchase price and then, in breach of contract, fails to pay the balance of the price, the possibility arises that the seller may keep the deposit, resell the property, and claim damages. In these circumstances the forfeiture of the deposit is not, or is not normally, an unenforceable penalty.<sup>52</sup> We examine the details of this area of law later.<sup>53</sup>

## Breach of contract

2.22 An enforceable penalty is a form of agreed damages. Damages are due only for breach of contract. It may, therefore, not be surprising that the control of penalty clauses applies only when there is a breach of contract, and not, for example, when a contract is terminated early under its terms.<sup>54</sup> Whether this is a sensible result is something we discuss.<sup>55</sup>

## Hire purchase contracts

2.23 One aspect of the problem arising from the difference between breach and early termination has been the operation of the law to compensation payments (often called depreciation payments) made by a hirer under a hire purchase contract, when the owner repossesses the goods. There are several sheriff court cases, with differing results. These cases are important for present purposes because they illustrate the divergent views which may be held about the operation of penalty clauses. In the nineteenth century Scots law worked through the problems in cases in which tenants misbehaved. In the twentieth century the equivalent was defaulting hirers who had tried to buy motor vehicles. The difference is that the result of the recent analysis is more obscure.

2.24 The decision of the First Division in *Bell Brothers (HP) Ltd v Aitken*<sup>56</sup> involved a hire purchase of a motor car. If the owners retook possession, or the hirer terminated, the hirer had to pay "liquidated damages". These were calculated according to a formula which reflected the total hire charges under deduction of an allowance for the value of the car. This was very similar to the way the court would have assessed damages at common law. So there would have been no problem about treating the clause as enforceable. But the clause was seen by the court as not really a penalty, but as an agreed term for return of the vehicle.

2.25 The subsequent sheriff court decisions featured two problems. The first was that if the depreciation charge did not reflect the value of the vehicle returned, it could be an unenforceable penalty. For example, if the charge was calculated as a percentage of the total hire charges, there could be a considerable bonus to the owner, especially if the vehicle was repossessed early in the period of hire. The owner could sell the vehicle and claim a substantial proportion of the hire charges which would have been paid if the contract had been performed. The owner recouped, potentially, much more than the loss arising from the hirer's breach. The second problem was whether the rules in penalty clauses applied at all if the hirer exercised an option to terminate.

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<sup>52</sup> *Roberts & Cooper v Salvesen & Co* 1918 SC 794; *Reid v Campbell* 1958 SLT (Sh Ct) 45; *Zemhunt (Holdings) Ltd v Control Securities plc* 1992 SC 58.

<sup>53</sup> Para 5.3.

<sup>54</sup> *Bell Brothers (HP) Ltd v Aitken* 1939 SC 577; *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296; *EFT Commercial Ltd v Security Change Ltd* 1992 SC 414.

<sup>55</sup> Paras 4.12 to 4.24.

<sup>56</sup> 1939 SC 577.

2.26 The cases are conflicting. They reflect the tension between the various approaches to penalty clauses. In one of the early cases, *United Dominions Trust (Commercial) Ltd v Bowden*<sup>57</sup> Sheriff Substitute Archibald Hamilton enforced a provision that a hirer had to pay up to 75% of the total cost of hiring as agreed compensation for depreciation. There was a default by the hirer after one month of the term of two years. There was held to be a reasonable pre-estimate of damages because it was impossible to estimate the loss in advance. Loss depended on the creditworthiness of the debtor,<sup>58</sup> and the state of demand for the vehicle in the motor trade. This case was followed by Sheriff Substitute J V M Shields in *United Dominions Trust (Commercial) Ltd v Murray*.<sup>59</sup>

2.27 On the other hand there is a line of cases which held that the depreciation money was an unenforceable penalty because the sum varied with the payments which had been made and which were to be made, and did not reflect the condition of, and depreciation in the value of, the vehicle which was repossessed. The cases are *Mercantile Credit Co Ltd v Brown*,<sup>60</sup> *Union Transport Finance Ltd v McQueen*,<sup>61</sup> and *Bowmaker (Commercial) Ltd v McDonald*.<sup>62</sup> It is significant that in the first two of these cases the sheriff looked at what had happened. There was a comparison between what the owner would have received if the hire had run its full term, and what the owner did receive when the hirer defaulted. It is arguable that it was impermissible for the sheriff to consider anything other than the circumstances at the time of the contract. For example in the *Clydebank* case Lord Davey said:<sup>63</sup> "I hold it to be perfectly irrelevant and inadmissible for the purpose of showing the clause to be extravagant, in the sense in which I use that word, to admit evidence such as the learned counsel who has last addressed us has drawn our attention to, of the damages which were actually suffered by the Spanish government." On the other hand recently the Privy Council observed in *Philips Hong Kong Ltd v The Attorney General of Hong Kong*:<sup>64</sup> "The fact that the issue has to be determined objectively, judged at the date the contract was made, does not mean what actually happens subsequently is irrelevant. On the contrary it can provide valuable evidence as to what could reasonably be expected to be the loss at the time the contract was made."

2.28 The further problem was whether the law on penalty clauses applied at all if the hirer exercised an option to have early termination of the agreement. Sheriff Substitute Wilson in *Mercantile Credit Co Ltd v McLachlan*<sup>65</sup> held that when a hirer exercised an option there was not a breach of contract, and therefore the law on penalty clauses was inapplicable. The result troubled him because he thought that the provisions in the agreement before him were penal in nature. He said:<sup>66</sup>

"I have felt myself forced into this decision, which may well put a premium on dishonesty. The hirer who honestly admits that he cannot keep up payments and terminates his agreement may have to pay a penalty; his less responsible neighbour, who simply goes on failing to pay the instalments until the finance company is forced to take action, may escape. Like Harman LJ in *Campbell*

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<sup>57</sup> 1958 SLT (Sh Ct) 10.

<sup>58</sup> The sheriff referred, at 12, to the "value of their debtor."

<sup>59</sup> 1966 SLT (Sh Ct) 21.

<sup>60</sup> 1960 SLT (Sh Ct) 41.

<sup>61</sup> 1961 SLT (Sh Ct) 35.

<sup>62</sup> 1965 SLT (Sh Ct) 33.

<sup>63</sup> At 82,83.

<sup>64</sup> (1993) 61 BLR 41 at 59.

<sup>65</sup> 1962 SLT (Sh Ct) 58.

<sup>66</sup> At 59.

*Discount Co v Bridge* [1961] 2 WLR 596 I have felt myself oppressed by that consideration. But the remedy is for the legislature."

We return to the English case of *Campbell Discount Co Ltd* in a moment. A different view was taken by Sheriff Substitute C D L Murray in the *Brown* case. In a graphic illustration he said:<sup>67</sup>

"I do not consider that the defender's action in terminating the contract was 'voluntary'. If a man about to be put to death is given the option of shooting himself or being burned alive as the only two alternatives, and if he chooses the former, it would be unreal to say 'He voluntarily terminated his life by shooting himself.' In the present case, the pursuers had worded the agreement in such a manner that the hirer who was unable to pay his instalments was forced into a choice between two evils only, both of which included liability for the 'depreciation money'. Further, the document was so framed that a man of normal intelligence would naturally choose what was seemingly the lesser of the two evils - namely to terminate the hiring and thus stop the accumulating liability for further instalments of hire which he could not pay. The defender did so in this case."

Apart from the illogicality which may be inherent in the distinction between whether there is breach or, instead, not a breach but the exercise of an option, there may obviously be fine lines to be drawn. What type of breach entitles the hirer to claim the protection of the penalty clause rules? Must there be a material breach? Will any breach, other than trivial breach, suffice? Must the breach be linked to repossession of the vehicle, or could it relate to some incidental matter?

2.29 Similar issues arose in the English case of *Campbell Discount Co Ltd v Bridge*.<sup>68</sup> This was a case of early termination of an agreement for the hire purchase of a car. There was to be a payment of a sum equal to two thirds of the hire purchase price. The House of Lords held that the hirer was in breach of his obligations and the amount due was not a genuine pre-estimate of loss. The House remitted to the court of first instance to determine the amount of loss. The majority of their Lordships appear to have been of the view that if the hirer had exercised an option he would have been bound to pay the sum. In the Court of Appeal (which had taken a different view on the facts as to whether there had been the exercise of an option) Harman LJ had observed about the state of the law:<sup>69</sup>

"... I feel constrained to add a word or two because of the uneasy feeling I have that the position of the law as it stands is not satisfactory. If the judgement of the majority in the *Cooden Engineering* case<sup>70</sup> be right, then the position may be different according to whether there is somewhere behind the termination of the contract a breach by somebody. It has been pointed out quite rightly to us that it is unsatisfactory if the man who honestly admits to the finance company that he cannot go on may have to pay a penalty, but that if he waits for the finance company to exercise their rights and in the meanwhile breaks the contract, he

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<sup>67</sup> 1960 SLT (Sh Ct) 41 at 43.

<sup>68</sup> [1961] 1 QB 445; [1962] AC 600.

<sup>69</sup> [1961] 1 QB 445 at 458.

<sup>70</sup> *Cooden Engineering Co Ltd v Stanford* [1953] 1 QB 86.

may be able to escape paying it on the ground that penalty for breach of contract is not enforceable in law. I have felt myself oppressed by that consideration."

In the context of the same problem in Northern Ireland it has been said:<sup>71</sup>

"This, however, is the legal position as I understand it. And if this view is correct, the anomaly and any injustice which it may involve can, I fear, only be corrected - if it is thought that they ought to be corrected - by the legislature."

2.30 The law on hire purchase is now affected, in many, but not all, instances, by statutory provisions.<sup>72</sup> Nevertheless the conflicting cases illustrate the type of problem which must be solved if the common law is to be reformed. Also there are hire, and hire-purchase, contracts which are outside the scope of the statutory provisions. For example, section 132 of the Consumer Credit Act applies only when an individual<sup>73</sup> hires goods for more than three months and the payments do not exceed £15,000.

### **Hire contracts**

2.31 Part of the Faculty of Advocates' concern, which prompted their suggestion that we look at this area of law, was the terms of contracts for the hire of photocopiers which have been the subject of recent litigation in the Scottish courts.<sup>74</sup> Although in only one of the cases cited was the issue of penalty clauses directly considered by the court, and then only in an obiter dictum by a Lord Ordinary,<sup>75</sup> the terms of the somewhat obscure contracts<sup>76</sup> suggest the potential for problems. A standard form for lease of a photocopier may have elaborate provisions about early termination of the contract, with penalty clauses and a provision for entry to the premises where the copier was installed with a right to take possession of the copier. These clauses could raise many of the issues of present concern - whether the contractual provisions provide for an enforceable or unenforceable penalty, the effect of a breach or alleged termination, and the forfeiture of rights to use property.

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<sup>71</sup> *Lombank Ltd v Kennedy* [1961] NI 192 at 215 per Black LJ.

<sup>72</sup> Consumer Credit Act 1974, s 93, s 100, s 132.

<sup>73</sup> Including sole traders and partnerships. See ss 15 and 189.

<sup>74</sup> Eg *Eurocopy Rentals Ltd v McCann Fordyce* 1994 SLT (Sh Ct) 63; *Common Services Agency v Purdie and Kirkpatrick Ltd, Eurocopy (Scotland) plc v Lothian Health Board* 1995 SLT (Sh Ct) 34, 1995 SLT 1356; *Eurocopy Rentals Ltd v Tayside Health Board* 1996 SLT 224, 1996 SLT 1322.

<sup>75</sup> *Eurocopy Rentals Ltd v Tayside Health Board* 1996 SLT 224 per Lord Coulsfield at 228-229. His Lordship's opinion was that the clause was an unenforceable penalty.

<sup>76</sup> See opinion of Sheriff Principal Nicholson in *Common Services Agency* especially at 40: "I consider it to be one of the more bizarre and ill drafted documents that I have ever seen."

2.32 The photocopier cases also illustrate a feature to be found in many of the Scottish cases on penalty clauses. The parties to the contracts do not include individual consumers. Nor is it evident that the party subject to harsh provisions was suffering from an inequality of bargaining power.<sup>77</sup> In some instances the problems arise because businesses do not in reality negotiate the details of every contract. In the words of Diplock LJ, "so often one party cannot satisfy his contractual hunger a la carte but only at the table d'hote of a standard printed contract".<sup>78</sup>

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<sup>77</sup> In several cases the party was a Health Board. See *Common Services Agency* and the unreported sheriff court cases referred to by Sheriff Principal Nicholson.

<sup>78</sup> *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428 at 1447.

## Part 3 Advantages of enforcement within limits

### Introduction

3.1 Before consideration of criticisms of the present law, there should be an analysis of its strengths. It may be that it is not the basic approach of the law - enforcement within limits - that needs reform so much as the precise way in which the line between enforceable and unenforceable clauses is drawn.<sup>1</sup>

### Why should penalty clauses be enforced?

3.2 The arguments which might be stated in favour of the enforceability of penalty clauses include the general principle that contracts should be respected; the desirability of encouraging performance; and the reduction of uncertainty.<sup>2</sup> These merit consideration at greater length.

(1) Contracts reflect the agreement of the parties and contracts should be enforceable. As it was said in the judgment of the Supreme Court of Canada in *Elsley v J G Collins Insurance Agencies Ltd*:<sup>3</sup>

"It is now evident that the power to strike down a penalty clause is a blatant interference with freedom of contract and is 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 *Export Credits Guarantee Department v Universal Oil Products Co*<sup>4</sup> Lord Roskill observed:<sup>5</sup>

"My Lords, one purpose, perhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant. But it is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an onerous or possibly even a commercially imprudent bargain."

Even if the penalty does overcompensate, the courts should enforce a bad bargain. The courts do not normally inquire into the price payable under a contract;<sup>6</sup> nor should they inquire into

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<sup>1</sup> The Law Commission for England and Wales in *Penalty Clauses* did not propose any radical change to the law but did, amongst other issues, suggest alteration to the law on sums payable otherwise than on breach and to the law on forfeiture of monies paid.

<sup>2</sup> See McBryde, *Remedies* p 74; R Zimmermann, "Stipulatio Poenae" (1987) 104 SALJ 399 discusses the functions of penalties in Roman law. See also Mattei, "The Comparative Law and Economics of Penalty Clauses in Contracts" 43 Am J Comp L (1995) 427.

<sup>3</sup> (1978) 83 DLR (3rd) 1 at 15.

<sup>4</sup> [1983] 1 WLR 399.

<sup>5</sup> At 403.

<sup>6</sup> *McKirdy v Anstruther* (1839) 1 D 855 per Lord Gillies at 863; *McLachlan v Watson* (1874) 11 SLR 549 per Lord Mackenzie at 550, per Lord Ardmillan at 551; *Caledonian Ry Co v N British Ry Co* (1881) 8 R (HL) 23 per Lord

the agreed sums payable when a contract is breached. It would be illogical, for example, to refuse to consider whether daily payments to a contractor to remain on site are excessive;<sup>7</sup> but, on the other hand, to examine similar payments which had to be made by a contractor whose work was delayed. It is not the function of the law on penalties to provide a remedy for errors of financial judgment. The South African Conventional Penalties Act 1962, the Unidroit rules and the Lando Commission rules all start with the proposition that the agreement of the parties should be enforced. This is then qualified in stated circumstances. There is much to be said in favour of this approach.

(2) It has been recognised that penalty clauses have a coercive effect and that they may encourage performance of a contract. Bell referred to a penalty clause as "truly an instrument of restraint"<sup>8</sup> and to a penalty clause attached to an obligation to perform, or not to perform, as intended "to enforce, by more than the usual consequences, what the party is anxious to secure".<sup>9</sup> Kames described a penalty as "a spur on the debtor to perform."<sup>10</sup> This is the traditional Civil Law approach; it may also agree with one commercial view of the function of penalty clauses.<sup>11</sup> Whether it is consistent with the concept of a genuine pre-estimate of loss is debatable. As we explain later<sup>12</sup> the introduction of the pre-estimate test was due to Scottish judges, not as often thought because of common law influences alien to a Civilian tradition. The recognition that there may be value in the coercive force of penalty clauses appears to have been one of the motivations for the South African Conventional Penalties Act 1962 which starts in section 1 with the principle that a penalty stipulation should be enforced when it is either a penalty or liquidated damages. Also penalty clauses are common in standard form building contracts and, as demurrage clauses, in charterparties, and yet there is a notorious dearth of reported litigation about the validity of these clauses.<sup>13</sup> The reality may be that the clauses appear in the correct form for an enforceable clause, ie they are proportionate in effect according to the nature of the breach. The sums specified may not really be a genuine estimate of loss - the issue may not be fully considered or negotiated - but the coercive nature of these clauses fulfils a valid commercial function which the law should recognise.<sup>14</sup>

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Blackburn at 31: "If a man chooses to bargain that he will pay ten times the value of a thing I do not think you have, in the absence of undue influence, any right to cut down the price to the tenth part of what was agreed upon."

<sup>7</sup> *Robertson Construction Co (Denny) Ltd v Taylor* 1990 SLT 698.

<sup>8</sup> *Bell Commentaries* 1, 700; *Clydebank* case (1904) 7 F (HL) 77 at 84 per Lord Robertson.

<sup>9</sup> *Commentaries* 1, 699.

<sup>10</sup> *Principles* p 378.

<sup>11</sup> H Beale, *Remedies for Breach of Contract* (1980) (hereafter *Remedies*) p 53: "There can be little doubt that in commercial circles the agreed damages provision is viewed as a form of incentive provision. The law takes a slightly different viewpoint." Also at p 57.

<sup>12</sup> At para 4.4.

<sup>13</sup> McGregor, *Damages* refers to one type of demurrage clause at para 485: "The true analysis has also been obscured by the long acceptance of demurrage clauses even before liquidated damages clauses in general were accepted and understood. The result has been that this type of clause has never gone through an express testing in the courts, but there can be no doubt that it is properly held to constitute liquidated damages since the sum is payable on one form of breach and is graduated in line with the size of that breach." I N Duncan Wallace, *Hudson's Building and Engineering Contracts* (11th ed 1995) para 10-092 states: "... virtually no cases are reported in England or the Commonwealth in which periodical fixed sums stipulated as damages for delay in completion by the contractor have been invalidated as being excessive. Periodical fixed sums are undoubtedly acceptable in principle in construction contracts as a means of pre-estimating this class of damage, and will be enforced whether or not any damage has as a fact been incurred, or, if it has, regardless of its extent." See also at para 10-021.

<sup>14</sup> It is also notoriously difficult to obtain valid empirical evidence about attitudes to clauses in contracts. Beale and Dugdale in "Contracts between businessmen; planning and the use of contractual remedies" (1975) 2 BJLS 45 found that engineering firms in the Bristol area did not often use penalty clauses because of difficulties in negotiation and enforcement. The survey was small and limited in scope, and it is now dated. It and this issue are discussed in T A Downes, "Rethinking Penalty Clauses" in P Birks (ed), *Wrongs and Remedies in the Twenty First Century* (1996) 249 at 266-267. See also Beale, *Remedies* pp 58-59.

(3) Penalty clauses reduce uncertainty as to the the amount of damages which might be awarded. This limits the expense and delay arising from a dispute.<sup>15</sup>

"... [T]he court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld. Any other approach will lead to undesirable uncertainty especially in commercial contracts."<sup>16</sup>

The clauses are of particular value when it is difficult to estimate the loss caused by a breach, for example, when there is a delay in completion of a contract to supply a warship,<sup>17</sup> or to build a school or a reservoir, or to construct a road,<sup>18</sup> or when the loss caused by an employee setting up a competing business may be awkward to calculate;<sup>19</sup> or similarly when there is breach of a prohibition on selling tea to third parties;<sup>20</sup> or when the nature and effect of a breach may be unpredictable, eg when there is a contract to remove standing timber and it cannot be foreseen which trees, in which site, might be left standing with what effect on amenity, sport or estate management.<sup>21</sup> As that last example illustrates a penalty clause might be used to allow recovery of loss which otherwise could be regarded as speculative or too remote.

### Should all penalty clauses be enforced?

3.3 If penalty clauses are generally of value, the question arises as to whether there is any case for enforcing every penalty clause. It might be suggested that, subject to such rules as exist on unfair terms in contracts,<sup>22</sup> all agreed terms in a valid contract should be enforced.

3.4 The proposition can be tested by looking at the cases in which the Scottish courts have refused to enforce a penalty clause. These cases include:

- (1) miscropping cases;<sup>23</sup>
- (2) cases on penalties in bonds;<sup>24</sup>
- (3) cases on sums payable under indentures of apprenticeship;<sup>25</sup>
- (4) cases where a large lump sum is payable for any breach of contract, however slight;<sup>26</sup>
- (5) cases where the amount of the penalty for delay in supplying an item is close to the value of the item to be supplied;<sup>27</sup>
- (6) cases where it is almost impossible for the contracting party to avoid the penalty;<sup>28</sup>

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<sup>15</sup> Eg *Clydebank* case (1904) 7 F (HL) 77 at 78 per L C Halsbury.

<sup>16</sup> *Philips Hong Kong Ltd v The Att Gen of Hong Kong* (1993) 61 BLR 41 at 59 (PC).

<sup>17</sup> *Clydebank* case.

<sup>18</sup> *Philips Hong Kong* case.

<sup>19</sup> *Page v Sherratt* (1908) 15 SLT 731.

<sup>20</sup> *Webster v Bosanquet* [1912] AC 394.

<sup>21</sup> *Cameron-Head v Cameron & Co* 1919 SC 627.

<sup>22</sup> In particular under the Unfair Contract Terms Act 1977 and the Unfair Terms in Consumer Contracts Regulations 1994 (SI 1994/3159).

<sup>23</sup> Paras 2.7 to 2.9.

<sup>24</sup> Para 2.4.

<sup>25</sup> Para 2.5.

<sup>26</sup> *Craig v McBeath* (1863) 1 M 1020; *Dingwall v Burnett* 1912 SC 1097.

<sup>27</sup> *Forrest and Barr v Henderson, Coulborn & Co* (1869) 8 M 187.

- (7) hire purchase cases;<sup>29</sup>
- (8) other miscellaneous cases where the clause involves payment of a sum which is clearly beyond any loss which might be suffered.<sup>30</sup>

When the cases dealing with these matters are examined it can be seen that the control over penalty clauses is not a purely theoretical matter in Scots law. Nor did most of the cases involve consumer contracts. Although there is statutory control over certain types of clauses in contracts with consumers which might have a penal effect,<sup>31</sup> the problem remains of what otherwise the law should be.<sup>32</sup>

3.5 The cases of *Forrest and Barr*<sup>33</sup> and *Robertson*<sup>34</sup> can be used to illustrate the policy of the present law.

3.6 The substance of the problem in *Forrest and Barr* was that the penalty for a delay produced an amount which was close to the value of the item supplied. There was a contract to supply and erect a crane. The crane cost £2000. For late performance the penalty was £20 per day. When there was a delay of 75 days, the penalty claimed was £1,500. The question whether or not this was exorbitant was left to a jury (which awarded damages of £100). There was evidence that the reason for the amount of the penalty was a security for fulfilment of the contract because of a history of delay. If the delay had been 100 days, one party could have obtained a crane free of charge. An even longer period of delay would have produced the result that the supplier would have had to install the crane for nothing and pay sums by way of penalty. If the law allowed enforcement of any penalty the paradoxical result can be reached that one party to the contract would wish a breach of contract, because more is gained from breach than from performance.

3.7 *Robertson* involved a penalty of £2 per day for each day work on a house was unfinished. The problem was that the contractor had a very limited time to finish the work - three days for some of the tasks. Lord Justice Clerk Moncreiff said:<sup>35</sup> "The Court will not enforce a penalty where the thing undertaken could not possibly be done in the time." Lord Young observed:<sup>36</sup>

"But if, again, the penalty be truly a penalty - that is, a punishment -the Court will not allow that, because the law will not let people punish each other. They may contract that the one will be bound to reimburse the other for any loss

<sup>28</sup> *Robertson v Driver's Trs* (1881) 8 R 555.

<sup>29</sup> Paras 2.23 to 2.30; see also the obiter of Lord Coulsfield in *Eurocopy Rentals Ltd v Tayside Health Board* 1996 SLT 224 at 228-229 (hire of a photocopier).

<sup>30</sup> See eg *Watson v Noble* (1885) 13 R 347; *Chris Hart (Business Sales) Ltd v Mitchell* 1996 SLT (Sh Ct) 132; *Wirral Borough Council v Curry's Group plc*. (OH) Lord Hamilton 29 April 1997 unrep but see 1997 GWD 19-900.

<sup>31</sup> See paras 2.30, 3.7 and 4.17. Other statutory controls are mentioned at paras 2.4 and 2.9.

<sup>32</sup> It is noteworthy that the Uncitral and Unidroit rules are confined to commercial contracts. The Council of Europe Resolution, and the provisions of many civilian codes, apply to all penal clauses, while allowing special provision for particular types of contracts.

<sup>33</sup> (1869) 8 M 187.

<sup>34</sup> (1881) 8 R 555.

<sup>35</sup> At 561.

<sup>36</sup> At 562. See also *Craig* (1863) 1 M 1020 at 1022 per LJC Inglis, "Parties cannot lawfully enter into an agreement that the one party shall be punished at the suit of the other." Gloag, *Contract* p 339 took the view that the case involved an ambiguity, but that does not appear to have been the ground of decision. *Steel v Bell* (1900) 3 F 319 has been contrasted to *Robertson*, but the facts and the terms of the contract were very different of Gloag, *ibid*; J M Arnott and W J Wolffe, "Building Contracts" in *The Laws of Scotland: Stair Memorial Encyclopaedia* (hereafter *Stair Encyclopaedia*) vol 3 para 111.

caused, but not for punishment. Anything beyond compensation, which is a reasonable enough penalty, is punishment, and will not be enforced. That is the result of all the decisions."

The court in *Robertson* looked at the substance of what was involved and refused to enforce an agreement which was impossible to implement. The decision illustrates that the Scottish courts will not enforce a contract at any cost, an attitude also reflected in the discretions which apply under the modern law when the remedy of specific implement is sought.<sup>37</sup> The Court of Session may also have a discretion, in exceptional circumstances, to withhold a remedy.<sup>38</sup> In two cases involving moneylending contracts at the turn of the century the Court of Session refused at common law to enforce extortionate bargains.<sup>39</sup> For example, in the second of these cases a crofter had borrowed £25, had paid back £198 and was being sued for a further £33, with interest. The case was referred to by Lord Kincairney as "gross and scandalous".<sup>40</sup> It was held that the court will not enforce a manifestly extortionate agreement. There was a reference to the "similar principle" which applied to penalty clauses.<sup>41</sup> There is now statutory control of some extortionate credit bargains.<sup>42</sup>

3.8 The control over penalty clauses might possibly be regarded as part of a general control in Scots law of extortionate or unconscionable provisions, but the law has not received any detailed and systematic analysis or exposition.<sup>43</sup> What does seem clear is that the removal of all control over penalty clauses would be likely to lead to results which

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<sup>37</sup> McBryde, *Contract* paras 21-08 to 21-12.

<sup>38</sup> *Grahame v Magistrates of Kirkcaldy* (1882) 9 R (HL) 91 at 91-92 per Lord Watson; *Wilson v Pottinger* 1908 SC 580; *Plato v Newman* 1950 SLT (Notes) 29; *White and Carter (Councils) Ltd v McGregor* 1962 SC (HL) 1 at 14 per Lord Reid; *Salaried Staff London Loan Co Ltd v Swears and Wells Ltd* 1985 SC 189; *Anderson v Brattisanni's* 1978 SLT (Notes) 42; *Stockton Park (Leisure) Ltd v Border Oats Ltd* 1990 SC 209; *Cameron v Lighthouse* 1996 SLT 1038.

<sup>39</sup> *Young v Gordon* (1896) 23 R 419; *Gordon v Stephen* (1902) 9 SLT 397; see also *United Dominions Trust Ltd v McDowell* 1984 SLT (Sh Ct) 10 in which the sheriff refused to enforce a loan agreement when the rate of interest was calculated by him to be 75% per annum - he was reversed on appeal because he had no power in an undefended action to dismiss the claim *ex proprio motu*.

<sup>40</sup> At 398.

<sup>41</sup> At 398.

<sup>42</sup> Consumer Credit Act 1974, ss 137-140.

<sup>43</sup> But see W W McBryde, "Extortionate Contracts" (1976) 21 JLSS 322-325; McBryde, *Remedies* pp 54-55. Note also how the law has developed in Australia with a tendency towards a control of oppression *AMEV-UDC Finance Ltd v Austin* [1986] 162 CLR 170; Law Reform Commission of Victoria, *Liquidated Damages* paras 35, 36 which recommended that the courts should be given a power to set aside an agreed damages clause which was unconscionable in all the circumstances.

would be regarded as particularly unconscionable. Our conclusion is that it would be a retrograde step if every control over penalty clauses in Scots law was removed.

# Part 4 Main criticisms and proposals

## Introduction

4.1 There are two main criticisms of the present law. The first is that the distinction between penalty clauses and liquidated damages is an unsuitable test. It is difficult to apply in some cases and it results in some provisions being struck down as unenforceable when it would be reasonable to enforce them. The second is that the control over penalty clauses is too limited because it arises only when there is a breach of the contract. Cases can occur where an oppressively penal sum is payable, not on breach, but in other circumstances such as insolvency or the exercise of an option to terminate or to perform in one way rather than another.

## The standard by which a penalty is judged

4.2 In *Dunlop Pneumatic Tyre Co Ltd* Lord Dunedin said:<sup>1</sup>

"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."

This approach appears inaccurate. The phrase "*in terrorem*" has been subject to both judicial and academic criticism. Lord Radcliffe in *Campbell Discount Co Ltd* observed about the phrase:<sup>2</sup>

"It obscures the fact that penalties may quite readily be undertaken by parties who are not in the least terrorised by the prospect of having to pay them and yet are, as I understand it, entitled to claim the protection of the court when they are called upon to make good their promises."

Professor McBryde has argued that "it is difficult to imagine most 'penalty' clauses producing fright, fear, dread, panic or terror". He said:<sup>3</sup>

"Lord Chancellor Halsbury in the *Clydebank Engineering Co* case gave us an example of a penalty, the payment of a million for failure to build within a year a house for £50.<sup>4</sup> The knowledgeable party would not be terrorised by this at all, because he would know that it was unenforceable. But the closer the penalty is to the probable amount of actual loss, the greater the pressure on the party in breach, because the greater the difficulty in successfully challenging the clause. It does not aid practitioners much to ask themselves the question: 'is the clause *in terrorem*?' That test works when the result is obvious, but does not help in the

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<sup>1</sup> [1915] AC 79 at 86.

<sup>2</sup> [1962] AC 600 at 622.

<sup>3</sup> *Contract* para 20-133.

<sup>4</sup> (1904) 7 F (HL) 77 at 78.

borderline cases. Nor anyway is the existence of terror necessary for a successful challenge of a clause."<sup>5</sup>

4.3 The genuine pre-estimate of damage test is also difficult to apply in some cases. An advantage of penalty clauses is that they can be used when it is not possible to have a pre-estimate of loss, or when proof of actual loss would be very difficult. The *Clydebank* case is a prime example. The loss to the Spanish government caused by the late delivery of warships was very difficult, if not impossible, to estimate, either prior to or after the contract. A similar argument can be applied to some public works contracts.<sup>6</sup> The reality may be that the amount put in some penalty clauses is arbitrary, but the clause will be enforced unless the payment is out of all proportion to any possible loss. The genuine pre-estimate test may, in practice, be abandoned.

4.4 As our history of the Scottish law on this subject demonstrates, the true test may be whether the provision is exorbitant or extortionate or extravagant or unconscionable.<sup>7</sup> The origins of the "genuine pre-estimate" test are said to lie in the opinion of Lord Kyllachy, the Lord Ordinary, in the *Clydebank* case.<sup>8</sup> His words were adopted in Lord Robertson's speech in that case<sup>9</sup> and the phrase appeared in Lord Dunedin's speeches in *Public Works Commissioner v Hills*<sup>10</sup> and in *Dunlop Pneumatic Tyre Co.*<sup>11</sup> Thus through the comments of three Scottish judges, the "genuine pre-estimate" test became part of the law in England, an Empire and then a Commonwealth.

4.5 South African law, after conflicting decisions, was made the same as English law by the decision of the Privy Council in *Pearl Assurance Co v Government of the Union of South Africa*.<sup>12</sup> After some harsh judicial criticism<sup>13</sup> the distinction between liquidated damages and unenforceable penalties was removed by the Conventional Penalties Act 1962.<sup>14</sup> This Act provided for the enforceability of all stipulations, whether by way of penalty or liquidated damages. It was thus recognised that clauses may be coercive in their effect and an estimate of damages is not necessary for an enforceable clause. There was a control over excessive penalties in these terms:<sup>15</sup>

"If upon the hearing of a claim for a penalty, it appears to the court that such penalty is out of proportion to the prejudice suffered by the creditor by reason of the act or omission in respect of which the penalty was stipulated, the court may reduce the penalty to such extent as it may consider equitable in the circumstances: Provided that in determining the extent of such prejudice the court shall take into consideration not only the creditor's proprietary interest,

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<sup>5</sup> Citing Lord Radcliffe, *Campbell Discount Co Ltd*, cited above.

<sup>6</sup> See para 3.2(3).

<sup>7</sup> Paras 2.3, 2.4 and 2.15.

<sup>8</sup> (1902) 5 F 1016 at 1022. See the derivation mentioned in McGregor on *Damages* para 442. In fact references to an estimate of damages appear in earlier Scottish cases eg *Forrest and Barr* (1869) 8 M 187 at 193 per LP Inglis.

<sup>9</sup> (1904) 7 F (HL) 77 at 84.

<sup>10</sup> [1906] AC 368 at 375, 376.

<sup>11</sup> [1915] AC 79 at 87.

<sup>12</sup> [1934] AC 570. See R H Christie, *The Law of Contract in South Africa*, (3d ed Durban 1996) pp 618-623.

<sup>13</sup> In *Tobacco Manufacturers Committee v Jacob Green and Sons* 1953 (3) SA 480 (A) at 493 Van den Heever JA described the *Pearl Assurance* decision as a "blemish on our legal system which militates against good faith, trust and business morality." The Privy Council was the highest court for the Union of South Africa until 1950.

<sup>14</sup> It was also the intention of the Indian Contract Act 1872 s 74, before amendment, to abolish the distinction between a penalty and liquidated damages. This was incorporated into the Cyprus Law of Contract (cap 149 of the Laws of Cyprus) 1930 s 74.

<sup>15</sup> s 3.

but every other rightful interest which may be affected by the act or omission in question."

There was also a control on damages and penalties being exacted in respect of the same event.<sup>16</sup> The Act does not define "penalty," although (1) forfeiture stipulations are treated as penalty stipulations,<sup>17</sup> and (2) as mentioned, the court is given a discretion on what is equitable. These issues have featured in subsequent case law.<sup>18</sup>

4.6 When the Law Commission for England and Wales considered this topic in their 1975 Working Paper<sup>19</sup> they observed: "If it was a genuine pre-estimate then this, we think, comes to much the same thing as saying that it was reasonable."<sup>20</sup> They cited the 1973 Recommendation on Liquidated Damages by the California Law Revision Commission which proposed that "a contractual stipulation of damages should be valid unless found to be unreasonable...".<sup>21</sup> The American Restatement (Second) of Contracts also uses a reasonableness test. It provides:

"Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."<sup>22</sup>

4.7 We doubt whether the validity of a penalty clause in Scotland should be judged by a criterion of reasonableness.<sup>23</sup> The policy of the law has been to strike a balance between the need to enforce contracts, and to have some certainty, on the one hand, and the reluctance to have the courts use their powers to compel extortion on the other hand. To move to a standard of reasonableness may be tipping the balance too far in favour of judicial intervention, although there are now precedents in other areas<sup>24</sup> and, as we have seen, there are examples in comparative law. The Council of Europe in their Resolution on Penal Clauses in Civil Law used the term "manifestly excessive."<sup>25</sup> They made this interesting commentary on the criteria which the courts might use:<sup>26</sup>

"The main purpose of the clause (i.e. to discourage litigation) would be lost if the court could set it aside too easily, and the court should therefore exercise its power with much discretion. In order to indicate the exceptional character of judicial intervention a number of formulae have been discussed. In addition to the term proposed, namely 'manifestly excessive,' other terms such as 'exorbitant', 'unconscionable' (in French '*abusive*'), 'unreasonable', were considered. However, the term 'exorbitant' was felt to restrict too narrowly the

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<sup>16</sup> s 2.

<sup>17</sup> s 4.

<sup>18</sup> Christie, *The Law of Contract in South Africa*, (3d ed Durban 1996), pp 618-623; A J Kerr, *The Principles of the Law of Contract* (4th ed Durban 1989) pp 598-607; *Sun Packaging (Pty) Ltd v Vreulink* 1996 (4) SA 176 (A).

<sup>19</sup> The Law Commission, *Penalty Clauses*.

<sup>20</sup> Para 29.

<sup>21</sup> See also the California Law Revision Commission *Recommendations* of 1975 and 1976.

<sup>22</sup> s 356.

<sup>23</sup> Or some similar term like "fair and reasonable". See eg the Unfair Contract Terms Act, ss 16(1), 17(1), 18(1), 24.

<sup>24</sup> Notably in the Unfair Contract Terms Act 1977 and the Unfair Terms in Consumer Contracts Regulations 1994. Also restraint of trade clauses are subject, at common law, to a test based on what is reasonable. See McBryde on *Contract* paras 25-62 to 25-98.

<sup>25</sup> Article 7.

<sup>26</sup> Explanatory Memorandum, art 7 (para 24).

power of judicial review; the term 'unconscionable' was considered insufficiently precise within the context of judicial review of penal clauses; the term 'unreasonable' in English was found when used in this connection to have no acceptable equivalent in French legal terminology. The committee therefore finally decided in favour of the term 'manifestly excessive', which is in fact already used in the existing legislation of some member states."

4.8 The Unidroit rules state that specified sums are payable irrespective of actual loss. There may be a reduction of that sum if it is "grossly excessive".<sup>27</sup> The Lando Commission adopts the same phrase.<sup>28</sup> There would be great advantage in having a rule in Scotland which was compatible with that in other European countries, and consistent with recent analysis. We are provisionally of the view that the test should be expressed as "grossly excessive" but other formulations are possible<sup>29</sup> and we would be grateful for the views of consultees on this point. It should be noted that one result of such a change would be to abandon the "genuine pre-estimate" test and to make penalty clauses easier to enforce. On the other hand, other reforms we suggest would extend the areas in which the doctrine of penalty clauses would operate.

4.9 If the standard is "grossly excessive" the question arises - excessive compared with what? Most legislative provisions appear to avoid the issue.<sup>30</sup> The South African Conventional Penalties Act<sup>31</sup> provides that the power of reduction exists if it appears that the penalty is "out of proportion to the prejudice suffered by the creditor by reason of the act or omission in respect of which the penalty was stipulated". One problem is whether there should be a comparison with the aggrieved party's *actual* loss or his *recoverable* loss.<sup>32</sup> The distinction is important if rules on remoteness or mitigation control recoverable loss. It is difficult to believe that a payment would be excessive when it is similar to the actual loss which has arisen. To have regard to actual loss, however, assumes a point which we discuss later;<sup>33</sup> that it should be competent to consider circumstances since the time of the contract. Any view on how to determine what is excessive must be conditional on the factors which can competently be examined.

4.10 There is a further problem with any detailed statement about what a penalty is. It may make it more difficult for a person who challenges a penalty to aver and prove that there is a penalty. If it must be shown that the penalty is excessive compared to actual loss, that poses a practical problem for the person who has not suffered that loss, but who is the person challenging the penalty. In Scottish procedure insufficient averment in written pleadings of the other party's loss, or absence of evidence during proof, could result in failure of a challenge. This might be so even when it is obvious that the penalty is excessive eg when it relates to money lending and the loss to the lender cannot be anywhere near the amount claimed. Onus of proof, which we discuss later,<sup>34</sup> might provide some solution; but we are provisionally of the view that the onus of proof should lie on the person who contends that the penalty should not be enforced. The result is that it may be that the statement about what is a penalty should be

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<sup>27</sup> Unidroit, art 7.4.13.

<sup>28</sup> Lando Commission, art 4.508.

<sup>29</sup> Including the "manifestly excessive" favoured by the Council of Europe. We doubt whether there would be much difference in practice between these two formulations.

<sup>30</sup> Treitel, *Remedies* pp 224-225.

<sup>31</sup> s 3.

<sup>32</sup> Treitel *ibid*.

<sup>33</sup> Paras 5.25 to 5.28.

<sup>34</sup> Paras 5.30 to 5.40.

brief to minimise the difficulties of challenge, and to allow the courts some flexibility. Perhaps that is a reason why other countries' legislatures have not tried to elaborate on the definition of penalty. On balance, we think that there would be more disadvantages than advantages in requiring a comparison to be made with actual loss.

### Questions for consideration

4.11 We would welcome responses to the following questions.

1. (a) **Should the agreement of contracting parties on a penalty be enforceable in all cases, or in no cases, or should there be some judicial control?**
- (b) **If there should be some judicial control, should the criterion for its exercise be that the penalty is grossly excessive (our provisional preference) or should there be some other criterion?**
- (c) **If some other criterion is preferred, what should it be?**

### Breach of contract

4.12 We have mentioned earlier the problem which has arisen in hire purchase cases where the difference between a breach by the hirer and the exercise of an option to terminate has produced a variety of judicial reactions, including criticisms of the present law.<sup>35</sup> That the law on penalties applies only on breach was affirmed by the House of Lords in *Export Credits Guarantee Dept v Universal Oil Products*.<sup>36</sup> The law favours the party who acts in breach compared to the party who complies with the terms of the contract. The party in breach can claim a judicial control over a penalty; the other party cannot.

4.13 The problem has also been illustrated in Scotland by two cases involving claims arising on the appointment of a liquidator or a receiver - *Granor Finance Ltd v Liquidator of Eastore Ltd*<sup>37</sup> and *EFT Commercial Ltd v Security Change Ltd*.<sup>38</sup> In the second case Lord Weir observed:<sup>39</sup> "While recognising that there may be an anomaly in these circumstances, I do not consider that the court in the absence of clear authority can or should innovate on the law." Lord Caplan said:<sup>40</sup> "I think it has to be acknowledged that in practice the difference between the rights available on a breach of contract and the rights which may be available by agreement in other circumstances

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<sup>35</sup> Paras 2.28 to 2.29; see also the observations on South African law in the recent decision of the Appellate Division in *Sun Packaging (Pty) Ltd v Vreulink* 1996 (4) SA 176 (A) at pp 182, 183 where the link between a penalty and breach it was observed "may give rise to a quaint state of affairs, namely a debtor who, in order to avoid or reduce liability, contends that he breached his contractual obligation. But that is the effect of the Act." In that a case an employer contended that a provision for compensation to an employee on premature termination of the contract of employment was a penalty and out of all proportion to the loss suffered by the employee. The clause was held not to be a penalty stipulation even although an employer who had acted in breach of contract would have been in a better position.

<sup>36</sup> [1983] 1 WLR 399; see also *Jervis v Harris* [1996] 2 WLR 220 per Millett LJ at 229.

<sup>37</sup> 1974 SLT 296.

<sup>38</sup> 1992 SC 414.

<sup>39</sup> At 431.

<sup>40</sup> At 434.

can give rise to anomalies. However the court must apply the law as it stands." On the other hand Lord President Hope referred to the principle of freedom of contract. He said:<sup>41</sup>

"Difficulties to which the defenders provided no satisfactory answer would arise if the court were to attempt to compare the sum payable under the contract on the occurrence of a specified event not amounting to a breach of contract with any loss or harm that has actually been sustained. These problems seem to me to confirm the desirability of confining the rule to the limited case of breach of contract to which it has always been applied."

4.14 If there is an early termination of a contract it is not entirely clear why there should be any special difficulty in calculating the actual loss to either party.<sup>42</sup> In principle the method of termination of future obligations under a contract - whether by accepted repudiation, by rescission following material breach, or by notice of termination - does not affect the nature of the contract, or prevent calculation of loss arising from a premature end to the contract. The other problem is the special considerations which may apply to consumer contracts,<sup>43</sup> but excessive payments can be required under contracts between commercial concerns. There does, however, appear to have been some judicial disagreement on the wisdom of the present law. The issues may be different if the genuine pre-estimate of damages test is abandoned, if penalty clauses become easier to enforce and the link with breach and liquidated damages disappears. The question is whether a court should enforce a payment which is grossly excessive (or excessive according to whatever other formula is adopted). Should the parties be able to punish each other? If there are circumstances where a penalty should not be enforced, the courts should not be constrained by the form of the contract but should be able to have regard to the substance of a penal provision.

4.15 If a contract is terminated on an event other than a breach, such as insolvency or the appointment of an insolvency practitioner, the rules on penalty clauses do not apply, under the present law. It seems to follow that the claim which may be made in the insolvency may be extravagant or unconscionable or excessive - out of all proportion to any loss. This could be to the detriment of other creditors. There is an incentive to draft extortionate provisions, and to have a termination without a breach.

4.16 One other possibility is clever drafting using bonuses or incentives, on which there is no Scottish authority.<sup>44</sup> A building contract with a price of £100,000 could provide that the contractor was to suffer a penalty of £1,000 for every day's delay after 1 April, which is the basis of the traditional liquidated damages clause. So a contractor who is 10 days late loses £10,000, or receives £90,000. An alternative is to draft the contract so that the contractor has so much time to complete the contract that there is unlikely to be breach; but completion by the agreed date will result in a derisory payment. If the contractor completes early, say by 1 April, the payment will be £100,000. The bonus for early completion reduces as time passes; by 11 April

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<sup>41</sup> At 428. Lord President Hope agreed (at p 423) with the Lord Ordinary, Lord Coulsfield, who distinguished concerns about hire purchase contracts with consumers from commercial contracts concluded between parties of substantially equal bargaining capacity.

<sup>42</sup> See for example Diplock LJ's detailed calculation for a contract of hire in *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428 at 1444-1445. Recoverable loss is another issue, because *Hadley v Baxendale* principles do require a reference to breach.

<sup>43</sup> See paras 2.30, 3.4 and 4.17.

<sup>44</sup> An example similar to that in the text is given in Atiyah, *An Introduction to the Law of Contract* (5th ed 1995), p 436. Treitel, *Remedies* pp 210,211 discusses the problems of a bonus for early completion and a discount for early payment.

the sum is £90,000. In this example there is not a breach by the contractor who finishes on 11 April and no possibility of challenge of the contract as involving a penalty. The contract states that early completion attracts a bonus; when in reality later completion involves a penalty. Professor Beale refers to the "glorious possibilities for a draftsman".<sup>45</sup> He gives an example:<sup>46</sup> "For instance a University Hall of Residence wishing to encourage students to pay their fees at the beginning of term could provide that the student has a choice of paying £200 at the beginning of term or £250 at the end." We do not know to what extent parties in practice draft contracts to avoid a breach and the application of the penalty clause rules.<sup>47</sup> We would welcome information. In theory, however, there is scope for avoidance of the rules on penalties by drafting contracts so that, instead of providing for one method of performance with a penalty for breach, they provide options for performing in different ways, some of which attract heavily penal consequences.

4.17 It is not our intention in this discussion paper to consider ways of controlling all types of unfair clauses in contracts. A certain amount of control is provided by the Unfair Contract Terms Act 1977. For consumer contracts there are also controls provided by the Unfair Terms in Consumer Contracts Regulations 1994.<sup>48</sup> Even if the control of penalty clauses is widened in specific ways there will remain scope for contract terms, such as terms giving one party the right to vary the contract unilaterally, which in some circumstances might seem harsh or oppressive. That is unavoidable if the option of a general control over harsh or oppressive clauses is rejected.<sup>49</sup> The question with which we are here concerned is simply whether the present law on penalty clauses is too narrow in concentrating on breach of contract.

4.18 We are of the opinion that the control over penalty clauses should apply outside the restriction of breach of contract. The Law Commission for England and Wales reached a similar provisional conclusion in 1975.<sup>50</sup> The rules on penalty clauses should apply at least to the type of case illustrated by *Granor Finance Ltd* and *EFT Commercial Ltd*<sup>51</sup> where there is a termination of the contract for reasons other than a breach. The distinction between breach and the exercise of an option to terminate should not be relevant for this purpose. It is also our provisional view that the rules should apply to cases where the contract is so drafted that there is an option to perform in different ways, some ways resulting in penal consequences.

4.19 The problem is how to define the circumstances in which the control over penalty clauses should arise, because it is not acceptable that every sum payable under a contract should be potentially subject to judicial scrutiny. It is this dilemma which has given rise to judicial concern, extending over centuries from the miscropping cases to *EFT Commercial Ltd*, about how to reconcile contractual freedom with the law on penalty clauses. Recent considerations of the subject such as the Council of Europe rules,<sup>52</sup> the Uncitral rules, the Lando

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<sup>45</sup> *Remedies* p 63.

<sup>46</sup> *Ibid.* In a footnote the author acknowledges his debt to Professor J C Smith for this example.

<sup>47</sup> Atiyah, *ibid.*, suggests this occurs with certain types of mortgages where "it has long been the practice to provide that the interest rate should be X per cent, but if the interest is paid punctually on the due date it should instead be X minus 1/2 per cent. This has long been upheld by courts of equity as not being penal." We consider the problems of accelerated payments at para 5.2.

<sup>48</sup> See the examples in Schedule 3.

<sup>49</sup> See para 1.7 above.

<sup>50</sup> The Law Commission, *Penalty Clauses* paras 17-26.

<sup>51</sup> See para 4.13 above.

<sup>52</sup> But para 2 of the operative part of the Resolution invites member states "to consider the extent to which the principles set out in the appendix can be applied, subject to any necessary modifications, to other clauses which have the same aim or effect as penal clauses." It is a feature of international negotiations that there is a tendency to

Commission rules and the South African Conventional Penalties Act 1962, restrict their operation to circumstances where there is a failure to perform the contract. We would prefer a slightly wider formulation.

4.20 At its heart the problem is the definition of "penalty" from the point of view of the type of event which should trigger the possibility of judicial control. There are various options:

- (1) Make no reference to breach and leave it to the courts to decide what a penalty is, so avoiding the need for a definition.
- (2) Define a penalty in terms of a provision which secures the true purpose or primary obligations of the contract.
- (3) Define a penalty in terms of a breach of contract, or a failure to perform or to perform in a particular way, or an early termination of the contract.

4.21 *Option 1 - The courts decide.* This has the attraction of avoiding thinking about the problem for the present and introducing flexibility into the law. But it leaves the issue to be decided in a multitude of cases at the expense of litigants. There may be a tendency to apply the existing rules on penalty clauses. It is doubtful if there would be a clarification of the law. We note that the South African Conventional Penalties Act 1962 does not define a penalty stipulation, but on this issue it is not an example which we would wish to follow.<sup>53</sup>

4.22 *Option 2 - True purpose or primary obligations.* There are hints of a test of this nature in the Law Commission for England and Wales' earlier thinking<sup>54</sup> and in the Council of Europe resolution.<sup>55</sup> This is clearly an attempt to distinguish price and other obligations for which the contract exists from remedies following a failure of the contract to fulfil completely its function. We have doubts, however, whether there is sufficient precision for the purposes of legislation. A division of the obligations in a complex commercial contract into those which are primary and those which are secondary is not a task which has much appeal.<sup>56</sup> Even if it were possible, there would be much scope for disagreement. Nor are the purposes of the contracting parties necessarily the same. To determine the "true purpose" may be to ignore many incidental benefits which will vary according to circumstances.

4.23 *Option 3 - Breach, failure to perform and early termination.* This option has the advantage that it is addressed to the problems which have been seen to need reform. It provides a more precise limitation of the circumstances in which penalty clause control arises than in the other options. We prefer a reference to both "breach of contract" and "failure to perform". Breach covers a variety of passive events which do not, or may not, involve performance, such as an

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concentrate on the typical case on which it may be possible to have widespread agreement. Domestic legislation may have to go further.

<sup>53</sup> Problems have arisen in subsequent case law in South Africa in the determination of the scope of the Act. See G F Lubbe and C M Murray, *Farlam & Hathaway, Contract: Cases, Materials and Commentary* (3rd ed 1988) (hereafter *Farlam & Hathaway*) pp 641-644 and the recent decision of the Appellate Division in *Sun Packaging (Pty) Ltd v Vreulink* 1996 (4) SA 176 (A) discussed in a note to para 4.12.

<sup>54</sup> The Law Commission, *Penalty Clauses* para 26.

<sup>55</sup> Council of Europe, *Penal Clauses* art 1; "A penal clause is, for the purposes of this resolution, any clause in a contract which provides that if the promisor fails to perform the principal obligation he shall be bound to pay a sum of money by way of penalty or compensation." The phrase "principal obligation" appears in all the subsequent seven articles of the resolution.

<sup>56</sup> Despite Lord Diplock's wish to develop this distinction - *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 at 849; *Lombard North Central plc v Butterworth* [1987] 1 QB 527 per Mustill LJ at 538, 539.

inaccuracy in a statement of facts or breach of warranty. A failure to perform, on the other hand, may cover events which by drafting are not a breach, such as failure to pay an instalment timeously.<sup>57</sup> It should be made clear that it covers failure to perform in a particular way. Failure to perform would probably cover failure to perform because of early termination, but for the avoidance of any doubt on this important point at this stage we refer to early termination expressly. This option is provisionally the option which we favour.

## **Proposal**

4.24 We would welcome comments on whether the control over penalty clauses should extend to circumstances other than breach of contract and, if so, how that control should be expressed. We provisionally propose:

2. **Judicial control over penalty clauses should not be confined to cases where the penalty is due when the promisor is in breach of contract. It should extend to cases where the penalty is due if the promisor fails to perform, or to perform in a particular way, under a contract or when there is an early termination of a contract.**

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<sup>57</sup> See the discussion on accelerated payments at para 5.2, and the discussion of substance and form at paras 5.19 to 5.20.

# Part 5 Other proposals

## Introduction

5.1 In this part we consider the different forms which a penalty may take. We ask whether irritancy clauses should be brought within the new law on penalty clauses. We also discuss the extent of the courts' power to look at substance rather than form in assessing whether a provision is a penalty clause; the effect of a penalty clause on the recoverability of damages; the time at which the enforceability of a penalty clause should be assessed; the onus of proof; and the question whether the court should have power to modify a penalty rather than strike it down altogether.

## Different forms of penalty

5.2 *Payment of money.* The classic penalty clause takes the form of an obligation to pay a sum of money. The only problem of which we are aware in relation to this kind of penalty is caused by obligations to make accelerated payment. In *White & Carter (Councils) Ltd v McGregor*,<sup>1</sup> for example, it was a condition of the contract that in the event of an instalment of price being due and unpaid for 4 weeks the whole amount due for 3 years, or the outstanding balance, was immediately due and payable. Clauses of this type have not normally been treated as penalties because the sum due is the debt due under the contract.<sup>2</sup> Nevertheless it has been observed that "it is abundantly clear that such clauses are often singularly penal in practice".<sup>3</sup> We draw attention to this question but we do not consider that any special provision needs to be made for it. It will be a question turning on the terms of the contract and the facts in each case whether a clause of this type is a penalty clause and, if so, whether the penalty is so grossly excessive that it should be subject to control. Most clauses providing for accelerated payments of sums due under the contract are perfectly reasonable and acceptable, but there may be exceptional cases where a provision of this kind constitutes in reality a grossly excessive penalty.

5.3 *Forfeiture of money.* It seems clear on principle that it should make no difference whether a penalty takes the form of a payment of a sum or of the forfeiture of a sum already paid.<sup>4</sup> This is just a matter of the mechanics of the transaction which should not affect the result. There have been conflicting views in Scotland as to whether the law on penalty clauses applies to the forfeiture of deposits or instalments already paid. Lord Skerrington thought that there could be cases in which forfeiture of a deposit might be a penalty.<sup>5</sup> This has been doubted

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<sup>1</sup> 1962 SC (HL) 1.

<sup>2</sup> *White & Carter (Councils) Ltd* at 11 per Lord Reid, at 25 per Lord Keith. There may be a penalty if other sums are due immediately, such as future interest or retrospective interest - *The Angelic Star* [1988] 1 Lloyd's Rep 122; *Lordvale Finance plc v Bank of Zambia* [1996] QB 752.

<sup>3</sup> JDL Hope, "Contractually Stipulated Remedies" in *Stair Encyclopaedia* vol 15 para 811.

<sup>4</sup> Or the payment of a sum which must, because of events which have already happened, be forfeited. See *Hinton v Sparkes* (1868) LR 3CP 161. In this case the seller of property, who had lost £10 on a resale after a purchaser defaulted, sued to recover a £50 deposit which the purchaser had never paid. The court allowed recovery. What would, or should, have been the result if the deposit had been £1000 and if the maximum loss which the seller could possibly have incurred had been £10?

<sup>5</sup> *Roberts & Cooper v Salvesen & Co* 1918 SC 794 at 813-814 under reference to *Dagenham (Thames) Dock Co ex parte Hulse* (1873) LR 8 Ch App 1022.

by Lord Marnoch.<sup>6</sup> It has been held in the sheriff court that a provision in a contract for the sale of a house by instalments was not a penalty clause even although it provided for the forfeiture of the deposit and all monthly instalments already paid if the buyer defaulted.<sup>7</sup> There is now, however, a decision of the Privy Council on appeal from the Court of Appeal of Jamaica that forfeiture of a deposit of 25% in a contract for the sale of land was not reasonable and was a penalty.<sup>8</sup> It is clear that the consequences of forfeiting sums already paid could be just as harsh as the consequences of being required to pay a sum as a penalty.<sup>9</sup> Of course, not all provisions for forfeiture of sums already paid would be regarded as penalty clauses, far less grossly excessive penalty clauses. There are many cases where one party pays for an option and where there is nothing remotely penal in forfeiture of the sum paid if the option is not exercised.

5.4 *Transfer of property.* A penalty may take the form of a transfer of property. In *Watson v Noble*<sup>10</sup> there were two transactions; (1) an agreement for sale of shares in a trawler; and (2) an agreement by the seller to hold the shares in trust. The buyer, who was to take command as master of the trawler, agreed that he forfeited his shares and claims for repayment of the purchase price if he was dismissed because he was intoxicated or in breach of his obligations. The seller dismissed the master for alleged drunkenness and refused to transfer the shares. The master sued, successfully, for repetition of the price.

5.5 As Lord Young said at the beginning of his opinion:<sup>11</sup> "This is a confusing case, looking to the contract between the parties, and the agreement between them, which is oddly worded." But he did conclude:<sup>12</sup>

"The main question in the case, and that on which its decision must turn, relates to the clause of forfeiture, that if the pursuer gets drunk, although he does no damage at all, he is to forfeit the shares which he has bought and paid for. Now, I am not prepared to enforce that. I think it is a penalty, and that it cannot be enforced - at least in this action."

5.6 In *Jobson v Johnson*<sup>13</sup> there was a sale of shares in a football club. The buyer had to re-transfer the shares on a default in payment and the seller could retain instalments of the price. The clause was held to be a penalty clause both before Harman LJ and on appeal to the Court of Appeal.<sup>14</sup> Lord Justice Dillon observed:<sup>15</sup>

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<sup>6</sup> *Zemhunt (Holdings) Ltd v Control Securities plc* 1992 SC 58 at 65.

<sup>7</sup> *Reid v Campbell* 1958 SLT (Sh Ct) 45. The logic of this decision would apply even if the buyer defaulted on the last instalment. A succession of buyers who defaulted late would enable the seller to sell the same property over and over again.

<sup>8</sup> *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573; see also *Stockloser v Johnson* [1954] 1 QB 476 at 491 per Denning LJ who considered the case of a 50% deposit. The *dicta* in *Stockloser* are complex, conflicting and controversial. See, for example, *Galbraith v Mitchenhall Estates Ltd* [1965] 2 QB 473.

<sup>9</sup> In *Stockloser* Denning LJ at 491 observed: "Suppose a buyer has agreed to buy a necklace by instalments, and the contract provides that, on default in payment of any one instalment, the seller is entitled to rescind the contract and forfeit the instalments already paid. The buyer pays 90 per cent of the price but fails to pay the last instalment. He is not able to perform the contract because he simply cannot find the money. The seller thereupon rescinds the contract and retakes the necklace and resells it at a higher price. Surely equity will relieve the buyer against the forfeiture of the money on such terms as may be just." In certain circumstances there may be a conditional sale agreement regulated by the Consumer Credit Act 1974.

<sup>10</sup> (1885) 13 R 347.

<sup>11</sup> At 350.

<sup>12</sup> At 351-352.

<sup>13</sup> [1989] 1 WLR 1026; cf *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130.

<sup>14</sup> In the narrow sense. Much of the report is about the remedy which was appropriate and involves details of English law.

"Does it make any difference then, that the penalty in the present case is not a sum of money? In principle, a transaction must be just as objectionable and unconscionable in the eyes of equity if it requires a transfer of property by way of penalty on a default in paying money as if it requires a payment of an extra, or excessive, sum of money. There is no distinction in principle between a clause which provides that if a person makes default in paying a sum of £100 on a certain day he shall pay a penalty of £1000, and a clause which provides that if a person makes default in paying a sum of £100 on a certain day he shall by way of penalty transfer to the obligee 1000 shares in a certain company for no consideration. Again there should be no distinction in principle between a clause which requires the defaulter, on making default in paying money, to transfer shares for no consideration, and a clause which in like circumstances requires the defaulter to sell shares to the creditor at an undervalue. In each case the clause ought to be unenforceable in equity in so far as it is a penalty clause."

5.7 We believe that there is much sense in these views and that the law on the control of penalty clauses should extend to clauses providing for a transfer of property.<sup>16</sup> This is not the approach adopted in the Council of Europe, Uncitral, Unidroit or Lando Commission rules. These are all restricted to penalties which are payments of money. On the other hand the German Civil Code recognises that performance other than the payment of a sum of money may be a penalty.<sup>17</sup> Professor Treitel gives the example of a provision requiring a seller to deliver more goods for the same price on his failure to deliver the agreed quantity at the agreed time.<sup>18</sup> We believe that the present law of Scotland on this issue should be preserved in any new definition of "penalty." When we refer to the transfer of property we mean to include all property, including incorporeal property. An obligation to transfer valuable rights, for example to assign a valuable long lease, could be just as much a penalty as an obligation to convey corporeal property.

5.8 *Forfeiture of property.* On principle it seems clear that a forfeiture of property could be just as much a penalty, and just as oppressive a penalty, as a transfer of property. On principle, therefore, we think that a clause providing for forfeiture of property should be within the new system of control of penalty clauses. There is, however, a special problem with irritancy clauses which we consider separately later.<sup>19</sup>

5.9 *Other forms.* Following a provision in the South African Conventional Penalties Act 1962 we believe that the control over penalties should also extend to an obligation to do something.<sup>20</sup> We are not aware of any relevant problem in Scotland, but this extension seems sensible. There might for example be a contract of employment which provided that an employee who was five minutes late for work on any weekday would have to work at the week-end for no extra pay. Everything would depend on the particular circumstances but

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<sup>15</sup> At 1034-1035.

<sup>16</sup> See also the consideration of the photocopier cases at paras 2.31 to 2.32. Repossession of the copier might, in all the circumstances, be part of a penal provision. See also *Lombard North Central plc v Butterworth* [1987] 1 QB 527. In a building contract a clause providing for forfeiture of plant and machinery might also be a penalty cf *Forestry Commission of New South Wales v Stefanetto* (1975) 133 CLR 507 (H Ct of Australia); *Moore v Gledden* (1869) 7 M 1016.

<sup>17</sup> BGB para 342.

<sup>18</sup> Treitel, *Remedies* p 209. The author also discusses the Indian Contract Act s 74 and the French Civil Code. See also the South African Conventional Penalties Act 1962 s 1 reproduced in the Appendix.

<sup>19</sup> Paras 5.11 to 5.18.

<sup>20</sup> Conventional Penalties Act 1962 s 1. See also the French Code Civile art 1226 and the BGB para 342.

there is no obvious reason why a provision should escape control simply because it provides for the performance of services rather than the payment of money. It would be useful for other reasons to frame any provision in a general way. A provision limited to the transfer or forfeiture of property might not catch, for example, the grant of a new right, or the transfer or forfeiture of a right or an opportunity which was of such a nature that it would not naturally be thought of as property.<sup>21</sup> The general principle should, in our view, be that the exact form of the penalty is immaterial.

5.10 *Proposal.* Our provisional view is that it should make no difference what form a penalty takes. We would welcome views on this proposal:

3. (1) **Judicial control over penalty clauses should apply whatever form the penalty takes. It should, in particular, apply whether the penalty takes the form of a payment of money, a forfeiture of money, a transfer of property, or a forfeiture of property.**

5.11 *Irritancies.* "The irritancy of a right is its forfeiture in consequence of some neglect or contravention."<sup>22</sup> Irritancy clauses can be found in contracts dealing with various matters. The most common type involves forfeiture of land, or of an interest in land, for non-payment of money or breach of other conditions under which the land is held. Irritancies have developed their own specialities as an area of law,<sup>23</sup> and have not been regarded as coming within the modern law on penalty clauses. This is understandable in the context of the existing law. Irritancy clauses are not provisions for liquidated damages. If they had been regarded as coming within the law on penalty clauses they would always have been unenforceable. This would have been an unacceptable result. Most irritancy clauses are entirely reasonable. However, the matter has to be considered afresh in the light of our proposal to alter the test for deciding whether a penalty clause is unenforceable. In this new context it would be possible to treat contractual irritancy clauses as coming within the law on penalty clauses. Normal, acceptable irritancy clauses would be enforceable. Irritancy clauses which had the effect of imposing a grossly excessive penalty would be subject to the court's control. That there are, or could be, such irritancy clauses cannot be doubted. In our work on leasehold casualties we have come across many building leases granted in the eighteenth and nineteenth centuries for 999 years. The ground rent or tack duty is on average about £4 a year. It is not normally collected by landlords because the cost of collection often exceeds the amounts recoverable. The original tenants under these leases built on the land at their own expense. It would be hard to imagine a more grossly excessive penalty than the forfeiture of the lease by the current tenant for the non-payment of the trifling rent.

5.12 Similar problems can arise under modern commercial leases. In *Dorchester Studios (Glasgow) Ltd v Stone and Another*<sup>24</sup> the House of Lords held that an irritancy incurred by the tenant's failure to pay an instalment of rent on the due date could not be purged by an offer of payment of the arrears made shortly after that date. Lord Kilbrandon expressed doubts about

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<sup>21</sup> Eg the right or opportunity to purchase the property which is subject to a hire purchase contract; or the right to compensation for improvements; or the right to claim redress for unjustified enrichment. See *In re Dagenham (Thames) Dock Co ex parte Hulse* (1873) LR 8 Ch App 1022; *Da Mata v Otto* NO 1972 (3)SA 858.

<sup>22</sup> *Bell's Dictionary and Digest of the Law of Scotland* (7th edn 1890), at 584.

<sup>23</sup> Illustrated by recent litigation - *CIN Properties Ltd v Dollar Land (Cumbernauld) Ltd* 1992 SC (HL) 104; *Dollar Land (Cumbernauld) Ltd v CIN Properties Ltd* 1997 SLT 260.

<sup>24</sup> 1975 SC (HL) 56.

the soundness of the law from the point of view of social policy and suggested that the law on irritancies in leases might be examined by the Scottish Law Commission.

5.13 Following on the *Dorchester Studios* case, the topic of irritancies in leases was referred to this Commission. The Commission consulted on the subject and submitted a report<sup>25</sup> which was implemented by the Law Reform (Miscellaneous Provisions) (Scotland) Act 1985.<sup>26</sup> Section 4 of this Act provides that a landlord cannot rely on an irritancy clause providing for termination of the lease for non-payment of rent, or failure to make any other payment, unless he has given due notice requiring payment within a period of not less than 14 days.<sup>27</sup> Section 5 applies to irritancy clauses other than those covering non-payment of money. The landlord cannot rely on any such clause "if in all the circumstances of the case a fair and reasonable landlord would not seek so to rely". Although this was a useful reform it is now clear, with the benefit of hindsight, that the Commission missed an opportunity to consider whether truly penal irritancies for non-payment of rent should be brought under further judicial control.

5.14 The law on irritancies in leases came before the House of Lords again in *CIN Properties Ltd v Dollar Land*.<sup>28</sup> Here a valuable lease of a shopping centre was terminated under an irritancy clause for non-payment of rent. The 1985 Act did not prevent termination because the landlord had complied with section 4 of the Act by giving due notice. The result was that the tenants lost an investment of £2.2 million, which was the sum they had recently paid for an assignation of the lease. It was recognised in the House of Lords that the law was "clearly capable of operating with extreme harshness in the case of a long building lease".<sup>29</sup> However, the court felt unable to provide a remedy, for example by making the exercise of the irritancy conditional on the landlord reimbursing the tenant for the value of tenant's improvements. Paradoxically, the limited reforms made by the 1985 Act were thought to preclude development of the common law on such lines, the reasoning being that if Parliament had wanted to subject penal irritancy clauses to wider judicial control it would have done so in the 1985 Act. Lord Jauncey of Tullichettle was of the view that consideration should be given to further legislative reform. He thought that, notwithstanding section 4 of the 1985 Act,

"further consideration could profitably be given to situations where a tenant, because of an oversight or omission on his part, stands to lose huge sums of money with consequent benefit to the landlord."<sup>30</sup>

5.15 The tenants in the above case subsequently made a claim based on unjustified enrichment in an attempt to recover the amount which they alleged the landlord had gained at their expense. This claim was unsuccessful in the Court of Session.<sup>31</sup> The majority of the court considered that the landlord's enrichment resulted from the terms of the contract between the parties. It was not therefore legally unjustified. It was the natural result of the irritancy clause. Any claim in respect of unjustified enrichment was foreclosed by the parties' contractual provisions and expressed intentions. Lord Rodger dissented. He accepted that it was "unquestionably the law that in the ordinary case where a landlord irritates a lease, the tenant

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<sup>25</sup> *Irritancies in Leases* (Scot Law Com No 75, 1983).

<sup>26</sup> ss 4 to 7.

<sup>27</sup> This is a simplified account of the provision. It deals with various possibilities, including the possibility that the landlord may not know the tenant's address.

<sup>28</sup> 1992 SC (HL) 104.

<sup>29</sup> Lord Keith of Kinkell at p 119.

<sup>30</sup> At p 126.

<sup>31</sup> *Dollar Land (Cumbernauld) Ltd v CIN Properties Ltd* 1997 SLT 260.

has no claim for unjustified enrichment: any gain to the landlord results simply from the operation of the contractual terms which brings the tenant's rights to an end".<sup>32</sup> However, he considered that there was a special feature of the contractual terms in this case which meant that there was, exceptionally, some potential room for a claim based on unjustified enrichment. We understand that this case has been appealed to the House of Lords. Even if the House of Lords were to hold that the landlords were under an obligation to redress an unjustified enrichment, that would not, in our view, mean that the question of bringing irritancy clauses within the new rules on penalty clauses should be put aside. The law on unjustified enrichment is in an unsatisfactory state.<sup>33</sup> It is difficult for practitioners to give reliable advice on it. Resort to the law on unjustified enrichment is best regarded as a last resort. In any event it seems unlikely that any claim based on unjustified enrichment would ever be available in any case where an irritancy clause was drafted in such a way as to exclude it.<sup>34</sup>

5.16 This discussion paper provides an opportunity to give further consideration to the law on those irritancy clauses which have a truly penal effect. It seems to us that the most principled approach, given the difficulty of drawing any justifiable distinction between a transfer and a forfeiture, would be to subject irritancy clauses to the new law on the control of penalty clauses. In practice it would only be necessary to use the law on penalty clauses in relation to irritancies arising on non-payment of rent or another sum of money. In relation to other irritancies the "fair and reasonable landlord" test in section 5 of the 1985 Act would normally provide an adequate remedy. In any new legislation on penalty clauses it could be provided that nothing in any enactment (including the 1985 Act) or rule of law (including the rule of law expressed and confirmed in the *Dorchester Studios* case) should prevent the law on the control of penalty clauses from applying to irritancy clauses or clauses having similar effect. The 1985 Act would continue to apply. Even an irritancy clause which could not be struck down under the law on penalty clauses (and most irritancy clauses would fall into this category)<sup>35</sup> should be exercised in a reasonable way and the 1985 Act would remain necessary to secure that result. We seek views later on the question whether the courts should have power, not only to strike down penalty clauses entirely, but also to modify them. A power to modify would give effect to Lord Keith's suggestion<sup>36</sup> that in some cases the appropriate result would be to attach conditions to the exercise of an irritancy provision.

5.17 Although bringing irritancy clauses within the scope of the control on penalty clauses would be an important reform, its effect should not be exaggerated. It would certainly not follow that all irritancy clauses, or even all irritancy clauses in leases where the tenant had developed or improved the subjects, would be struck down or modified. The Scottish courts have in the past shown themselves to be well aware of the benefits of irritancy clauses and there is no reason to suppose that they would be unrestrained in the exercise of a new power. There is nothing inherently unreasonable in a provision which enables a party to bring a

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<sup>32</sup> At p 276.

<sup>33</sup> See the observations in *Morgan Guaranty Trust Company of New York v Lothian Regional Council* 1995 SC 151 at pp 173-174 and our Discussion Paper on *Judicial Abolition of the Error of Law Rule and its Aftermath* (Discussion Paper No 99, 1996) Part IV.

<sup>34</sup> In the *Dollar Land* case Lord Rodger noted that "Not surprisingly, counsel for the pursuers did not argue that an action of recompense could be brought if the parties had expressly agreed that it could not." See 1997 SLT 260 at p 278.

<sup>35</sup> There is nothing inherently unreasonable in a clause which enables one party to bring a contract to an end on a breach by the other. Indeed the general law on contract enables a party to terminate the contract for material breach. Unreasonableness may, however, arise if, on termination, the party in breach must pay, transfer or forfeit something whose value is out of all proportion to any loss of the terminating party.

<sup>36</sup> 1992 SC (HL) 104 at p 119.

continuing contract to an end in certain defined circumstances. Usually both parties will cease to have rights and obligations when that happens. One party may benefit more than the other but that will have been within the contemplation of the parties. As in the case of other clauses with potentially penal effects, everything would depend on the circumstances. Significant factors would include the period of the lease, the period still left to run, the amount of the rent, the value of any improvements and developments by the tenant, and the respective obligations of the parties.

5.18 We will be considering irritancy clauses in our work on the feudal system and long leasehold tenure. It may be that we will wish to recommend that in certain specific cases irritancy clauses will be automatically void. We are aware that there are other problems with the current law on irritancies, particularly in the context of receiverships.<sup>37</sup> We are also aware that English law has traditionally provided extensive relief against the operation of forfeiture clauses in leases<sup>38</sup> and that the Law Commission for England and Wales has recommended that the termination of tenancies should be placed entirely within judicial control.<sup>39</sup> We are investigating whether the wider aspects of irritancies could be dealt with in our next programme of law reform. However, the fact that more radical reforms, or reforms dealing with other aspects of irritancy clauses, may be considered later does not mean that the penal aspects of irritancy clauses cannot be appropriately dealt with in this paper. It would be artificial and unprincipled to exclude them and it could also lead to anomalies if further reforms were found, after consultation, not to be required or were to be confined to certain specific situations or types of irritancies. Our provisional proposal, on which we would welcome views, is that

3. (2) **It should be provided that nothing in any enactment or rule of law should prevent the law on the control of penalty clauses from applying to irritancy clauses or clauses having similar effect.**

### Substance and form

5.19 One of the difficulties with the law on penalty clauses is the natural tendency of the draftsman to try to avoid judicial review of the clause. Examples in the present law are the avoidance of behaviour being a breach, and the granting of options or privileges. No doubt there are variations not yet thought of. Any reform of the law has to contend with the probability that attempts will be made to evade the rules. As was observed in the recent South African case of *Sun Packaging (Pty) Ltd v Vreulink*:<sup>40</sup>

"Then it was said (I quote from counsel's heads) that 'such an approach ... would be an invitation to the framers of contracts to evade the application of the Act by a mere contrivance of words.' But there is nothing wrong with that. There is no

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<sup>37</sup> Our attention has been drawn specifically to the cases of *Blythswood Investments Ltd v Clydesdale Electrical Stores Ltd (In receivership)* 1995 SLT 150 and *Aubrey Investments Ltd v D S Crawford Ltd (In receivership)* 2 June 1997, unreported (Lord Penrose). It has been represented to us that, because receivers enjoy no specific protection against the operation of irritancy clauses, receiverships involving commercial leases are much more difficult to manage efficiently under Scottish law than under English law.

<sup>38</sup> From an early date the courts exercised an equitable jurisdiction to give relief against forfeiture for non-payment of rent and these powers have been confirmed and extended by statute. In relation to forfeiture for other reasons, section 146(2) of the Law of Property Act 1925 gives the courts a very wide discretion indeed including power to grant relief "on such terms, if any ... as the court, in the circumstances of each case, thinks fit." See the account in the Law Commission's report on the *Termination of Tenancies Bill* (Law Com No 221, 1994) Appendix C.

<sup>39</sup> See their report on the *Termination of Tenancies Bill* (Law Com No 221, 1994).

<sup>40</sup> 1996 (4) SA 176 (A) per Nestadt JA at 185.

reason why parties to a contract should not so structure their relationship. They did so here."

5.20 An early principle of Scots law was that the courts should look at substance rather than form.<sup>41</sup> While detailed description of what a penalty is, in line with our previous proposals, may be welcome, it is also possible to argue that the courts should continue to have a general power, exercisable in limited circumstances, to decide whether or not there is a penalty. The principle that parties should not be allowed to punish each other should not be evaded by drafting. This power need not be as extensive as a control over all extortionate provisions; nor as uncertain as a refusal to provide any definition of penalty. The question for consideration here is whether the courts' power to disregard form and concentrate on substance in deciding whether a provision is a penalty clause should be strengthened in some way. It is not clear how this could be done without conferring a power which would be unacceptably wide. We would welcome responses to the following proposal.

4. (1) **In any new law on penalty clauses the courts should continue to have power to have regard to the substance of the transaction rather than to its form.**
- (2) **Views are invited on the question whether there is any need to strengthen the courts' powers so as to make it less easy for the control on penalty clauses to be avoided by drafting devices.**

#### **The penalty as a limit on the sums recoverable**

5.21 We have commented earlier on *Dingwall v Burnett*.<sup>42</sup> The effect of this decision is that if a provision is held to be an unenforceable penalty, common law damages may be claimed, which can be higher than the amount of the penalty. This gives an incentive to a person in whose favour the penalty provision was inserted to argue that the provision is invalid.<sup>43</sup> This result is produced by a combination of two rules; (1) that the time for examination of the validity of the penalty is when the contract was entered into - the actual loss may be irrelevant; and (2) that a lump sum for a variety of different types of breaches may be a penalty. But it is arguable that the end result can be strange. If the penalty is struck down on the principle that it is an impermissible punishment, why should the court award a greater sum? What principle is being applied?

5.22 Earlier Scottish cases suggested that the penalty was the limit of recovery.<sup>44</sup> There is also a decision of the Supreme Court of Canada that limits the party to the amount of the penalty. In *Elsley v JG Collins Insurance Agencies Ltd*<sup>45</sup> it was decided that the foundation of the law on penalty clauses being oppression it is not oppressive to limit a party to the penalty which he has stipulated.

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<sup>41</sup> Paras 2.7, 2.10.

<sup>42</sup> Para 2.13.

<sup>43</sup> Whether it is competent so to argue is obscure.

<sup>44</sup> See para 2.13.

<sup>45</sup> (1978) 83 DLR (3rd) 1 at 14-16. See also *Pearl Assurance Co v Government of the Union of South Africa* [1934] AC 570 at 584 per Lord Tomlin.

5.23 It may be suggested, however, that once it is decided that a penalty provision is unenforceable, it is logical to ignore the provision in fixing the amount of damages. There may also be a problem with the derisory penalty ie the penalty which is fixed at a very low amount.<sup>46</sup> This is, however, an aspect of the law on exclusion or limitation of liability, which is not our present concern. Nor have our courts applied the rules on penalty clauses to exclusion and limitation of liability clauses which it has been recognised are "penalty clauses in reverse".<sup>47</sup> We invite views on the following question.

**5. Should the value of an unenforceable penalty be the limit of the recoverable loss?**

**Cumulative remedies**

5.24 Normally a party should not be able to recover both the penalty and damages for the same act. Conversely when a penalty is due for late performance the creditor may be entitled both to enforce performance and claim the penalty.<sup>48</sup> If the penalty is enforceable the creditor cannot ignore the penalty and claim damages. Nor does the debtor have the option of paying the penalty instead of performing the contract.<sup>49</sup> It will be a question of construction of the contract whether the breach which has occurred is the type of breach for which the penalty is payable; or whether the remedy is common law damages.<sup>50</sup> There are possibly some very difficult issues arising from the interrelationship between a penalty and other remedies or rights. The South African Conventional Penalties Act 1962 provides:<sup>51</sup>

**"Prohibition on cumulation of remedies and limitation on recovery of penalties in respect of defects or delay.**-(1) A creditor shall not be entitled to recover in respect of an act or omission which is the subject of a penalty stipulation, both the penalty and damages, or, except where the relevant contract expressly so provides, to recover damages in lieu of the penalty.

(2) A person who accepts or is obliged to accept defective or non-timeous performance shall not be entitled to recover a penalty in respect of the defect or delay, unless the penalty was expressly stipulated for in respect of that defect or delay."

We doubt whether it would be necessary in Scots law to legislate in these terms. We are not aware that there is a problem in Scots law. As has been said:<sup>52</sup>

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<sup>46</sup> *Cellulose Acetate Silk Co Ltd v Widnes Foundry (1925) Ltd* [1933] AC 20. Cf a problem with building contracts where the liquidated damages are specified as "nil", which has been held to exclude damages for delay - *John Maxwell & Sons (Builders) Ltd v Simpson* 1990 SCLR 92 which refers to previous authority, and JM Arnott and J Wolffe, "Building Contracts" in *Stair Encyclopaedia*, vol 3 para 111.

<sup>47</sup> *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428 at 1446 per Diplock LJ. There is a theoretical difference between a limitation of liability clause and a penalty clause. Actual loss has to be proved with limitation of liability - *Suisse Atlantique Societe D'Armement Maritime SA v NV Rotterdamsche Kole Centrale* [1967] AC 361 per V Dilhorne at 395.

<sup>48</sup> Cf Uncitral, art 6.

<sup>49</sup> As is demonstrated in miscropping cases. See para 2.8.

<sup>50</sup> *British Glanzstoff Manufacturing Co Ltd v General Accident, Fire and Life Assurance Corporation Ltd* 1912 SC 591 affd 1913 SC (HL) 1; *Suisse Atlantique Societe D'Armement Maritime SA*.

<sup>51</sup> s 2. The background papers to the Council of Europe Resolution also show extensive discussion in civilian systems about the relationship between penalties and other remedies.

<sup>52</sup> Per consulted judges in *University of Glasgow v Faculty of Physicians and Surgeons* (1840) 1 Rob 397 at 415 cited in Glog, *Contract* p 673. It was competent to enforce a penalty and have interdict.

"When a penalty is imposed to enforce an obligation, no option is given to the party against whom it is directed to get quit of his obligation by paying the penalty. In the language of the law of Scotland the penalty is by and attour performance. It is one mode of enforcing the obligation added to every other mode which would otherwise have been competent."

There is a case for minimal legislative correction of the law and it may be that any problems of cumulative remedies can be left to be decided by the courts in the light of what the parties have agreed. We would welcome views.

**6. Views are invited as to whether it is necessary to have legislation on the relationship between a penalty and other remedies.**

**The time for examination of a penalty**

5.25 In considering whether a penalty is enforceable a court may, in theory, adopt one of several approaches. It may put itself strictly in the position of the parties at the time of contracting and refuse to take account of anything which happened after that date. It may put itself in the position of the parties at the time of contracting but have some regard for certain purposes to events after that date. Or it may consider the question in the light of all the circumstances, including events after the date of contracting.

5.26 Under the present law the second approach is the one adopted. The starting point is the time the contract was entered into.<sup>53</sup> But the court may be influenced by what happened after the contract.<sup>54</sup> What has happened since the contract may, in any event, have to be considered. The sums sued for might be based on the number of days the defender was late in making delivery or the number of instalments unpaid in a hire purchase contract, or the changing salary of an employee under a contract of service.<sup>55</sup> Also the present state of the law makes it necessary to distinguish between a breach of contract and a termination without breach. So even if averments of loss are irrelevant, circumstances since the contract was entered into cannot be ignored. The Privy Council in an appeal from a decision of the Court of Appeal of Hong Kong has said that what happened since the contract was made "can provide valuable evidence as to what could reasonably be expected to be the loss at the time the contract was made".<sup>56</sup>

5.27 If there is a test of "genuine pre-estimate" of loss it is logical to take as the starting point the circumstances at the time the estimate is made. But if that test is abandoned, there is no need for the penalty to mirror, even approximately, the damages which might have been awarded. The true philosophy behind penalty clauses can emerge. What the law should be concerned with is a remedy which in the circumstances is grossly excessive. If the sum payable is not extortionate for the breach which has in fact occurred, why should the sum not be payable? Why should an agreement to pay the sum be struck down, with the consequence that there must be a detailed proof of loss? In the end the damages awarded could be much the same as the agreed sum, or, as in *Dingwall's* case, greater than the sum agreed. If there has been part performance the benefit of this should be taken into account.

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<sup>53</sup> *Clydebank* case (1904) 7 F (HL) 77 at 82 per Lord Davey.

<sup>54</sup> *Forrest & Barr* (1869) 8 M 187; *Craig v McBeath* (1863) 1 M 1020; *Mercantile Credit Co v Brown* 1960 SLT (Sh Ct) 41.

<sup>55</sup> *Paterson v South West Scotland Electricity Board* 1950 SC 582.

<sup>56</sup> *Philips Hong Kong Ltd* (1993) 61 BLR 49 at 59.

5.28 Our provisional view is that, if the law moves away from the liquidated damages test, there would be great advantages in making it clear that the court can look at all the circumstances in deciding whether a penalty is grossly excessive. Allowing the court to look at circumstances since the contract does not mean that the court should ignore the commercial realities at the time of the contract. In the hire purchase or hire cases or instalment missives, for example, the future value of property which might have to be repossessed will be in doubt. The parties' agreement on uncertain events should not be disturbed merely because in the event, and with the benefit of hindsight, their predictions were incorrect. An advantage of the "grossly excessive" test is that it allows considerable scope for this sort of realistic approach.

5.29 We would welcome views on this provisional proposal:

7. **The enforceability of a penalty should be judged according to all the circumstances, including the loss arising from non performance or termination and other circumstances since the contract was entered into.**

### **The effect of an unenforceable penalty and onus of proof**

5.30 If a penalty is unenforceable a question arises as to what effect this has, or should have. The end result under the present law is clear. If the penalty is unenforceable the claimant may recover loss, subject to the normal rules on damages. There is some debate, involving subtle distinctions, as to how that result is reached.

5.31 In *Craig v McBeath*<sup>57</sup> the pursuers made no averment of actual damage but averred an agreement under which there was provided: "Penalty for non-performance of this agreement, £25 sterling." The agreement was the charter of a ship for the carrying of coals or tiles. The defenders did not allege that the penalty exceeded any damage sustained, but they were allowed to add a plea that the penalty ought to be modified to the actual damage.

5.32 Lord Justice-Clerk Inglis had no doubt that the sum of £25 was an unenforceable penalty:<sup>58</sup> "£25 is to be paid for any breach, slight or entire; for complete failure to fulfil the agreement, more is not to be paid, and the slightest failure, - as, for instance, failure of the shipper to provide a full cargo, though it might be that the cargo provided was only a very little less than a full cargo, - is sufficient to subject the party failing to the same penalty of £25." But he held that the action was relevant. The pursuer was entitled to sue for the penalty. The defender might allege that the damage had not been so great.<sup>59</sup> If after proof the damage exceeded £25 decree would be granted for the amount of the penalty. The other judges agreed although there was some difference of opinion on where the onus lay.

5.33 This view of the law was considered and followed recently by Lord Hamilton in *The Council of the Borough of Wirral v Currys Group plc*.<sup>60</sup> An action for a sum held to be an unenforceable penalty was not dismissed. The pursuers were given an opportunity to consider their position.<sup>61</sup>

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<sup>57</sup> (1863) 1 M 1020.

<sup>58</sup> At 1022-1023.

<sup>59</sup> Note this does not appear to be the application of a genuine *pre-estimate* of loss test.

<sup>60</sup> OH 29 April 1997 unrep; 1997 GWD 19-900.

<sup>61</sup> Which might be a difficult course of action after a proof.

5.34 There is a slightly different way of explaining the law which may derive from Professor Sir Thomas B Smith's treatment of the subject in *A Short Commentary on the Law of Scotland*<sup>62</sup> and repeated in the *Stair Memorial Encyclopaedia*.<sup>63</sup> Under this approach a penalty is unenforceable and incapable of any legal effect, in contrast with the view that the penalty is enforceable, but subject to modification. It is not necessary for us to express an opinion on what the present law is, nor to untangle the effect of *Craig* (and of the *Dingwall* case) on the development of Scots law. It may well be that the real philosophical problem arises not with these cases but with the introduction of the genuine pre-estimate of loss test. In any event there is uncertainty and a lack of clarity. The question is what the law should be.

5.35 If a penalty is grossly excessive (or whatever other formula is adopted) the penalty should not be enforced. The claimant should be entitled to recover actual loss, subject to the normal rules on damages which may limit recovery by rules on mitigation and remoteness. Whatever theory is adopted about the effect of an unenforceable penalty the end result is the same.<sup>64</sup> Differences in theory affect questions of procedure. Who must aver actual loss, and show that the penalty is excessive? The pursuer or the defender? In the Scottish system of written pleading this is critical, because it affects the relevancy of either party's pleadings, and the evidence which may be led on the basis of the written pleadings.

5.36 Assume, for example, that a pursuer seeks a sum which the defender alleges is a penalty. Must the pursuer show that there is nothing excessive in the claim? Or must the defender aver and prove that the sum is excessive? Under the present law of Scotland it is not necessary to show actual loss.<sup>65</sup> This is because of the liquidated damages test founded on the genuine pre-estimate rule. The decision on whether there is an unenforceable penalty might be made on consideration of the terms of the contract alone eg if the penalty is payable for both minor and major breaches. If, however, the law moves to a test of gross or manifest excess, the question arises as to who must prove the excessive nature of the clause.

5.37 The issue was considered by South African courts and by the Privy Council in *Pearl Assurance Company Ltd v Government of the Union of South Africa*.<sup>66</sup> It appears that there were many differences of opinion in writers on Roman Dutch law and in South African decisions. The majority view in the Supreme Court of South Africa, possibly derived from Roman law, was that the defendant had to satisfy the court that the amount was excessive and only then could the plaintiff be called upon to prove actual damage. The Privy Council, however, said that there was a distinction between liquidated damages and a penalty. Once it was held, as in that case, that there was an unenforceable penalty, the onus was on the party claiming compensation to prove its loss. If Scots law moves away from the genuine pre-estimate of loss rule, the problem faced by the Supreme Court of South Africa in *Pearl Assurance* will arise. Arguably the result reached by the majority of the Supreme Court was sensible.<sup>67</sup>

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<sup>62</sup> (1962) pp 857-60.

<sup>63</sup> JDL Hope, "Contractually Stipulated Remedies" in *Stair Encyclopaedia* vol 15 para 783.

<sup>64</sup> Subject to the question whether or not the penalty fixes a limit on the amount recoverable - see paras 5.21 to 5.23.

<sup>65</sup> Para 2.27.

<sup>66</sup> [1934] AC 570.

<sup>67</sup> Since the 1962 Act the position (after some confusion) has been that "the debtor bears the onus of establishing a discrepancy between the penalty and the prejudice to the creditor which is large enough to activate the court's discretion." Lubbe and Murray, *Farlam & Hathaaway* p 644; *Smit v Bester* 1977 (4) SA 937 (A); W A Joubert, *The Law of South Africa* 1st reissue vol 5 part 1 (Durban 1994) para 260.

5.38 It seems to us that the onus of showing that there is an unenforceable penalty should lie on the party who makes this allegation. As this question appears to be a matter of doubt<sup>68</sup> it would be helpful to have clarification of the law. Once the defender demonstrates that there is an unenforceable penalty, the pursuer would have to aver and prove actual loss if the pursuer wished to recover damages. The defender might show that the penalty was grossly or manifestly excessive by showing what the actual loss of the pursuer was. But this would not always be necessary; and it might be impossible for the defender to provide details of the pursuer's loss. In, for example, the hire purchase cases it may be a matter of common sense that the sums claimed by the owner were in excess of any actual loss, except in improbable circumstances. In Lord Halsbury's example of the penalty of a million pounds for failure to build within a year a house for £50, we would not expect the courts to need detailed averments or proof. Or in the *Craig* type of case where there is a penalty of £x per day for non supply of machinery worth £100x, it may be obvious there is a penalty, without knowing exactly what loss arose. It would be unfortunate if a party was unable to present a case that a penalty was unenforceable, merely because of lack of information about the other party's loss. This was one reason why we were hesitant about defining a penalty in terms which involved a comparison with the actual loss which a party has sustained.

5.39 If, on the other hand, the onus of showing that a penalty clause was not grossly excessive was placed on the party who was relying on the clause the result might be a considerable change in practice. For example, in building contracts and charterparties, where penalty clauses are at present rarely challenged,<sup>69</sup> there would be some incentive whenever a penalty was claimed for the contractor or charterer to claim that the penalty was excessive. The employer or shipowner would then have to justify the amount of the sum sought, if the onus was on them. This could defeat one of the virtues of penalty clauses, that they minimise dispute.

5.40 We have assumed that it should not be possible for a court on its own initiative to refuse to enforce a penalty.<sup>70</sup> We would welcome comments on the following proposal:

**8. The onus of showing that a penalty is unenforceable should lie on the party so contending.**

**Power to modify**

5.41 If the penalty is unenforceable the result under the existing law is that provable loss is recoverable. The penalty is not modified in the sense that the court reduces the penalty to what it considers a more moderate sum. For example if a deposit of 50% in a contract for sale of land is held to be an unenforceable penalty, the court has at present no power to reduce the sum to a 10% deposit.<sup>71</sup> The seller is not entitled to that sum, without proof of loss. This is not the only possible approach.

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<sup>68</sup> In the *Borough of Wirral* OH 29 April 1997 unrep; 1997 GWD 19-900 Lord Hamilton reserved his opinion on questions of onus of proof.

<sup>69</sup> Para 3.2(2).

<sup>70</sup> Cf *United Dominions Trust Ltd v McDowell* 1984 SLT (Sh Ct) 10; A J Kerr, "The Role of the Court in Civil Cases. The Conventional Penalties Act," (1991) 108 SALJ 245.

<sup>71</sup> In *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573 the Court of Appeal of Jamaica ordered the repayment of 15% out of a 25% deposit, leaving the bank with its normal 10% deposit. The Privy Council did not agree that this was the correct order. The bank had no right to 10%, but was allowed to retain a sum out of which damages might be satisfied.

5.42 It would be possible to give the court power to modify a penalty, for example by reducing it to an amount which it considers appropriate or not grossly excessive in the circumstances<sup>72</sup> or by attaching conditions to its recovery.<sup>73</sup> This is a common approach in other legal systems.<sup>74</sup>

5.43 A power to modify can be criticised on the ground that it would be a difficult power for a court to exercise. A court may be able to conclude without too much difficulty that a particular penalty is grossly excessive but it may be much more difficult to decide on what an appropriate penalty might be. Courts in other countries seem, however, to be able to exercise this discretion. A good deal would depend on the precise way in which the power was conferred. It would be preferable to give the courts a fairly wide power rather than require them to fix the precise point at which a penalty ceases to be grossly excessive.

5.44 A standard criticism of any judicial power to modify contractual provisions is that it leads to uncertainty. In relation to penalty clauses, however, the mere existence of judicial control leads to an element of uncertainty and it is not clear that the uncertainty is greater when there is a power to modify than when there is only a power to cut the penalty down altogether. Arguably, the uncertainty is greater when there is no power to modify because the possible variation in result is likely to be greater. There is more of a gamble involved.

5.45 It can be argued that a power to modify would encourage the use of grossly excessive penalty clauses because the person seeking to insert them would know that at worst they might be modified to what was within the normal limits and that the other party would have to litigate to obtain the modification. However, contractual penalty clauses require the agreement of both parties. The promisor would not wish to agree to a grossly excessive penalty clause, even if there was the possibility of judicial modification. The promisee would also have some incentive to avoid the use of a penalty clause which would simply invite judicial challenge. Contracting parties do not normally welcome the prospect of litigation. In any event the difference from the existing law would be merely one of degree. Under the existing law the promisee knows that if a penalty clause is struck down there is still a claim for damages.

5.46 There are arguments in favour of a power to modify rather than simply strike down.<sup>75</sup> To some extent these are the same as the general arguments in favour of the enforceability of penalty clauses. A power to modify enables the parties' freely negotiated agreement to be enforced as nearly as possible. If it is assumed that an apparently excessive penalty clause has been inserted for a particular purpose, for example because the promisee has strong non-economic reasons for requiring performance strictly in accordance with the contract and would not regard damages as a sufficient remedy, and if it is further assumed that the promisee has been prepared to pay a higher price in order to obtain the other party's acceptance of the penalty clause, then the absence of a power to modify may give the promisor an incentive to breach and litigate. The penalty, let us suppose, is bordering on the excessive even when the special circumstances are taken into consideration. It may be struck down entirely, in which

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<sup>72</sup> Compare art 7 of the Council of Europe's Resolution on Penalty Clauses and s 3 of the South African Conventional Penalties Act 1962, both set out in the Appendix.

<sup>73</sup> As suggested in relation to penal irritancy clauses by Lord Keith of Kinkell in *CIN Properties Ltd v Dollar land (Cumbernauld) Ltd* 1992 SC (HL) 104 at p 119. The English courts enjoy wide powers of this nature in relation to forfeiture clauses. See, in particular, the Law of Property Act 1925, s 146.

<sup>74</sup> See paras 1.8 - 1.10 above.

<sup>75</sup> See Mattei, "The Comparative Law and Economics of Penalty Clauses in Contracts", 43 Am J Comp L (1995) 427 at pp 442-443.

case only damages will be payable. The contract-breaker, who has received a higher price precisely because he agreed to pay more than damages in the event of breach, derives an unfair benefit. If there is a power to modify, the promisor may still have to pay more than damages, even if the penalty is regarded as excessive in the circumstances, and can be prevented from gaining an unfair advantage. There is a greater incentive to perform, less of an incentive to litigate and less risk of unfairness.

5.47 A power to modify would help to resolve difficulties in cases where the penalty seems grossly excessive in the light of any possible loss or prejudice that could have been sustained but where actual loss is impossible or very difficult to determine. It would also help to avoid extreme differences of result depending on whether a clause is just over or just under the limit for enforceability. It would enable the courts to give effect to the parties' bargain subject only to such adjustment as might be required to avoid oppression. In general, it would introduce an element of moderation and flexibility into the enforcement of penalty clauses and this might be particularly useful if it is made clear that a penalty may consist of a transfer or forfeiture of property. We have already noted that, in the context of irritancy clauses, judges have expressed the view that a power to attach conditions would be useful and beneficial.<sup>76</sup> It might be useful to provide that, in any case where actual loss was provable, the penalty could not be modified to an amount or value below the damages which could be recovered.<sup>77</sup> We would welcome the views of consultees.

9. **Should the courts have power to modify a penalty (for example, by reducing its amount or attaching conditions to the exercise of the relevant right) or should their powers be limited to declaring the penalty unenforceable?**

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<sup>76</sup> See *CIN Properties Ltd v Dollar land (Cumbernauld) Ltd* 1992 SC (HL) 104 by Lord Keith of Kinkel at p 119.

<sup>77</sup> See art 7 of the Council of Europe's Resolution.

## Part 6 Summary of questions and provisional proposals

1. (a) Should the agreement of contracting parties on a penalty be enforceable in all cases, or in no cases, or should there be some judicial control?
- (b) If there should be some judicial control, should the criterion for its exercise be that the penalty is grossly excessive (our provisional preference) or should there be some other criterion?
- (c) If some other criterion is preferred, what should it be?

(Para 4.11)

2. Judicial control over penalty clauses should not be confined to cases where the penalty is due when the promisor is in breach of contract. It should extend to cases where the penalty is due if the promisor fails to perform, or to perform in a particular way, under a contract or when there is an early termination of a contract.

(Para 4.24)

3. (1) Judicial control over penalty clauses should apply whatever form the penalty takes. It should, in particular, apply whether the penalty takes the form of a payment of money, a forfeiture of money, a transfer of property, or a forfeiture of property.

(Para 5.10)

- (2) It should be provided that nothing in any enactment or rule of law should prevent the law on the control of penalty clauses from applying to irritancy clauses or clauses having similar effect.

(Para 5.18)

4. (1) In any new law on penalty clauses the courts should continue to have power to have regard to the substance of the transaction rather than to its form.
- (2) Views are invited on the question whether there is any need to strengthen the courts' powers so as to make it less easy for the control on penalty clauses to be avoided by drafting devices.

(Para 5.20)

5. Should the value of an unenforceable penalty be the limit of the recoverable loss?

(Para 5.23)

6. Views are invited as to whether it is necessary to have legislation on the relationship between a penalty and other remedies.

(Para 5.24)

7. The enforceability of a penalty should be judged according to all the circumstances, including the loss arising from non performance or termination and other circumstances since the contract was entered into.

(Para 5.29)

8. The onus of showing that a penalty is unenforceable should lie on the party so contending.

(Para 5.40)

9. Should the courts have power to modify a penalty (for example, by reducing its amount or attaching conditions to the exercise of the relevant right) or should their powers be limited to declaring the penalty unenforceable?

(Para 5.47)

# APPENDIX

## THE SOUTH AFRICAN CONVENTIONAL PENALTIES ACT 1962

as amended by

General Law Amendment Act 102 of 1967  
Justice Laws Rationalisation Act 18 of 1996  
General Law Amendment Act 49 of 1996

### ACT

**To provide for the enforceability of penalty stipulations, including stipulations based on pre-estimates of damage, and of forfeiture clauses.**

#### **1 Stipulations for penalties in case of breach of contract to be enforceable**

(1) A stipulation, hereinafter referred to as a penalty stipulation, whereby it is provided that any person shall, in respect of an act or omission in conflict with a contractual obligation, be liable to pay a sum of money or to deliver or perform anything for the benefit of any other person, hereinafter referred to as a creditor, either by way of a penalty or as liquidated damages, shall, subject to the provisions of this Act, be capable of being enforced in any competent court.

(2) Any sum of money for the payment of which or anything for the delivery or performance of which a person may so become liable, is in this Act referred to as a penalty.

#### **2 Prohibition on cumulation of remedies and limitation on recovery of penalties in respect of defects or delay**

(1) A creditor shall not be entitled to recover in respect of an act or omission which is the subject of a penalty stipulation, both the penalty and damages, or, except where the relevant contract expressly so provides, to recover damages in lieu of the penalty.

(2) A person who accepts or is obliged to accept defective or non-timeous performance shall not be entitled to recover a penalty in respect of the defect or delay, unless the penalty was expressly stipulated for in respect of that defect or delay.

#### **3 Reduction of excessive penalty**

If upon the hearing of a claim for a penalty, it appears to the court that such penalty is out of proportion to the prejudice suffered by the creditor by reason of the act or omission in respect of which the penalty was stipulated, the court may reduce the penalty to such extent as it may consider equitable in the circumstances: Provided that in determining the extent of such prejudice the court shall take into consideration not only the creditor's proprietary interest, but every other rightful interest which may be affected by the act or omission in question.

#### **4 Provisions as to penalty stipulations also apply in respect of forfeiture stipulations**

A stipulation whereby it is provided that upon withdrawal from an agreement by a party thereto under circumstances specified therein, any other party thereto shall forfeit the right to claim restitution of anything performed by him in terms of the agreement, or shall, notwithstanding the withdrawal, remain liable for the performance of anything thereunder, shall have effect to the extent and subject to the conditions prescribed in sections one to three, inclusive, as if it were a penalty stipulation.

#### **5 Application of Act to credit transactions to which Act 75 of 1980 applies**

If any provision of the Credit Agreements Act, 1980, is, in terms of the said Act or any notice issued under the said Act, applicable to any credit transaction, the provisions of this Act shall not apply to such credit transaction in so far as they are in conflict with the provision in question.

[S 5 substituted by s 18(1) of Act 102 of 1967 and by s 4 of Act 18 of 1996.]

6 [S 6 repealed by s 1 of Act 49 of 1996.]

#### **7 Short title**

This Act shall be called the Conventional Penalties Act, 1962.

**COUNCIL OF EUROPE**  
**PENAL CLAUSES IN CIVIL LAW**  
Resolution (78) 3  
Adopted by the Committee of Ministers  
of the Council of Europe  
on 20 January 1978

The Committee of Ministers

Considering that the aim of the Council of Europe is to achieve greater unity between its members, in particular by the adoption of common rules in the field of law;

Considering that it is necessary to provide for judicial control over penal clauses in civil law in appropriate cases where the penalty is manifestly excessive;

Considering that penal clauses applicable on breach of contract constitute the most typical and frequent form of penal clauses and that it is therefore desirable to provide common rules for such clauses,

Recommends governments of member states

1. to take the principles concerning penal clauses in civil law contained in the appendix to this resolution into consideration when preparing new legislation on this subject;
2. to consider the extent to which the principles set out in the appendix can be applied, subject to any necessary modifications, to other clauses which have the same aim or effect as penal clauses;
3. to make this resolution and its appendix and the explanatory memorandum<sup>1</sup> available to the appropriate authorities and other interested bodies in their countries.

APPENDIX

Article 1

A penal clause is, for the purposes of this resolution, any clause in a contract which provides that if the promisor fails to perform the principal obligation he shall be bound to pay a sum of money by way of penalty or compensation.

Article 2

The promisee may not obtain concurrently performance of the principal obligation, as specified in the contract, and payment of the sum stipulated in the penal clause unless that sum was stipulated for delayed performance. Any stipulation to the contrary shall be void.

Article 3

A penal clause shall not of itself prevent the promisee from obtaining specific performance of the principal obligation instead of the sum due under that clause.

Article 4

The sum stipulated shall not be due unless the promisor is liable for the failure to perform the principal obligation.

Article 5

The promisee cannot obtain damages in respect of the failure to perform the principal obligation instead of, or in addition to, the sum stipulated.

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<sup>1</sup> Not reproduced.

#### Article 6

Despite any stipulation to the contrary, the promisee cannot obtain a sum in excess of either the sum stipulated under the penal clause or the damages payable for the failure to perform the principal obligation whichever is the larger.

#### Article 7

The sum stipulated may be reduced by the court when it is manifestly excessive. In particular, reduction may be made when the principal obligation has been performed in part. The sum may not be reduced below the damages payable for failure to perform the obligation. Any stipulation contrary to the provisions of this article shall be void.

#### Article 8

The provisions of the preceding articles shall be without prejudice to rules relating to any particular type of contract owing to its special nature.