

ISSUED ON BEHALF OF THE SCOTTISH LAW COMMISSION  
NOT FOR PUBLICATION OR BROADCAST  
BEFORE 0001 HOURS 30 NOVEMBER 2016

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## **PENALTIES CALLED ONSIDE?**

In the latest phase of its review of contract law in Scotland, the Scottish Law Commission today publishes a Discussion Paper on the rule against penalty clauses in contracts, raising for consultation purposes the possibilities that the rule be abolished outright, or be completely replaced by new, much better-targeted rules to deal appropriately with real abuses of contract power.

For a long time the judge-made law of penalties allowed parties to fix their own regime of damages for breach of a contract only if the relevant term (or clause) constituted a genuine pre-estimate of the loss likely to be suffered on a breach. Anything else was to be regarded as an unenforceable penalty, in line with the policy of the law that a contract could not provide for punishment of a contract-breaker as distinct from compensation for the innocent party.

This distinction has been heavily criticised for a long time as out-of-line with commercial reality, in which businesses seek to provide real incentives for their contracting counterparties to perform contracts in full accordance with their terms. In a case decided in November 2015 the UK Supreme Court made an attempt to revise what it described as “an ancient, haphazardly constructed edifice which has not weathered well”.<sup>1</sup>

The Court recognised that compensation for loss caused by breach was not the only legitimate interest that an innocent party might protect by way of a penalty clause, and that a clause directed towards such other interests in the context of the other party’s breach – for example, the promotion of business goodwill, distribution networks and other such commercial interests – could be enforceable even though not based upon a pre-estimation of loss. Such a clause would become unenforceable, however, if it was unconscionable, extravagant or disproportionate in its terms. Finally, the Court had no power in England & Wales to modify the clause to make it acceptable; the penalty was either enforceable or not as it stood.

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<sup>1</sup> *Cavendish Square Holding BV v El Makdessi; Parking Eye Ltd v Beavis* [2015] UKSC 67; [2015] 3 WLR 1373.

This ruling, while welcomed in some respects, has also been criticised for being too uncertain in its scope and insufficiently radical in the changes it brings about. The Scottish Law Commission, which was already considering the rule against penalties, has therefore decided to canvas the possibility of further reform (although leaving open the possibility of doing nothing for the moment, to see how the Supreme Court decision beds in).

Apart from doing nothing, the Scottish Law Commission raises two options for reform:

- (1) should the present law simply be abolished, apart from the statutory rules protecting consumers from unfair penalties?
- (2) should the present law (again, apart from the statutory consumer protection rules) be completely replaced?

In each alternative, the rule against penalties would be succeeded by a starting point that apart from consumer contracts penalty clauses are generally enforceable.

With the second option of an altogether new system, a penalty clause could only be challenged if the actual effects of its enforcement were shown to be out of all proportion to the interest of the innocent party that it was designed to protect. Moreover, a successful challenge could lead, not to unenforceability, but rather to the court modifying the penalty. This would mean, not reducing the penalty to the amount of any actual loss suffered by the innocent party, but only the removal of its excessive element.

Professor Hector MacQueen, the Commissioner leading the contract law review, said:

“Although we think that our suggested new system does strike a better balance between certainty and the correction of real unfairness, the Commission’s eventual conclusions and recommendations to the Scottish Government will be very much led by the responses which we receive to this consultative document. We know that many commercial lawyers favour outright abolition of the rule against penalties; but we are concerned that this might leave small businesses, employees and other persons of relatively low bargaining power vulnerable to excessive penalisation. We need to know how realistic these concerns are, and we therefore hope that the consultation response will be widespread.”

The closing date for the consultation is 24 February 2017, and the Commission hopes to complete its report on the subject by the end of that year.

## NOTES TO EDITORS

1. The Scottish Law Commission was set up in 1965 to promote the reform of the law of Scotland. The Chairman is the Hon Lord Pentland, a Court of Session judge. The other Commissioners are Caroline Drummond, David Johnston QC, Professor Hector L MacQueen, and Dr Andrew J M Steven. The Chief Executive is Malcolm McMillan.
2. Further information can be obtained by contacting Graham Crombie, Scottish Law Commission, 140 Causewayside, Edinburgh EH9 1PR (Tel: 0131 668 2131; email [info@scotlawcom.gsi.gov.uk](mailto:info@scotlawcom.gsi.gov.uk)).
3. The paper may be viewed on our website at <http://www.scotlawcom.gov.uk>.