

30 November 2016



Your ref:
Our ref: L/1/8/2C

Dear Consultee

DISCUSSION PAPER ON PENALTY CLAUSES (DISCUSSION PAPER No 162)

We invite comments on the Discussion Paper on Penalty Clauses, which has been published today.

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”. The Court’s ruling in *Cavendish Square Holding BV v El Makdessi; Parking Eye Ltd v Beavis* [2015] UKSC 67; [2015] 3 WLR 1373, 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. We were already considering the rule against penalties, and have 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, we raise two other 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.



Consultation is critical in all our law reform projects to ensure that the final recommendations contained in our report would, if implemented, result in law which is just, principled, responsive and easy to understand. We would therefore be grateful to receive your views on any or all of the questions in this Discussion Paper; they will be fully considered and analysed in the course of reaching our final conclusions. The consultation period lasts till **24 February 2017**.

Where possible, we would prefer the electronic submission of comments. You can use the electronic response form for this Discussion Paper on our website at <http://www.scotlawcom.gov.uk/publications/discussion-papers-and-consultative-memoranda/2010-present/>. The form has a questionnaire format which allows you to comment on any of the paper's questions which interest you. The form can be downloaded and emailed to us at info@scotlawcom.gsi.gov.uk, as can comments in other electronic formats. Alternatively, you may prefer to send your comments on the Discussion Paper by using the general comments form to be found on the website Contact us page (<http://www.scotlawcom.gov.uk/contact-us/>).

Please note that information about this Discussion Paper, including copies of responses, may be made available in terms of the Freedom of Information (Scotland) Act 2002. Any confidential response will be dealt with in accordance with the 2002 Act. We may also (i) publish responses on our website (either in full or in some other way such as reformatted or summarised); and (ii) attribute comments and publish a list of respondents' names.