NAVIGATING PENALTIES AND LIQUIDATED DAMAGES ACROSS COMMON LAW AND CIVIL LAW JURISDICTIONS

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ABSTRACT

The civil and common law approaches to fixed damages upon the occurrence of breaches of contract has taken different paths. Penalties are frowned upon in the common law but liquidated damages enforced. The reverse is broadly true in the civil law. There are a variety of approaches to the enforceability of liquidated damages in common law jurisdictions, some recently evolving, and in the civil law a wide discretion is given to judges and arbitrators to adjust penalties (or liquidated damages) to the particular circumstances of the case. How then to navigate these competing local law provisions in international construction projects when the forms of contract in general use, such as FIDIC, are common law based? This paper will discuss these competing legal approaches and seek to delineate a path through the thickets for the unwary.

1. INTRODUCTION

Penalties and liquidated damages are an area of law which has been the subject of much attention, change and scrutiny in recent times. In December 2015, the Supreme Court of England and Wales delivered its landmark decision in *Cavendish Square Holding BV v El Makdessi, ParkingEye Ltd v Beavis*[1] which modified the English doctrine of penalties as it stood for the last century, and steered English law in a new direction. In October 2016, the new French Civil Code entered into force, which consolidated the leading civil law jurisdiction's approach to penalties. Not only are common and civil law approaches to the doctrine of penalties evolving on different paths, but divergences along each path are plentiful, as various jurisdictions have departed from traditional doctrines, originating from England or the Napoleonic Code.

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[1] *Cavendish Square Holding BV v El Makdessi, Parkingeye Ltd v Beavis* (SC) [2015] UKSC 67; [2016] BLR 1; [2016] 1 Lloyd's Rep 55; [2016] AC 1172; [2015] 3 WLR 1373; [2016] 2 All ER 519; 162 Con LR 1 ("*Cavendish*").

Liquidated damages clauses are, almost invariably, found in construction contracts. It is therefore apposite to reflect on the development of liquidated damages, and in particular, cast a critical eye over the practical effect that these developments have in the international construction law context. As such, this article will address the topic in the following four parts:

- First, I will contextualise the discussion on liquidated damages by examining their historical place in the common law and in construction law;
- Secondly, I will examine the development of the law in England, the United States, Canada, Australia and other common law jurisdictions over the last century;
- Thirdly, I will compare those approaches with the position in civil law jurisdictions such as France and Egypt; and
- Finally, I will evaluate the suitability of common law and civil law approaches to liquidated damages and penalties in the international construction world and consider areas for improvement in the recommended approach.

2. BACKGROUND

2.1 Historical background

From where did the penalties doctrine emerge? Let me take you briefly to the late 15th and early 16th century. The penalty rule then operated as a form of relief from defeasible bonds. These bonds were written legal instruments designed to secure performance of a specified condition through the legal threat of a sum of money as damages, should the obligee fail to perform. The problem this created was that bond holders could bring common law actions in debt for the specified amount when non-performance occurred, enabling a bond holder to claim for an amount unrelated to, and often significantly more than, their actual losses. This is because an action in debt made it unnecessary for holders to substantiate their losses, and the common law, of course, enforced these bonds.

Equity, however, saw the intention of these bonds as security only and reduced their enforcement so that the obligee paid only actual damages, interest, and costs.[2] Two principles were applied in this exercise; first, that the bond was intended to secure the recovery of actual damage, and second,

[2] *Ibid*, fns 2–3 paragraph 4 (Lords Neuberger and Sumption), quoting *Sloman v Walter* (1783) 1 Bro CC 418, 419 (Lord Thurlow LC).

that the security could be achieved by staying the court proceedings on terms that the defendant paid damages.[3]

Thus, the court, when confronted with potential penalty clauses, must strike a balance between two competing interests. On the one hand, there is the desirability of legal and commercial certainty, which rests upon the doctrines of freedom of contract and party autonomy. On the other hand, there is a need to protect vulnerable contracting parties from certain predatory tactics open to use by larger commercial players.[4]

2.2 Construction law - the value of fixed sum damages

Construction contracts and liquidated damages clauses go hand in hand. Most construction contracts, particularly international ones, are implemented over many years and entail considerable uncertainty. Exposure to a broad range of risks, including political, environmental and financing risk, induces significant stress in such contracts. By providing for a fixed sum payment in the event of non-compliance with particular obligations, such as timely performance, liquidated damages clauses help avoid the massive time and expense of proving losses in an area where such proof is notoriously difficult.

By agreeing in advance on the amount to be paid for a specified delay, the interest of the Project Owner in receiving the project on time, or being compensated for the delay, is protected. Such an agreement places the Contractor on notice about the extent of damages for which it may be liable. Further, liquidated damages are sometimes used as a limitation of liability for delay where the actual loss far exceeds what was estimated. On the other hand, general damages may not adequately compensate a party for non-performance. The value of public infrastructure projects cannot be measured in cash flows or revenue streams, and a court or tribunal therefore cannot accurately value these intangible losses such as community disadvantage and political embarrassment. In this context, liquidated damages promote economic efficiency and reduce uncertainty in major projects.

3. COMMON LAW

3.1 Development of the law in England

Until recently, the historical decisions governing the law on penalties in England and many other common law jurisdictions was the early 20th

[3] *Ibid*, fn 3 paragraph 5 (Lords Neuberger and Sumption).

[4] See *AMEV-UDC Finance Ltd v Austin* (HCA) [1986] HCA 63; (1986) 162 CLR 170, 194 (Mason and Wilson JJ); approved by the New Zealand Court of Appeal in *Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd* (NZCA) [2004] 2 NZLR 614, paragraphs 57–58 (Gault, P, Blanchard and McGrath JJ).

century House of Lords case of *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*.[5] Whilst England and other jurisdictions now rely on more recent leading authorities, it is useful still to briefly explore *Dunlop*, as new authorities have built upon and referred to this case.

This case confirmed the general principle that where a contract clause stipulates payment *in terrorem*, that is as a legal threat given with the intention of compelling performance of the contract, the courts will find that clause to be a penalty clause and unenforceable. By contrast, a clause which stipulates payment in an amount reflecting a genuine pre-estimate of damage is characterised as a liquidated damages clause, and is thus enforceable.

Dunlop

Dunlop was a tyre manufacturer who had an agreement with New Garage, a retailer, not to resell their tyres for a price lower than its listed price. Breach of this clause made New Garage liable to pay £5 per tyre "by way of liquidated damages and not as a penalty" as the contract stipulated. New Garage breached the sale agreement and challenged the £5 provision on the ground that, despite being labelled as liquidated damages, it was actually a penalty. The court held in favour of Dunlop, finding that a significant part of the damage done by this breach was indirect damage to Dunlop's business model. As this damage was an unquantifiable amount, it was not relevant to their Lordships that the clause would come into effect no matter the level of deviation from the listed price.

In *Dunlop*, their Lordships emphasised that the law against penalties will be attracted only where a contract provides for an agreed sum to follow a breach of contract that exceeds what can be regarded as a genuine pre-estimate of probable damage.[6] To assist with this determination, Lord Dunedin set out four principles he considered likely to assist. These principles have been applied consistently in subsequent cases and as they are known to any student of contract law, I will simply outline the two that are most relevant to this article:

- a clause will be held to be a penalty if the sum stipulated is extravagant and unconscionable in comparison with the greatest loss that could conceivably be proved to have followed from the breach; and
- that losses are indeterminable is no obstacle to the sum stipulated being a genuine pre-estimate of damage. To the contrary, that is precisely the situation when it is probable that pre-estimated damage was the true bargain between the parties.

[5] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* (HL) [1915] AC 79 ("*Dunlop*").
[6] *Ringrow Pty Ltd v BP Australia Pty Ltd* (HCA) [2005] HCA 71; (2005) 224 CLR 656, 662 paragraph 10 (Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ) ("*Ringrow*").

Coming out of *Dunlop*, the courts recognised the importance of liquidated damages clauses in situations where precise pre-estimation of loss is impossible. In the situations contemplated by many construction contracts, this may well be the case and this may be sufficient to protect the parties' agreement from the penalties doctrine.

Further still, as a result of the decision in *Dunlop*, common law courts recognised that their jurisdiction allows them only to either honour a liquidated damages clause, or strike it down entirely. The court holds no jurisdiction to modify the liquidated damages agreed upon to bring it to a more sensible level. Thus, in those scenarios, a party is left to proving its losses in accordance with the general law, carrying with it all those associated disadvantages in the construction context.[7]

These principles established by *Dunlop* must now be considered in light of the extensive review in the appeal of *Cavendish*.

Cavendish

No discussion of *Cavendish* can begin without the lament of their Lordships for the quasi-statutory status to which Lord Dunedin's passage in *Dunlop* has risen in subsequent case-law.[8] Lord Dunedin did not suggest that his passages were more than just general guidelines, and neither did any other Law Lord in *Dunlop* expressly adopt his principles. Of particular note to their Lordships in *Cavendish* was the fact that Lord Dunedin himself acknowledged that his four tests were intended as a simplistic approach to basic penalty clause disputes, whereas in larger, more complex cases, the essential question to be asked was whether the clause in question was "unconscionable or extravagant".

But, "unconscionable or extravagant" in what context?

Lords Neuberger and Sumption were of the opinion that Lord Atkinson's passage in *Dunlop*, which respected the broad interests of contracting parties, was more instructive than Lord Dunedin's.[9] The appropriate question to answer was "what was the nature and extent of the innocent party's interest in the performance of the relevant obligation?"[10] In a modern context, this is synonymous with asking for the commercial justification for the inclusion of the liquidated damages clause. Thus, their Lordships in *Cavendish* revolutionised the way in which the doctrine of penalties is to be approached in the United Kingdom in the following words:

[7] Dunlop [1915] AC 79 cf, *Andrews v Australia and New Zealand Banking Group Ltd* (HCA) [2012] HCA 30; (2012) 247 CLR 205, 216–217 paragraph 10 (French CJ, Gummow, Crennan, Kiefel and Bell JJ) ("*Andrews*").

[8] *Cavendish* [2015] UKSC 67, 10–1 paragraph 22 (Lords Neuberger and Sumption).

[9] *Cavendish* [2015] UKSC 67, 11–2 (Lords Neuberger and Sumption).

[10] *Ibid* (Lords Neuberger and Sumption).

> "The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."[11]

A "genuine pre-estimate of loss" is no longer the relevant test to be applied in England, nor whether the clause is aimed at deterring breach. Instead, *Cavendish* asks the courts to balance the clause against the legitimate interest of the party seeking to enforce it or, alternatively, to consider whether there is a commercial justification for the clause.

It is instructive to consider the application of this test. One of the appeals in *Cavendish* concerned a parking ticket dispute in which a Mr Beavis overstayed a two-hour free parking limit and was fined £85 in accordance with numerous warnings around the car park.[12] Whilst the owner of the car park conceded the fine was not a genuine pre-estimate of damage (having suffered little to no damage), their Lordships found it was an effective clause for a number of cumulative reasons including that the owner had legitimate interest in obtaining income to cover its costs and ensuring a steady flow of new customers to the retail outlets for which the car park catered.

The other appeal concerned a share purchase dispute which contained a restrictive covenant preventing the seller, Makdessi, from engaging in competing activities.[13] Makdessi subsequently did so. The covenants entitled the buyer, Cavendish, to withhold the final instalments for the shares and to acquire them for a lower price that did not take into account goodwill. Whilst this clause did not directly penalise Makdessi, their Lordships considered that a clause disentitling a party to a benefit otherwise due could rightly constitute a penalty, however, that the covenants were not penalties as Cavendish had legitimate interest in protecting its goodwill and competition.

Common to the determination of both appeals was a broader examination of the legitimate interest of a party in receiving performance, and not a mechanical fixation on possible loss. This is a particularly useful development in the construction industry given the fact that many construction contracts have a broader interest than just money, being also concerned with community expectations, reputation and goodwill.

Many common law superior courts have yet to have the opportunity to respond to *Cavendish* and consider whether to alter the course of the penalties doctrine in their jurisdiction. However, divergence from the traditional approach in *Dunlop* is already evident in many common law jurisdictions.

[11] *Ibid*, fn 17 paragraph 32 (Lords Neuberger and Sumption).
[12] *ParkingEye Ltd v Beavis* [2015] UKSC 67.
[13] *Cavendish* [2015] UKSC 67.

3.2 Divergence from English doctrine

United States

In North America, the English doctrine has been influential, but some notable differences have emerged. Two aspects of the US approach are particularly distinguishable. First, liquidated damages clauses will only be valid when the damages anticipated to result from a breach are uncertain in amount or difficult to prove.[14] This frames Lord Dunedin's rule in the reverse. Instead of indeterminable losses being no obstacle to the stipulated sum being a "genuine pre-estimate of loss", it is a necessity to consider whether damages could otherwise be proven in deciding the validity of a clause.

Secondly, the United States takes a different approach in relation to the timing of the test. This aspect of the law largely followed the English doctrine until the enactment of the Uniform Civil Code in 1952. The English approach is to assess the stipulated sum at the time of contract formation. The Uniform Civil Code[15] and the Restatement (Second) of the Law of Contracts[16] however, permit the reasonableness of the clause to be established by reference to either "anticipated or actual" loss of harm.[17] This approach means that the clause can either be considered at the time of contracting or at the time the breach transpired. The consequence of such an approach is to increase the possibility that liquidated damages clauses will be enforceable.

Canada

The Canadian law on penalties was influenced by the decision in *Dunlop*, with the Supreme Court of Canada adopting the same reasoning in its 1915 decision, *Canadian General Electric Co v Canadian Rubber Co*.[18] The key divergence which has emerged from subsequent decisions is a conceptual difference in the rationale for the penalty jurisdiction. In *HF Clarke Ltd v Thermidaire Corp*, Laskin CJ considered that "judicial interference with the enforcement of what the courts regard as penalty clauses is simply a manifestation of a concern for fairness and reasonableness".[19] This sentiment extended into the case of *Elsley v JG Collins Insurance Agencies* in which the Supreme Court considered, "[t]he power to strike down a penalty clause … is designed for the sole purpose of providing relief against oppression".[20]

[14] *Banta v Stamford Motor Co* 92 A 665 (Conn 1914) 667–668; *Priebe & Sons Inc v United States*, 332 US 407 No 16. Argued 13 October 1947. Decided 17 November 1947.

[15] Section 718(1).

[16] Section 356(1).

[17] *Lake River Corp v Carborundum Co* 769 F 2d 1284 (7th Cir 1985).

[18] *Canadian General Electric Co v Canadian Rubber Co* (SCC) (1915), 52 SCR 349; (1915) 27 DLR 294.

[19] *HF Clarke Ltd v Thermidaire Corp Ltd* (SCC) [1976] 1 SCR 319, 330–331.

[20] *Elsley v JG Collins Insurance Agencies* (SCC) [1978] 2 SCR 916, 937 (Dickson J).

Consequently, a line of Canadian case law has developed with unconscionability as the underlying rationale for the rule against penalties. This position has been unequivocally rejected in the United Kingdom, most prominently in *Cavendish*[21] which leaned towards economic efficiency and commercial justifications as the basis for determining whether there was a penalty. It would seem that there is a great need for a clear restatement from the Supreme Court of Canada on which doctrine is to be preferred.[22]

Australia

The development of Australian law may be considered the most significant departure among traditional common law jurisdictions. This came from the 2012 High Court of Australia decision of *Andrews*[23] in which Mr Andrews led a 38,000 strong class action against ANZ alleging that certain bank fees imposed were penalties at law.

Prior to *Andrews*, the penalty doctrine was understood to be engaged following a breach of contract.[24] This was because it was thought that the rule against penalties had ceased being a rule of equity, but had instead become one of the common law.

In *Andrews*, the High Court disagreed. It found that the penalties rule still exists both in common law and equity and, although the common law rule is only engaged upon a breach, equity is not so constrained. The court in *Andrews* went on to assert that a contractual stipulation imposes a penalty on a party if, as a matter of substance, it is collateral to a primary stipulation in favour of the other party, and that collateral stipulation, upon failure of the primary stipulation, imposes an additional detriment to the benefit of the other party. This is because the collateral stipulation would be in the nature of a security for and *in terrorem* of the satisfaction of the primary stipulation.[25]

In making this statement, the High Court did not modify the penalties doctrine but rather significantly expanded its scope to potentially any contractual stipulation, rather than just breach.

Andrews has had the effect of creating divergent lines of authority between Australia, and other leading common law jurisdictions: the

[21] *Cavendish* paragraph 169 (Lord Neuberger and Lord Sumption).

[22] St Aubin, J and Sebastiano, R, "Liquidated Damages: Canadian Adoption, Divergence and the Necessity for Restatement" (2017) 1 *Journal of the Canadian College of Construction Lawyers* 139, 165.

[23] *Andrews* (HCA) [2012] HCA 30; (2012) 247 CLR 205.

[24] *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (NSWCA) [**2008**] NSWCA 310; (2008) 257 ALR 292.

[25] *Andrews* (HCA) [2012] HCA 30; (2012) 247 CLR 205, 216 paragraph 10 (French CJ, Gummow, Crennan, Kiefel and Bell JJ).

UK,[26] US[27] and Canada,[28] with regards to what is necessary to enliven the doctrine of penalties. The High Court reaffirmed its holding in the 2016 decision of *Paccioco and Another v Australia and New Zealand Banking Group Ltd.*[29] In his judgment, French CJ noted that although convergence is generally preferable to divergence in comparative law, the common law of Australia is distinct from that of the UK, and disagreement does exist.[30] Thus, it seems unlikely that the position in Australia will return to its pre-*Andrews* position.

3.3 Other common law jurisdictions

From this background, the law in India[31] and related jurisdictions such as Brunei[32] has developed on substantially different lines. In these countries, there is no principled distinction made between a penalty and a liquidated damages clause,[33] nor a general entitlement to receive the agreed amount upon the occurrence of a breach. Instead, the court must consider two distinct issues.

First, in the case where a party can prove their actual losses, it must do so and the liquidated damages clause cannot be relied upon to dispense with proof.[34] Secondly, in the event that a party cannot prove their losses, or this is difficult to do, the court has the power to award "reasonable compensation" not exceeding the amount agreed to by the parties.[35] The liquidated damages clause therefore operates as an upper limit on damages, however the total amount awarded can be adjusted to anywhere beneath this ceiling.

In my view, this approach to the penalties doctrine limits the utility of liquidated damages clauses and the certainty these clauses can offer. This is because it substantially limits the circumstances in which a liquidated damages clause is given (even partial) effect. It further does not appropriately recognise the benefit in allowing fixed compensation without a need to evidence losses, nor the fact that not all losses are measureable, or even observable. It is therefore notable that in November 2018, the Federal Court of Malaysia unanimously departed from a long line of authority which followed the Indian courts' approach[36] and restated the law on liquidated damages in the case of *Cubic Electronics Sdn Bhd (In Liquidation) v*

[26] *Cavendish* paragraph 42 (Lords Neuberger and Sumption).
[27] Restatement (Second) of Contracts section 356; Uniform Commercial Code section 2-718.
[28] *Canadian General Electric Co v Canadian Rubber Co* (SCC) (1915) 52 SCR 349; (1915) 27 DLR 294, 295.
[29] *Paciocco and Another v Australia and New Zealand Banking Group Ltd* (HCA) [2016] HCA 28.
[30] *Ibid*, paragraphs 6–10 (French CJ).
[31] Contracts Act 1872 section 74.
[32] Laws of Brunei, Chapter 106 (Contracts) section 75.
[33] *Fateh Chand v Balkishan Das* (1964) SCR (1) 515, 526.
[34] *Maula Bux v Union of India* (1970) SCR (1) 928, 933, *Kailash Nath Associates v DDA* (2015) 4 SCC 136.
[35] Indian Contracts Act 1872 section 74; *Fateh Chand v Balkishan Das* (1964) SCR (1) 515, 526–527.
[36] Contracts Act 1950 section 75. See *Selva Kumar a/l Murugiah v Thiagarajah a/l Retnasamy* [1995] 1 MLJ 817.

Mars Telecommunications Sdn Bhd.[37] The court held that reasonable compensation can be awarded by the court irrespective of whether actual loss or damage is proven. Additionally, the concepts of "legitimate interest" and "proportionality" as enunciated in *Cavendish* were said to be relevant to determining what amounts to "reasonable compensation".[38]

From a practical perspective however, liquidated damages clauses in India still have some utility. This is because damages for delay, and similar breaches, will often fall into the category of cases for which a party cannot readily establish their losses.[39] As discussed, the court then has the power to award reasonable compensation in response to that breach. If the amount that the parties have agreed to in the liquidated damages clause is a genuine pre-estimate of loss, the court will likely defer to that figure,[40] and consider it to be reasonable compensation.[41] Thus, the agreement of the parties is often upheld in practice.

Therefore, although the position in India is more restrictive in comparison to England, the evidential difficulties associated with most construction contracts mean that part of the utility of a liquidated damages clause still remains. However, there are aspects of the common law that are deficient in addressing the unique issues associated with a construction project. In light of this, I turn now to the civil law, where a particularly liberal approach is taken to the doctrine of penalties, in which some value can be discerned.

4. CIVIL LAW

The operation of the doctrine of penalties differs substantially between common law and civil law jurisdictions. There are two crucial distinctions to be made:

1. Civil law countries presume the enforceability of penalty clauses as a valid means of compelling performance. There is therefore little distinction made between penalty clauses and liquidated damages clauses;[42] and
2. Courts and Arbitrators applying civil law have the authority to adjust or proportion an amount stipulated as a penalty. As I have mentioned, the courts in most common law jurisdictions do not have this power.

[37] *Cubic Electronics Sdn Bhd (In Liquidation) v Mars Telecommunications Sdn Bhd* [2018] MLJU 1935.

[38] *Cubic Electronics Sdn Bhd (In Liquidation) v Mars Telecommunications Sdn Bhd* [2018] MLJU 1935, paragraph 74.

[39] See, e.g., the analysis in *Sakinas Sdn Bhd v Siew Yik Hau and Another* [2002] 3 CLJ 275.

[40] *Oil & National Gas Corporation Ltd* (2003) 5 SCC 705.

[41] *Maula Bux v Union of India* (1970) SCR (1) 928, 933–934.

[42] Antonio Pinto Monteiro A P, "Dictionary/Dictionnaire/Lexikon" (2001) 9(1) *European Review of Private Law* 149.

4.1 History

To offer an initial word of caution, as with common law jurisdictions, there is a significant variation in detail between the laws of civil law jurisdictions. This is in relation to both the code provisions and the approach to interpretation of particular provisions. Further, the overlay of administrative law on the enforceability of government contracts cannot be ignored. Therefore, the comments that follow must thus be qualified.

As a brief history, the enforceability of penalty clauses in civil law stems from modern civil codes having their roots in the Napoleonic Code of 1804, itself a product of earlier Roman law, and in particular the 6th century Justinian Code.[43] Roman law operated under the principle of literal enforcement, where courts would enforce any type of penalty clause without mitigation.[44] This principle saw codification in the Napoleonic Code, which was subsequently spread throughout Continental Europe during the years of the Napoleonic Wars.[45]

Many countries have, over time, progressively abandoned this strict literal enforcement approach and have made provisions for civil courts and decision-makers to review and adjust the amount stipulated under a penalty clause in certain circumstances. A leading catalyst for this development came in 1971 from the Council of Europe, which issued a "Resolution on Penalty Clauses" with the aim of unifying the application of penalty clauses for member states. The resolution maintains the presumption in favour of penalty clauses, but allowed the amount stipulated to be reduced if the courts found that it was manifestly excessive or if part performance of the contract had occurred.[46]

To guide determinations of whether a penalty clause is "manifestly excessive", the explanatory memorandum to the Council of Europe's Resolution provides a list of factors to consider. These include the comparison of the pre-estimated damages to the actual harm, the legitimate interest of the parties, the industry relevant to the contract, the circumstances in which it was concluded, the position of the parties, and even whether the penalty was made in good or bad faith.[47]

With this historical context, I move now to the modern operation of the penalties doctrine in civil jurisdictions.

[43] Holtman, R B, *The Napoleonic Revolution* (Louisiana State University Press, 1981).

[44] Zimmermann, R, *The Law of Obligations: Roman Foundations of the Civil Tradition* (Oxford University Press, 1990).

[45] Holtman, above fn 34.

[46] Resolution 78(3) of the Committee of Ministers of the Council of Europe; Relating to Penal Clauses in Civil Law.

[47] DiMatteo L A, "A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages" (2008) 38(4) *American Business Law Journal* 633, 653.

4.2 Operation

The Napoleonic Code currently the "French" Civil Code, will frame much of my discussion of the civil law approach to the penalty doctrine. Many other jurisdictions have similar laws, and therefore this analysis is relevant to the broader civil law world.

A penalty clause is referred to as a "clause pénale" under French law. In the new French Civil Code which entered into force on 1 October 2016, sections of the code which address penalty clauses have been consolidated into one section: Article 1231-5. Importantly, despite the nomenclature "penalty clause", this section covers what the common law world would consider to be both liquidated damages clauses and penalty clauses.

The first paragraph of the Article states, "Where a contract stipulates that the person who fails to perform shall pay a certain sum of money by way of damages, the other party may be awarded neither a higher nor a lower sum." Analogous to common law "liquidated damages", the Article requires only that a party bind themselves to an agreement of payment in the event of breach.

Relevant for our discussion, however, is the flexibility inherent in the civil law approach. French courts are given authority to adjust the amount of a penalty clause under paragraph two of Article 1231-5 in the event that the amount "is manifestly excessive or derisory". Although a common law lawyer would criticise this as the courts now modifying the bargain between the parties, this approach might alternatively be understood as the court honouring the parties' agreement to the maximum possible extent permitted by the law and public policy. Such an approach would be more deferential to the agreement of the parties providing for a liquidated damages clause.

Further, in practice, French courts objectively approach this situation by using, in addition to the factors listed in the Council of Europe's Resolution, the contract price and actual loss as a basis for the amount of the penalties award, and they rarely award an amount greater than 5 per cent of the contract price.[48] Indeed, a 2012 French Court of Cassation ruling made clear that an innocent party cannot claim more than the damages the penalty clause would address without first demonstrating the existence of specific damages outside the scope of the penalty clause.[49]

Another opportunity to adjust the amount of a penalty clause presents itself where part performance has occurred. Article 1231-5 allows the court to reduce the penalty clause in proportion to the advantage which part performance has procured for the innocent party. Similar definitions,

[48] Karila, L and Vincigeurra, M E, "The Civil law Concept of Penalties and the Common Law Concept of Liquidated Damages" (2014) 2(10) Insight from Hindsight 1, 2 <https://www.navigant.com/-/media/www/site/insights/construction/2017/civillawconceptofpenalties.pdf>.

[49] Cass. 3e civ., 23 October 2012, n° 11-19602, 1255, *Bull.*

provisions and operations of the doctrine of penalties can be found all across civil code countries, for example Italy,[50] Spain,[51] Germany,[52] the Netherlands,[53] Switzerland,[54] Belgium,[55] China,[56] and Russia.[57]

Turning to the Middle East and North African region, in Egypt, liquidated damages are not permitted in the absence of loss suffered, and may be reduced if the amount fixed was "grossly exaggerated".[58] This position has influenced that of the region, such as Algeria[59] and Bahrain[60]. In the UAE[61] and Oman,[62] the position is even more broad; the court is granted power to vary any agreement upon the application of a party so as to make the compensation equal the loss.

5. EVALUATION OF THE COMMON LAW AND CIVIL LAW WORLDS

5.1 The common and civil law divergence - what pathway to follow?

Having canvassed the varying common and civil law pathways, it becomes clear that parties embarking on a contractual undertaking must be wary of the merits and obstacles posed by the different approaches of the common and civil law worlds.

The need for commercial certainty in large commercial contracts, such as those in the construction world, is in my view, a particularly important consideration. Upsetting an agreement because of competing local law

[50] Article 1382 of the Codice Civile entitles the use of penalty clauses; Article 1384 of the Codice Civile allows courts to reduce the penalty amount if it is "manifestly excessive" or in the event of part performance.

[51] Articles 1152 and 1153 of the Código Civil presume in favour of penalty clauses; Article 1154 of the Código Civil provides judges with an ability to reduce the amount in the event of part performance, but not if the amount is excessive.

[52] Articles 340 and 341 of the Bürgerliches Gesetzbuch (BGB) allows for the enforcement of penalties in the event of non-performance and improper performance; Article 343 of the BGB allows for the reduction of the penalty amount if it is "disproportionately high" with consideration for "every legitimate interest of the obligee, not merely financial".

[53] Article 6:94 of the Dutch Civil Code allows adjustments of penalty clauses if required "by the standards of reasonableness and fairness".

[54] Article 163(3) of the Code de Obligation Suisse allows mitigation of penalty clauses that are "excessive".

[55] Article 1231 of the Code Civil presumes in favour of penalty clauses and allows mitigation where it "obviously exceeds the actual damage" and in the event of part performance.

[56] Article 114 of the Contract Law of the People's Republic of China presumes in favour of liquidated damages and allows the adjustment of the penalty amount higher or lower in proportion to the actual loss.

[57] Article 330 of the Civil Code of the Russian Federation presumes in favour of penalty clauses and Article 333 allows reduction of the penalty amount if it is "obviously out of proportion" to the actual losses.

[58] Article 224 of the Egyptian Civil Code.

[59] Article 184 of the Algerian Civil Code.

[60] Article 226 of the Bahrain Civil Code.

[61] Article 390(2) of the UAE Civil Transactions Law.

[62] Article 267 of the Omani Civil Code.

provisions can create further uncertainty in a field where it is already rife, and in doing so, effectively disregards the extensive consideration and resources the parties have invested in the drafting of the clause.

Divergent approaches between jurisdictions means that the choice of governing law in an international construction contract is of vital importance. By way of comparison, international contracts for the sale of goods fall under the United Nations Convention on Contracts for the International Sale of Goods (CISG). In the construction law context, there is no equivalent instrument prescribing uniform international construction law principles. It has been suggested that use of the UNIDROIT Principles as the governing law of a contract can bring us closer to a unified system of construction law.[63] Alternatively, *lex mercatoria* principles in relation to construction law could be developed further and applied in the interpretation and enforcement of international contracts.[64]

In the absence of a universally adopted standard, a wise course of action would be to take care to select a country whose legal framework delivers contractual certainty and is non-interventionist. In standard forms of contract such as the FIDIC suite, a wide range of governing laws and languages are accommodated.[65] The FIDIC Red, Yellow and Silver Books' governing law provision is contained in sub-clause 1.4 which provides that the contract is to be governed by the law of the country (or other jurisdiction) stated in the contract data.

Of course, in selecting a governing law, one must not lose sight of other contractual provisions. For example, the common law distinguishes between substantial completion and performance of a contract, however many civil codes do not. Thus, in choosing a governing law, the validity of liquidated damages will be one of many considerations. I now turn to evaluate the suitability of common law and civil law approaches to the penalties doctrine.

Common law

A consequence of the English refocus on legitimate interest is that the court will also be more concerned with the agreement of the parties, who are better positioned to understand their interests than the court. As a result, the decision in *Cavendish* provides potentially more sensible commercial outcomes in the sense that it provides more flexibility in taking account of the particular interests of contracting parties.

The decision, however, did not address common law courts' inability to modify or adjust the amount of liquidated damages claimed, nor was

[63] Charrett, D in Klee, L, *International Constructional Contract Law* (Wiley-Blackwell, 2015), 100.

[64] Molineaux, C, "Moving Toward a Lex Mercatoria – A Lex Constructionis" (1997) 14(1) *International Arbitration* 55.

[65] Furst, S and Ramsey, V, *Keating on Construction Contracts* (Sweet & Maxwell, 2015) 1043.

it a question put to their Lordships. As it stands, a court's determination that the amount in question is out of all proportion even to the party's legitimate interest would be struck down, and the injured party would remain deprived of full compensation. Despite this, *Cavendish* is still a positive decision which has extended the categories of interests liable for compensation.

By contrast, the Australian position, arising from the decision in *Andrews* may implicate any contractual stipulation, including clauses which the parties had no intention to enforce within the scope of the penalties doctrine. This development has received substantial academic and judicial criticism, largely revolving around its implications on the drafting of contracts.[66]

In construction, consider, for example, the case of performance-based contracts with variable payment dependent on the standard or speed of performance. In such a scenario, delivering a project slightly earlier or later is not a breach of contract; the parties simply agreed on a sliding scale in their commercial discussions on price. Nevertheless, post-*Andrews*, such a pricing scheme could fall foul of the rule against penalties if the reduction in payment is out of all proportion to the actual loss caused by the failure to meet that performance indicator. Noting this example and others, Lords Neuberger and Sumption in *Cavendish* were unequivocal in their criticism surrounding this area.[67]

Civil law

A contract under the civil law will be met with a somewhat different approach. In a construction context, it is unlikely that an applicant would be able to prove the absence of loss, and therefore the general inquiry under the civil law approach will surround whether the agreed damages are grossly exaggerated, or do not match the loss. In assessing this, the court must look at the *actual losses* suffered, not whether the agreed amount was grossly exaggerated at the time of entry into the contract. Such a step adds an element of retrospectivity to an agreement that was previously concluded on permissible terms, and increases uncertainty about a party's true liabilities and obligations. The court should also recognise that such clauses are finely balanced in the entire scheme of a large project transaction, and should therefore require cogent evidence before overturning such an agreement.

[66] See, e.g., Gray, A, "Contractual Penalties in Australia Law After Andrews: An Opportunity Missed" (2013) 18(1) *Deakin Law Review* 1, 14-25.

[67] *Cavendish* [2015] UKSC 67, 22-3 paragraph 42 (Lords Neuberger and Sumption).

5.2 Potential for improvement in the common law world?

It is apparent that the application of a penalties clause will vary depending on whether the governing law favours a common law or civil law approach. Nevertheless, a careful analysis suggests that there is scope for both approaches to undergo further development in the future.

In the common law word, it is hoped that, in light of the benefits of a restrictive approach to penalties in a construction context, other jurisdictions will follow suit and similarly adopt the English position. This should bring about greater certainty in the drafting of large commercial contracts.

The common law system would also do well to take some lessons from our civil law counterparts, in particular, the option to modify and adjust the rate at which liquidated damages are levied, as opposed to the rejection of the clause outright. The broad range of stakeholder interests in large-scale public and private construction projects means that although some delay losses are compensable by the general law (despite being difficult to prove), others such as community disadvantage are not. For these reasons, the penalty doctrine as it stands is, in my view, less than satisfactory, particularly in the context of carefully negotiated construction agreements formulated to address the unique interests of the contracting parties.

6. CONCLUSION

The historical development of the doctrine of penalties is a tale of the protectionist position of the courts to protect parties whose unequal bargaining power has been abused to their disadvantage. However, in modern construction contracts, at least, this scenario appears less often than would justify court intervention, and no doubt where courts do intervene, an injured party risks emerging more injured than when it entered.

Thus, in an industry where uncertainty is rife, it is important for courts to champion flexibility in their analysis of the bargains of commercial parties. The recognition of legitimate interests in *Cavendish* was a step in the right direction and a legal victory for the construction world. It would in my view be desirable for all courts to build on the *Cavendish* decision, thus creating a consistent approach that will provide greater certainty for parties when choosing a governing law in international construction contracts. That is not to say, however, that *Cavendish* represents the most ideal approach for construction parties. Taking relevant lessons from India as well as the civil code countries, the ability of the court to adjust liquidated damages and award reasonable compensation instead of

merely striking down “penal” provisions is certainly worth considering for construction industry participants.

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