

SCOTTISH LAW COMMISSION
(Scot Law Com No 171)

Report on Penalty Clauses

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The Scottish Law Commission was set up by section 2 of the Law Commissions Act 1965 for the purpose of promoting the reform of the law of Scotland. The Commissioners are:

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SCOTTISH LAW COMMISSION

Item 4 of our Fifth Programme of Law Reform

Penalty Clauses

To: The Rt Hon the Lord Hardie, QC
Her Majesty's Advocate

We have the honour to submit our Report on Penalty Clauses.

(Signed) BRIAN GILL, *Chairman*
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N RAVEN, *Secretary*
12 April, 1999

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ABBREVIATIONS

Council of Europe's Resolution on Penal Clauses

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)

Gloag, *Contract*

W M Gloag, *The Law of Contract* (2nd edn, Edinburgh, 1929)

McBryde, *Contract*

W M McBryde, *The Law of Contract in Scotland* (Edinburgh, 1987)

Principles of European Contract Law

The Principles of European Contract Law (Part I: Performance, Non-performance and Remedies), Prepared by the Commission on European Contract Law (Chairman, Professor Ole Lando) (Dordrecht, 1995)

Stair Memorial Encyclopaedia

The Laws of Scotland: Stair Memorial Encyclopaedia (25 volumes; Edinburgh, 1987-96)

Unidroit *Principles*

Principles of International Commercial Contracts (UNIDROIT, Rome, 1994)

Part 1 Introduction

Aim of report

1.1 In this report we recommend reform of the law on penalty clauses. The report forms part of our review of the law of contract under our *Fifth Programme of Law Reform*.¹

What are penalty clauses?

1.2 Contracts often provide for payment of a stated sum in the event of breach, or provide a formula by which such a sum is to be calculated. In the present law a distinction is made between clauses which genuinely attempt to pre-estimate the damages which would be payable on the breach and clauses which do not make any such attempt but simply provide for a fixed payment to be made instead of damages. Clauses of the first type are referred to as liquidated damages clauses and are enforceable: clauses of the second type are referred to as penalty clauses and are, in theory, unenforceable.² However, both provide for agreed payments to be made by the party in breach and both serve the same function of avoiding disputes and reducing uncertainty. In practice, both may also serve as an incentive to performance. In practice, many payments which are not genuine pre-estimates of loss are forced into the category of liquidated damages in order to make them enforceable.³ In this report, the term "penalty clause" is used to include both liquidated damages clauses and clauses which, at present, are theoretically unenforceable because they are penal.

Background to report

1.3 The need to consider reform of the current law on penalty clauses was first brought to our attention by the Faculty of Advocates. Problems with this area of the law were highlighted further at our seminar on Remedies for Breach of Contract organised with the University of Edinburgh on 21st October 1995.

1.4 In December 1997 we published our discussion paper on *Penalty Clauses*⁴ ("the discussion paper").

1.5 The discussion paper identified two main problems in the existing law on penalty clauses. One is that some contractual provisions, which are in no way oppressive or unreasonable, are liable to 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.⁵ If this danger is often avoided in practice it is only by straining the concept of

¹ Scot Law Com No 159 (1997) Item No 4: Obligations paras 2.21–2.23.

² *Robertson v Driver's Trs* (1881) 8 R 555 at 562 – "They may contract that the one will be bound to reimburse the other for any loss caused, but not for punishment".

³ See eg *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* (1904) 7 F (HL) 77.

⁴ Discussion Paper No. 103. We gratefully acknowledge the substantial contribution by Professor W W McBryde to this discussion paper.

⁵ See eg *Dingwall v Burnett* 1912 SC 1097 in which a modest penalty was held to be unenforceable because, the same amount being payable for breaches of different degrees of seriousness, it could not be regarded as a genuine pre-estimate of loss.

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. The discussion paper sought views on whether the correct test is used to identify unenforceable penalty clauses⁶ and on whether control should be extended to certain clauses having an effect essentially similar to that of the classic penalty clause.⁷

1.6 The discussion paper also sought views on some consequential matters - such as whether the precise form of a penalty should matter, whether new rules on penalty clauses should apply to irritancy clauses,⁸ whether courts should be able to have regard to circumstances arising after the conclusion of the contract and whether courts should have power to modify exorbitant penalties, rather than find them to be completely unenforceable.⁹

European and international developments

1.7 There has been recent European and international activity in the area of penalty clauses. The Council of Europe published a report on penalty clauses in 1978.¹⁰ 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 contracts¹¹ 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.¹² The *Principles of International Commercial Contracts*, produced by UNIDROIT¹³ and the *Principles of European Contract Law* prepared by the Commission on European Contract Law under the chairmanship of Professor Ole Lando¹⁴ both contain articles on "Agreed payment for non-performance". The issue has also been considered by law reform bodies in England,¹⁵ California,¹⁶ Canada¹⁷ and Australia.¹⁸

1.8 There has been a convergence between the formerly disparate approaches of civil and common law countries. In countries whose law was heavily influenced by the English common law, penalty clauses were once viewed as completely unenforceable. In countries whose law was heavily influenced by the Napoleonic code, however, penalty clauses were fully enforceable and were seen as an effective way to encourage performance and thus

⁶ Para 4.11.

⁷ Para 4.24.

⁸ An irritancy clause is one which provides for a continuing contract, such as a lease, to come to an end in certain circumstances with consequent forfeiture of all rights under it.

⁹ These, and a few other consequential matters, were discussed in Part 5 of the discussion paper.

¹⁰ *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 Resolution on Penal Clauses").

¹¹ *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*. Official Records of the General Assembly, Thirty-eighth Session, Supplement No 17 (A/38/17, annexes 1 and 2).

¹² Resolution No 38/135 of the 101st plenary meeting 19 December 1983.

¹³ Art 7.4.13.

¹⁴ Art 4.508.

¹⁵ The Law Commission Working Paper No 61, *Penalty Clauses and Forfeiture of Monies Paid* (1975).

¹⁶ California Law Revision Commission, *Recommendations Relating to Liquidated Damages*, Appendix XIV to the Annual Report for 1975 and Appendix X to the Annual Report for 1976 (13 Cal L Rev Comm Rep).

¹⁷ Ontario Law Reform Commission: Report on *Amendment of the Law of Contract* (1987) Ch. 7.

¹⁸ Law Reform Commission of Victoria: Discussion Paper No 10: *Liquidated Damages and Penalties* (1988).

avoid litigation. However, most modern or recently revised civil codes now depart from the general principle of literal enforcement by allowing penalties to be modified where they are 'disproportionately high' or 'excessively high' or 'excessive' or 'unreasonable' or 'manifestly excessive'.¹⁹ In common law systems the distinction between penalties and liquidated damages can be used, or deliberately blurred, to allow recovery of many sums which the parties have agreed should be payable in the event of non-performance. Thus, in many systems it seems that a degree of compromise has been accepted in order to minimise the tension between the desire to enforce what was agreed between the parties and the injustice of enforcing an excessively penal provision.

1.9 This convergence of approaches is reflected in recent international instruments on the subject. The Council of Europe's Resolution on Penalty Clauses, for example, assumes that penalty clauses are, in general enforceable, but provides that

"The sum stipulated may be reduced by the court when it is manifestly excessive."²⁰

The *Principles of European Contract Law* provide that

"(1) Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of his actual loss.

(2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances."²¹

The Unidroit *Principles* have a virtually identical provision.²²

Draft Bill

1.10 A draft bill to implement our recommendations is contained in Appendix A. This is drafted in Westminster Bill form because, at the time of drafting, the form of a Bill for the Scottish Parliament was not known.

The Scotland Act 1998

1.11 Although the recommendations in this report would, if implemented, make modifications to Scottish private law as it might apply to certain reserved matters as set out in Schedule 5 to the Scotland Act 1998, any resulting legislation, in modifying Scottish private law, would apply consistently to reserved matters and otherwise, thus falling within the exception contained in section 29(4) of the Act. We believe, therefore, that the recommendations in this report are within the legislative competence of the Scottish Parliament.

¹⁹ Treitel, *Remedies for Breach of Contract: A Comparative Account*, (1988) at 224.

²⁰ Art 7.

²¹ Art 4.508.

²² Art 7.4.13.

Acknowledgements

1.12 The discussion paper was widely distributed and we are grateful to those who submitted comments on the provisional proposals.²³ We were also greatly assisted in this project by the members of the Contract Law Advisory Group²⁴ and by those who attended and contributed to the debate at our seminar on Remedies for Breach of Contract.²⁵ To them also we extend our gratitude.

²³ Those who submitted written comments are listed in Appendix B.

²⁴ The members of the Contract Law Advisory Group are listed in Appendix C.

²⁵ See para 1.3 above.

Part 2 The existing law

The development of the law

2.1 The early law was concerned with exorbitant sums payable by borrowers and was affected by attitudes to usury.¹ It was accepted that the court could modify exorbitant penalties in bonds for the payment of money even if they were disguised as payments to cover the expenses of recovering the debt.² Stair regarded the modification of exorbitant penalties in bonds and contracts as part of the *nobile officium* of the Court of Session.³ Extortionate credit bargains are now regulated by statute.⁴

2.2 A practice which gave rise to much early litigation was miscropping by tenants under leases. It was held that the words used in the lease were not conclusive. A payment might be a penalty in reality, and subject to control by the court, even if it was described as an additional rent.⁵ However, it was also held that if the lease genuinely gave the tenant an option to follow a less desirable rotation of crops on paying additional rent, then the court could not interfere.⁶ Penalty clauses in leases of agricultural holdings are now controlled by statute.⁷

2.3 After the middle of the nineteenth century most of the reported cases on penalties were concerned with building contracts⁸ or contracts for the supply of goods or services.⁹ In one case in 1869, concerning a penalty for delay in supplying a crane to shipbuilders, the court took the view that whether a clause provided for a penalty or for liquidated damages made no difference.¹⁰ If the amount payable on breach was, in all the circumstances, exorbitant and unreasonable it could be modified. Unfortunately these statements were later "explained" as meaning that if a liquidated damages clause were exorbitant it must really be a penalty clause.¹¹

The modern law

2.4 Two House of Lords decisions at the beginning of this century are often taken as encapsulating the present law.

¹ *Home v Hepburn* (1549) Mor 10033; McBryde, *Contract* para 20-127.

² This power was given a statutory basis by the Debts Securities (Scotland) Act 1856 which provided that "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".

³ Stair, IV.3.2; I.10.14; III.2.32; IV.5.7, and IV.51.11.

⁴ Consumer Credit Act 1974 ss 137 – 140 (replacing earlier provisions in the Pawnbrokers Acts 1872 and 1960 and the Moneylenders Acts 1900 and 1927).

⁵ *Stratton v Graham* (1789) 3 Pat 119.

⁶ *Fraser v Ewart* 25 Feb 1813 FC.

⁷ The Agricultural Holdings (Scotland) Act 1991 s 48 (re-enacting earlier legislation) prevents a landlord obtaining more than actual loss in consequence of "any breach or non-fulfilment" of a term or condition of the lease.

⁸ See eg *Johnston v Robertson* (1861) 23 D 646.

⁹ See eg *Forrest and Barr v Henderson, Coulborn & Co* (1869) 8 M 187.

¹⁰ *Forrest and Barr v Henderson, Coulborn & Co*, above.

¹¹ See *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* (1904) 7 F (HL) 77 at 82.

2.5 In *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda*,¹² it was confirmed that the courts had to look at the substance rather than the form of the provision in deciding whether it provided for liquidated damages, in which case it would be enforceable, or a penalty, in which case it would not be enforceable. If a sum was proportionate to the rate of non-performance it was *prima facie* liquidated damages. An extravagant or unconscionable or exorbitant provision, however, would not be enforced.

2.6 In *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*¹³ Lord Dunedin summed up the law as follows.¹⁴

"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.

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, not as at the time of the breach.

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.
- (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. This though one of the most ancient instances is truly a corollary to the last test...
- (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'...
- (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."

¹² (1904) 7 F (HL) 77.

¹³ [1915] AC 79. This was an English case but Lord Dunedin's statement of the law is accepted as describing the law of both Scotland and England.

¹⁴ At 86 – 88 (references omitted).

Advantages of existing law

2.7 The existing law has the advantage of allowing penalty clauses (in the wide sense in which we use the term in this report) to be enforced within limits. There are good reasons for enforcing most penalty clauses. One reason is the general principle that contracts should be respected.

"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."¹⁵

A second reason is the desirability of encouraging performance of the contract. Bell, for example, described a penalty clause as a way of enforcing "by more than the usual consequences, what the party is anxious to secure".¹⁶ Kames described a penalty as "a spur on the debtor to perform."¹⁷ A third reason is that penalty clauses reduce the uncertainty which can often affect actions for damages. This in turn limits expense and delay in resolving the dispute.

2.8 There are also good reasons for subjecting penalty clauses to some measure of judicial control. In the absence of such control the law would be forced to tolerate unjust and extortionate results.

Criticisms of existing law

2.9 The main criticism of the existing law is that the liquidated damages test is a poor one. It can lead to perfectly legitimate and reasonable penalty clauses being held to be unenforceable. It is particularly difficult to apply, and indeed unrealistic, in those cases where it is impossible to estimate damages in advance. Yet such cases are often those where penalty clauses are most necessary and most useful.¹⁸

2.10 In the case of *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda*,¹⁹ late delivery of four torpedo boats, intended for use by the Spanish Government in the war against Cuban independence, led to a penalty of £67,500 (£500 for each week of late delivery of each vessel) being held to be enforceable. At the time of contracting, it would clearly have been impossible to pre-estimate the damage which might result from such a breach, and thus the agreed clause provided a solution to predictable difficulties and an incentive to performance. The clause was upheld, but the current emphasis on the distinction between pre-estimated damages and a penalty clause makes it more difficult to uphold such clauses than it would be if a more straightforward approach were adopted.

2.11 Another criticism of the existing law is that it does not allow any judicial control over exorbitant clauses which are the functional equivalent of penalty clauses but which are drafted in such a way that they come into operation on the occurrence of something other

¹⁵ *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 at 403.

¹⁶ Bell, *Commentaries* 1, 654 (5th Edn.).

¹⁷ Kames, *Principles of Equity* (5th ed, 1825) 378.

¹⁸ This was recognised by Lord Dunedin in the passage from *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 quoted above. There is, however, a difficulty in the view that a sum can be a genuine pre-estimate of damage even if a genuine pre-estimate is impossible.

¹⁹ (1904) 7 F (HL) 77.

than a breach of contract, for example if one party exercises an option to pursue one course of action rather than another. We consider this criticism more fully in Part 4 of this report.

Assessment

2.12 It is not the basic approach of enforcement within limits that is in need of reform, but rather the precise way in which the line between enforceable and unenforceable clauses is drawn. We believe that the law at present fails, for technical reasons, to achieve the correct balance between respecting freedom of contract and guarding against oppression.

Part 3 A more realistic test

Introduction

3.1 On consultation, there was general support for judicial control over penalty clauses in some form. There was also clear support for a move away from the unrealistic "genuine pre-estimate of loss" test. The Faculty of Advocates commented that the application of that test is no more than a fiction in many cases. We agree with consultees on both of these points and make appropriate recommendations later.¹

3.2 The remaining question for consideration in this part of the report is what the criterion for judicial control should be. To some extent this may not matter as much as might be supposed at first sight. Most of the expressions which might be considered as serious candidates would probably lead to the same results. The policy aim is to respect the parties' freedom to contract for the payment of agreed sums, or for equivalent sanctions, in specified circumstances and to restrict judicial intervention to cases where the penalty is so excessive, or so exorbitant and unreasonable,² that it would be unconscionable to permit it to be exacted. The history of the law on penalties and irritancies shows that the courts have been in sympathy with this aim and have tried to achieve it in spite of the twists and turns which the law has taken. We do not think that a change to a more realistic test, however it might be framed, would make the courts less conscious of the desirability of giving effect to parties' agreements.

Options considered in discussion paper

3.3 In the discussion paper, we invited views on tests such as "unreasonable", "manifestly excessive" and "grossly excessive".³

3.4 Although there are examples in comparative law⁴ and precedents in other areas⁵, we doubted whether the enforceability of a penalty should be judged by a criterion of reasonableness. We thought that this would set the threshold for judicial intervention at too low a level.

3.5 Our provisional preference⁶ as the criterion for the exercise of judicial control was "grossly excessive". This is the expression used in the *Unidroit Principles*⁷ and in the *Principles of European Contract Law*.⁸ However, we mentioned, as another possible

¹ Paras 3.8 – 3.10.

² The expression sometimes used in earlier Scottish cases.

³ Paras 4.7 – 4.11.

⁴ The American Restatement of Contracts, for example, uses a test of reasonableness. Such a test was also recommended by the Californian Law Revision Commission in 1973, and considered by the Law Commission for England and Wales in 1975. See discussion paper, paragraph 4.6.

⁵ 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, *Contract* paragraphs 25-62 to 25-98.

⁶ Paragraph 4.8 of discussion paper.

⁷ Art. 7.4.13.

⁸ Art. 4.508.

formulation, the similar phrase "manifestly excessive" which is used in the Council of Europe's Resolution on Penal Clauses.

Consultation

3.6 In relation to the criterion for the exercise of judicial control opinions were divided more or less equally. Slightly over half of the responses received favoured 'grossly excessive'. Of those who favoured some other standard, the majority were in favour of "manifestly excessive".

3.7 One suggestion was that courts should be directed to have regard to a list of factors in determining whether a penalty should be regarded as unenforceable. We think, however, that this would add little of substance to a simpler standard and would run the risk of stating the obvious.

Assessment and recommendation

3.8 We doubt whether there would be any difference in practice between "grossly excessive" and "manifestly excessive". Either term would do, as indeed would various alternatives such as "exorbitant and unreasonable". On reflection, however, we have come down in favour of the term "manifestly excessive" which is used in the Council of Europe's recommendation on this subject. It helps to give the impression that the court should not examine agreed sanctions too closely. The excessive nature of the penalty should be immediately obvious to anyone considering it. It should be manifest and not a matter of nice calculation. Unless the specified penalty is manifestly excessive, it should be enforceable.

3.9 In our discussion paper,⁹ we considered whether a comparison with actual loss should always be required when it was being considered whether a penalty was excessive. We provisionally decided against such a requirement.¹⁰ We remain of this view. Penalty clauses are often used in cases where actual loss cannot, or cannot readily, be ascertained or where compensation for actual monetary loss would be an inadequate remedy. In such cases important factors to be taken into account in assessing whether a penalty is manifestly excessive might be the nature of the contract and the importance of providing an adequate incentive to due performance. However, in many ordinary cases a comparison between the amount or value of the penalty and the amount of the aggrieved party's loss will be a factor to be taken into account in deciding whether the penalty is manifestly excessive.¹¹

3.10 Taking into account the comments by consultees on our earlier proposal, we now recommend that:

1. (1) **There should continue to be judicial control over contractual penalties.**
- (2) **The criterion for the exercise of that control should be whether the penalty is "manifestly excessive".**

⁹ Para 4.9.

¹⁰ Para 4.10.

¹¹ In para 6.13 we recommend that all the circumstances, including circumstances arising after the conclusion of the contract, should be taken into account.

- (3) **Penalties which are not manifestly excessive should be enforceable even if they cannot be regarded as based on a genuine pre-estimate of loss.**

(Draft Bill, clause 1)

Part 4 Penalties arising otherwise than on breach

The existing law

4.1 Under the existing law the control of penalty clauses applies only where there is a breach of contract and not, for example, where one party exercises a contractual option to perform in one way rather than another or where a contract is terminated early under its terms.¹

4.2 The distinction has been important in hire purchase cases where the exercise of an option to terminate may result in clauses, which are in effect penal in nature, escaping all judicial control.²

4.3 The problem has also been illustrated by two cases involving claims arising on the appointment of a liquidator or a receiver. In the first case,³ an agreement between the parties provided that in the event of a company going into voluntary liquidation, the owners of machinery let to the company should be entitled to retake possession of the machinery, that the agreement should terminate and that the company should pay the owners a sum of money calculated as set forth in the agreement. The court held that the law on penalty clauses did not apply other than in cases involving breach of contract. In the second case,⁴ the lessees of an item of printing equipment became liable upon the appointment of a receiver (when the lessors exercised an option to terminate the agreement), for the rental payments which would have been payable during the unexpired period of the contract. The court held that the sum due under the contract was not subject to the rules on penalties, which were confined to cases of breach of contract, and was accordingly enforceable.

Criticisms of existing law

4.4 Because the law on penalty clauses applies only when there is a breach of contract, the law seems to favour the party who acts in breach rather than the party who complies with the terms of the contract. This is because the party in breach can seek judicial scrutiny of a penalty whilst the other party may not.

"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

¹ *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399; *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.

² See eg *United Dominions Trust (Commercial) Ltd v Bowden* 1958 SLT (Sh Ct) 10, where the hirer of a car had to pay up to 75% of the total cost of hiring as agreed compensation for depreciation when the contract was terminated. This case was followed in *United Dominions Trust (Commercial) Ltd v Murray* 1966 SLT (Sh Ct) 21. See also *Mercantile Credit Co Ltd v McLachlan* 1962 SLT (Sh Ct) 58; *Eurocopy Rentals Ltd v McCann Fordyce* 1994 SLT (Sh Ct) 63; *Common Services Agency v Purdie and Kirkpatrick Ltd* 1995 SLT (Sh Ct) 34; *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.

³ *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296.

⁴ *EFT Commercial Ltd v Security Change Ltd* 1992 SC 414.

goes on failing to pay the instalments until the finance company is forced to take action, may escape...I have felt myself oppressed by that consideration. But the remedy is for the legislature."⁵

4.5 Take, for example, the instance of a contract terminated on an event such as insolvency or the appointment of an insolvency practitioner.⁶ As we have seen, the rules on penalty clauses do not apply. Potentially, claims made in the insolvency may therefore be out of all proportion to any loss. Indeed, they may be extravagant or unconscionable or excessive. This could severely prejudice other creditors and might provide an incentive to draft extortionate provisions, and to have a termination without a breach.

4.6 Indeed there exists general scope for avoiding 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 may attract heavy penal consequences.

Extension of control over penalty clauses

4.7 In our discussion paper we suggested that control over penalty clauses should not be confined to cases involving breach of contract.⁷ We provisionally proposed that 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 where there is an early termination of a contract. In expressing our proposal in this limited way, rather than just referring to penal provisions generally, we were attempting to distinguish between sanctions due on breach or some other abnormal event and any consideration due in respect of the performance of the contract in the normal way. We had no wish to subject ordinary bad bargains to judicial control.

4.8 The Council of Europe's Resolution on Penal Clauses is confined to clauses which provide that if the promisor fails to perform the principal obligation, he is to be liable to pay a sum of money by way of penalty or compensation.⁸ However, it recommends governments of member states

"to consider the extent to which the principles ... can be applied, subject to any necessary modifications, to other clauses which have the same aim or effect as penal clauses".⁹

Consultation

4.9 The proposal to extend the control over penalty clauses in the way set out above was strongly supported on consultation.

⁵ *Mercantile Credit Co Ltd v McLachlan* 1962 SLT (Sh Ct) 58 at 59. Similar comments can be found in *Mercantile Credit Co Ltd v Brown* 1960 SLT (Sh Ct) 41 at 43, and *Campbell Discount Co Ltd v Bridge* [1961] 1 QB 445 at 458.

⁶ See *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296 and *EFT Commercial Ltd v Security Change Ltd* 1992 SC 414.

⁷ Para 4.18. The Law Commission for England and Wales reached a similar provisional conclusion in its Working Paper on *Penalty Clauses and Forfeiture of Monies Paid* (WP No 61,1975) paras 17 – 26.

⁸ Art 1.

⁹ Para 2 of the recommendations introducing the principles.

Recommendation

4.10 We accordingly recommend that:

2. **Judicial control over contractual penalties 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.**

(Draft Bill, clause 1(3))

Part 5 The form of a penalty

Introduction

5.1 In this part of the Report, we consider whether the particular form of a penalty should have any impact on the applicability of judicial control.

Different forms of penalty

Payment of money

5.2 The classic penalty clause takes the form of an obligation to pay a sum of money. Problems can arise where this type of penalty takes the form of an accelerated payment, that is to say, where the entire monies due throughout the term of the contract become due and payable when breach, as defined by the clause, occurs.¹ It has been observed that "it is abundantly clear that such clauses are often singularly penal in practice."²

Forfeiture of money

5.3 The recent case of *Zemhunt (Holdings) Ltd v Control Securities plc*³ clarified that the ambit of judicial control over penalties did not extend to the forfeiture of deposits or instalments already paid. It is clear, however, that the consequences of forfeiting sums already paid could effectively be as penal in nature as having to pay a penalty in the form of a sum of money.

Transfer of property

5.4 A transfer of property can constitute a penalty. In *Watson v Noble*,⁴ for example, a contract for the sale of shares in a trawler obliged the buyer to transfer his shares if he breached his obligations under the agreement. The clause was held to be an unenforceable penalty. Similarly, in the English case of *Jobson v Johnson*,⁵ Lord Justice Dillon observed that⁶

"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 payment of an extra, or excessive, sum of money."

¹ The question whether a clause of this type was, in the circumstances, a penalty clause or a liquidated damages clause was raised, but did not have to be decided, in *White & Carter (Councils) Ltd v McGregor* 1962 SC (HL) 1. See pp 11 and 25.

² JDL Hope, "Contractually Stipulated Remedies" in Stair Memorial Encyclopaedia vol. 15 paragraph 811.

³ 1992 SC 58. See also *Roberts & Cooper v Salvesen & Co* 1918 SC 794 at 813 – 814 and *Reid v Campbell* 1958 SLT (Sh Ct) 45.

⁴ (1885) 13 R 347.

⁵ [1989] 1 WLR 1026.

⁶ At 1034 .

Forfeiture of property

5.5 The forfeiture of property could be just as harsh a penalty as a requirement to transfer property. However, irritancy clauses involving the forfeiture of a right in land have some special features. We consider them separately below.⁷

Other forms

5.6 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. The example we gave in our discussion paper⁸ was of a contract of employment stating 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. In our view, the general principle ought to be that the exact form of the penalty is immaterial.

Consultation

5.7 In our discussion paper⁹ we asked for views on a proposal that judicial control over penalty clauses should apply whatever form the penalty takes and, in particular, whether the penalty takes the form of a payment of money, a forfeiture of money, a transfer of property, or a forfeiture of property.

5.8 There was strong support among consultees for our proposal that judicial control should apply whatever form the penalty takes. One consultee,¹⁰ however, whilst accepting the logic of the proposal, expressed concern that such a move would engender too much uncertainty. Another body¹¹ thought that it might be more difficult to identify a penalty which consisted of a transfer or forfeiture of property. Notwithstanding such concerns, we still hold to our view that the exact form of the penalty should be immaterial.

Recommendation

5.9 Accordingly, we recommend that:

3. (1) **Judicial control over contractual penalties 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.**

(Draft Bill, clause 1(3))

⁷ Paras 5.10 – 5.16.

⁸ At para 5.9. See also the South African Conventional Penalties Act 1962, section 1; French Code Civile, article 1226; BGB paragraph 342.

⁹ At para 5.10.

¹⁰ Mr Craig Connal of the Royal Faculty of Procurators.

¹¹ The Centre for Research into Law Reform (University of Glasgow).

Irritancies

Separate development of the law

5.10 Stair regarded the court's common law power to control grossly excessive irritancy clauses as akin to its general power, in the exercise of the *nobile officium*, to control exorbitant penalties.¹² The law was coherent at that stage. However, once the law on penalty clauses adopted a test based on a pre-estimate of damages it was necessary for the rules on irritancy clauses to follow a separate path. Irritancy clauses in leases were a standing demonstration of the inappropriate nature of the "genuine pre-estimate" test. Most such irritancy clauses were reasonable and deserving of enforcement. They provided an incentive to observance of the conditions of the lease and enabled the landlord to get rid of an unsatisfactory tenant. Yet the forfeitures of rights occasioned by them could not be regarded as genuine pre-estimates of the loss likely to be caused by a breach. The law therefore continued to develop separately along lines broadly similar to those which we now recommend for all penalty clauses. An irritancy clause was in general enforceable according to its terms but the court had a limited power to control abuse. As the law has developed, however, the test for interfering with an irritancy of a lease is narrower than the "manifestly excessive" test which we recommend for contractual penalties in this report. There must be something in the nature of oppression by the landlord before the court will exercise its common law power to intervene.¹³

Statutory intervention

5.11 There has been some statutory control of irritancies of leases.¹⁴ In relation to irritancy for non-payment of any money due under the lease, the statute requires adequate notice to be given before the irritancy is exercised.¹⁵ It does not introduce any control based on the actual effect of the irritancy, even where that effect is highly penal. In relation to irritancy for any other reason the statute provides that a landlord cannot rely on the irritancy provision if in all the circumstances of the case a fair and reasonable landlord would not seek so to rely.¹⁶ In the case of a remediable non-monetary breach regard must be had to whether a reasonable opportunity has been afforded to the tenant to enable the breach to be remedied.¹⁷ It is clear that these provisions do not provide a complete remedy for excessively penal irritancies, even in relation to the leases to which they apply. And they do not apply to leases of land used wholly or mainly for residential purposes or comprising an agricultural holding, a croft, the subject of a cottar or the holding of a landholder or a statutory small tenant.¹⁸ There have been statements in the House of Lords to the effect that statutory reform in this area has not gone far enough.¹⁹

¹² I.10.14; IV.5.7.

¹³ See *CIN Properties Ltd v Dollar Land (Cumbernauld) Ltd* 1992 SC (HL) 104; *Dollar Land (Cumbernauld) Ltd v CIN Properties Ltd* 1997 SLT 260. There was held to be no oppressive conduct by the landlords in this case but the existence of a power to intervene in appropriate cases was affirmed.

¹⁴ Law Reform (Miscellaneous Provisions) (Scotland) Act 1985 ss 4 – 7. These provisions implemented the Scottish Law Commission's Report on *Irritancies in Leases* (Scot Law Com No 75, 1983). The reference to the Commission was confined to "irritancy clauses in leases of commercial and industrial property".

¹⁵ 1985 Act s 4.

¹⁶ 1985 Act s 5 (1).

¹⁷ 1985 Act s 5 (3).

¹⁸ 1985 Act s 7. The reference to the holding of a landholder or a statutory small tenant has the same meaning as in the Small Landholders (Scotland) Acts 1886 to 1931.

¹⁹ See *CIN Properties Ltd v Dollar Land (Cumbernauld) Ltd* 1992 SC (HL) 104 at 119 and 126.

5.12 Further statutory intervention has been recommended. We have recently recommended the abolition of feudal irritancies in our report on *Abolition of the Feudal System*.²⁰ We have also recommended the abolition of irritancies in certain ultra-long ground leases in our report on *Leasehold Casualties*.²¹ Irritancy clauses for non-payment of feuduty or non-payment of rent under very long ground leases are penal by their very nature because the vassal or tenant stands to lose what is a valuable property right or its equivalent for non-payment of a trifling sum. The same does not apply to irritancy clauses in leases of normal duration. Such clauses may or may not be penal in effect.

Proposal in discussion paper

5.13 Given the difficulty of drawing any justifiable distinction between a transfer of property and a forfeiture of property, and the consideration that irritancy clauses can have a truly penal effect in some cases, the discussion paper provisionally proposed²² that irritancy clauses should not be excepted from the new test for deciding whether a penalty clause is unenforceable. Our provisional view was that it would be artificial not to deal with the penal aspects of irritancy clauses within this context. We therefore proposed that 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. The practical effect of this would have been that the test for court interference with an irritancy clause in a lease would have changed from one based primarily on oppressive conduct to one based on whether the irritancy amounted in the circumstances to a manifestly excessive penalty. The focus would have shifted from the conduct of the landlord to the actual effect of the irritancy. Another effect of bringing irritancies in leases within the scope of our proposals would have been to give the courts power to modify the effects of an irritancy, for example by attaching conditions to its exercise, if it were in effect a manifestly excessive penalty.²³

Results of consultation

5.14 Most consultees agreed with our provisional proposal. However, some consultees argued that it was not appropriate to effect reform of irritancies relating to land in the context of penalty clauses. The Faculty of Advocates said that a comprehensive review of irritancy clauses would be likely to identify a more appropriate way of resolving the perceived problems of irritancy clauses. The Centre for Research into Law Reform also expressed a preference for legislative change in relation to irritancies to be undertaken in another context.

Recommendation

5.15 Having given careful consideration to the comments of consultees, we consider, by a majority,²⁴ that it would be safer to leave irritancy clauses in leases for separate

²⁰ Scot Law Com No. 168 (1999).

²¹ Scot Law Com No. 165 (1998) para 8.8. The leases must be for 300 years or more.

²² At paras 5.11 - 5.18.

²³ See para 6.22.

²⁴ Dr Clive and Professor Reid consider that bringing manifestly penal consequences of irritancies in leases within the scope of the Commission's recommendations would be a useful and principled response to the calls for further reform of the law on irritancies in leases made by the House of Lords in *CIN Properties Ltd v Dollar Land (Cumbernauld) Ltd* 1992 SC (HL) 104. In relation to most leases, particularly where the obligations of landlord and tenant are reasonably balanced, as they would normally be in a commercial lease, or where there is already

consideration. The penal nature of certain irritancy provisions in the law of leases may not be the only question for re-examination in that branch of the law. There are questions as to the means of enforcement of such irritancies. The special function of irritancy in the law of agricultural holdings raises its own problems. The majority of us therefore consider that a systematic review of the law of irritancies in leases of land is not appropriate in the present exercise and that it should be considered for inclusion in our forthcoming *Sixth Programme of Law Reform*. However, we think that the difficulties of principle in distinguishing between irritancy provisions and other provisions providing for the forfeiture of rights are such that the exception should be kept within clear and narrow bounds. It is only in relation to irritancies in leases of land that there is a clearly developed separate body of law.²⁵ We think that the exception should be confined to such cases.

5.16 We therefore recommend that:

3. (2) **Without prejudice to the possibility of a systematic review of the law on irritancies of leases of land, the recommended judicial control over contractual penalties should not apply to such irritancies.**

(Draft Bill, clause 1(3))

statutory provision for compensation for tenants' improvements, the consequences of irritancy would not be manifestly penal. The reform would apply only to irritancy clauses entered into in the future. (See para 7.10.) It would not preclude an examination of other aspects of the law on irritancies in leases.

²⁵ Indeed it has been said that the ordinary law on penalty clauses would apply to a penal irritancy or forfeiture clause in a partnership agreement: *Hannan v Henderson* (1879) 7 R 380.

Part 6 Court powers

Introduction

6.1 In this Part of the report we consider the powers of a court dealing with a claim that something due under a contract is a manifestly excessive penalty. We consider whether the court should have power to consider the substance rather than the form of a provision, to have regard to all the circumstances of the case and to modify a penalty which is held to be manifestly excessive. When we use the word "court" we are referring to any body or person, including an arbiter, with power to adjudicate on the enforceability of a penalty in a particular case.

Power to consider substance rather than form

Existing law

6.2 It is well established in the existing law that a court should have regard to substance rather than form in deciding whether a clause is a penalty clause.¹

Consultation

6.3 In the discussion paper,² we raised the question of the retention of the power to have regard to the substance rather than the form of a clause, and also asked if there was a need to strengthen the courts' powers in order to combat avoidance of judicial control by drafting devices.

6.4 Almost all of the consultees were in agreement that the power to consider substance rather than form should be maintained in any future legislation. The Centre for Research into Law Reform pointed out the desirability of such a general power being used in limited circumstances only, to avoid it becoming an onerous burden on contractual freedom.

6.5 On the question of strengthening the courts' powers, the general view was that if the courts continue to have power to have regard to substance rather than the form, then specific legislation to combat drafting devices was not necessary.³

Recommendation

6.6 We therefore recommend that:

¹ *Stratton v Graham* (1789) 3 Pat 119; *Johnston v Robertson* (1861) 23 D 646; *Forrest and Barr v Henderson, Coulborn and Co.* (1869) 8 M 187.

² Para 5.20.

³ We recommend later, however, that there should be a prohibition on contracting out of the law on penalty clauses. See para 7.1.

4. In deciding whether a clause comes within the scope of the new law on penalty clauses regard should be had to the substance of the clause rather than to its form.

(Draft Bill, clause 1(3))

Power to consider all the circumstances

Existing law

6.7 Under the current law a court puts itself, initially at least, in the position of the parties at the time of contracting.⁴ What happened after the date of contracting may, however, influence the court in its decision as to whether the clause was exorbitant at the time of contracting.⁵ The court may be forced to consider the events following the contract if, for example, the sum sued for is based on the number of days the defender was late in making delivery, or the changing salary of an employee under a contract of service.⁶

6.8 Currently, it is logical for the court to take the circumstances at the date of the contract as the starting point because of the application of the "genuine pre-estimate of loss" test. If, however, the courts were to ask whether a penalty was "manifestly excessive" in a particular case it would be inappropriate to restrict consideration to the circumstances prevailing at the time at which the contract was made. Provided that the sum payable is not extortionate in relation to the breach or other triggering event which has in fact occurred, there is no reason why the penalty should not be enforceable.

Consultation

6.9 In our discussion paper,⁷ we invited consultees' views on our provisional view that it would be advantageous to make it clear that the court could look at all the circumstances, including any loss arising from non-performance, and other circumstances since the contract was entered into, in deciding whether a penalty was manifestly excessive.

6.10 A clear majority of the consultees agreed that the enforceability of a penalty should be judged according to all the circumstances. The Sheriffs' Association commented that, in their judicial experience, it was almost impossible not to be influenced, to some degree, by the circumstances following completion of the contract, and that it was often frustrating and artificial to be prevented from taking such factors into account. Another commentator⁸ noted that such a reform was desirable because what might appear to be excessive at the outset might not turn out to be so excessive once the actual loss was known.

6.11 The Faculty of Advocates disagreed, however. They were of the opinion that the true philosophy behind penalty clauses was to enable the parties to agree in advance what the consequences of a breach of contract (or other failure to perform) would be without the need for litigation. Attention should thus be focused upon what was in the parties'

⁴ *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* (1904) 7 F (HL) 77 at 82.

⁵ *Forrest and Barr v Henderson, Coulborn and Co* (1869) 8 M 187; *Craig v McBeath* (1863) 1 M 1020; *Mercantile Credit Co v Brown* 1960 SLT (Sh Ct) 41.

⁶ *Paterson v South West Scotland Electricity Board* 1950 SC 582.

⁷ Para 5.29.

⁸ Mr David Bone of the Royal Faculty of Procurators.

contemplation at the time of the contract. To do otherwise, they argued, would mean that those drafting penalty clauses would not know, without the benefit of hindsight, what might or might not turn out to be manifestly excessive. The Faculty therefore suggested that the courts be permitted to look at all the events since the contract was entered into, but with a view only to assessing what would reasonably have been contemplated at the time of execution. Mr R Craig Connal (of the Royal Faculty of Procurators) commented that having regard to all circumstances when judging the enforceability of penalty clauses would give rise to uncertainty.

Recommendation

6.12 On balance, and having taking into account the views of consultees, our view remains that, if the law were to move away from the liquidated damages test, as we have recommended,⁹ there would be great advantage in expressly stating that all the circumstances can be taken into account in deciding whether a penalty is manifestly excessive. The focus of attention under the new rule would not be whether the penalty clause was enforceable in the abstract but whether the penalty could be enforced in the particular circumstances which had arisen. Although not advocating the disturbance of parties' agreements merely because, with the benefit of hindsight, their predictions were incorrect, we believe that under the approach which we recommend the only realistic course is to allow courts to consider all the circumstances, including those arising after the date of the contract, in assessing whether a penalty is manifestly excessive.

6.13 We accordingly recommend that:

5. **The enforceability of a penalty should be judged according to all the circumstances, including circumstances arising since the contract was entered into.**

(Draft Bill, clause 1(4))

Power to modify

Existing law

6.14 In the earlier law it was accepted that the court could modify exorbitant penalties or irritancies. Stair, for example, pointed out that penalties in bonds which were disguised as payments for the creditor's expenses would be modified to the real expenses and damages but that the court took "slender probation of the true expenses" and in practice allowed more than would have been allowed in the absence of the penalty clause.¹⁰ He also saw the allowance of time to purge an irritancy as an example of the power to modify.¹¹ The courts regularly talked of modifying penalties.¹² Under the present law it is accepted that the power of a court which finds a provision to be a penalty clause, and hence unenforceable, is

⁹ Para 3.10.

¹⁰ IV.3.2.

¹¹ IV.18.3.

¹² See eg the statements in *Craig v McBeath* (1863) 1 M 1020 and *Forrest and Barr v Henderson, Coulborn and Co* (1869) 8 M 187.

restricted to awarding provable loss.¹³ The court, at present, has no power to modify the penalty by reducing the sum to a reasonable amount. By contrast, most of the modern or recently revised civil codes envisage the possibility that excessive penalties can be modified to a reasonable amount,¹⁴ as do recent international instruments.¹⁵

Advantages and disadvantages of power to modify

6.15 Enabling the courts to modify penalties would facilitate the enforcement of parties' original agreements as nearly as possible. If, for example, a contract has been entered into where non-performance could not be compensated by damages to the satisfaction of one of the parties, then it is likely that an unusually high penalty may be included in the contract in order to encourage performance. The promisee may also have paid a high price under the contract to obtain the other party's agreement to the substantial penalty. If non-performance ensues, in the absence of a power to modify, the penalty may be struck down as unenforceable and the aggrieved party's only course of action would be to resort to a claim for damages – a remedy earlier rejected as inadequate. The advantage to the contract breaker is only too clear. A power to modify would thus encourage performance and, in the event of litigation, prevent the contract breaker from achieving an unfair advantage.

6.16 Generally, a power to modify would provide the courts with the ability to enforce penalty clauses in a fair and flexible manner, thus facilitating the achievement of the objectives of penalty clauses. This might be particularly useful if it is made clear that a penalty may consist of a transfer of, or forfeiture of, property. There may be cases where a forfeiture of property would be a manifestly excessive penalty by itself but would cease to be so if the person forfeiting the property were compensated for improvements made to it. A power to modify would be particularly useful, if not essential, in those cases where no claim for damages exists¹⁶ or where the penalty has been agreed precisely because damages would be difficult or impossible to quantify.

6.17 On the other hand, a power to modify could be criticised on the ground that it would be difficult for the courts to exercise. Deciding on what an appropriate penalty might be may not be an easy task. Another criticism might be that such a power would lead to uncertainty. In relation to penalty clauses, however, judicial control already leads to an element of uncertainty. It is not clear that such uncertainty would be greater if a power to modify existed in addition to a power to strike down the penalty totally. It could be argued that the uncertainty is greater in the absence of a power to modify, because there is more of a gamble involved.

6.18 It might be suggested that a power to modify would encourage the use of manifestly excessive penalty clauses because the party seeking to insert them would know that, at worst, the penalty might be modified and that the other party would have to litigate to obtain the modification. This argument, however, could be levelled just as easily at the present law where an aggrieved party may opt for damages in the event of a penalty being

¹³ There is a theoretical debate as to whether the court modifies the penalty to the amount of the provable loss or holds the penalty completely unenforceable and awards damages for the provable loss as if there had been no penalty clause. See the discussion paper, paras 5.30 – 5.35.

¹⁴ See the discussion paper, paras 1.10 and 5.41 - 5.47.

¹⁵ See the Council of Europe's Resolution on Penal Clauses art 7; the *Principles of European Contract Law* art 4.508; the Unidroit *Principles* art 7.4.13.

¹⁶ Eg where the penalty is not payable in respect of a breach of contract.

unenforceable. It must be remembered that contractual penalty clauses require the agreement of both parties. The promisor would not wish to agree to a manifestly excessive penalty clause, even if there was the possibility of judicial modification of any penalty incurred. Moreover the court would have a discretion as to modification. A court might decline to exercise its power to modify and might hold the penalty manifestly excessive and entirely unenforceable.

Consultation

6.19 In the discussion paper¹⁷ we asked consultees whether it would be desirable to give the court power to modify a penalty, for example, by reducing it to an amount which it considers appropriate, or which is not manifestly excessive in the circumstances, or by attaching conditions to its recovery.

6.20 Most of the consultees who responded considered that the court should have power to modify a penalty that was manifestly excessive. The Lord President commented that if control is to extend to penalties incurred otherwise than by breach of contract, damages would not be available as an alternative in such cases, and thus it would be important for there to be a possibility of modifying the penalty. The Law Society of Scotland noted that such a power would save the resources of the parties and the court, given that a fresh action for damages would not be required. Members of the Contract Law Advisory Group suggested that the power to modify should be available on application only, and that it should be for the party seeking modification to lead evidence to support it.

6.21 Almost one third of the consultees expressed reservations about the introduction of a general power. This was the general view of the Faculty of Advocates although they agreed that it might be desirable to give the courts such a power in relation to penalties consisting of forfeiture of, or transfer of, property (including incorporeal property) by requiring the promisee to make such payments to the transferor as are reasonable in the circumstances.

Recommendation

6.22 We consider that a power to modify would be in line with the approach recommended in this report and would be useful in some cases and essential in others. We therefore recommend that:

6. **A court, or a tribunal or arbiter adjudicating on a penalty clause, should have power to modify a manifestly excessive penalty so as to make it enforceable - by for example, reducing its amount or attaching conditions to the exercise of the relevant right.**

(Draft Bill, clause 4)

¹⁷ Para 5.47.

Part 7 Other matters

Contracting out

7.1 The Faculty of Advocates suggested that it would be helpful if any future legislation on penalty clauses made it clear that parties could not contract out of it. We agree that this would constitute a prudent provision and recommend that:

7. **In any new law on penalty clauses it should be made clear that parties cannot contract out of the application of that law.**

(Draft Bill, clause 3)

Penalty and other remedies

Existing law

7.2 Under the existing law a party is not normally able to recover both the penalty and damages for the same act. A penalty over and above damages would clearly not be liquidated damages and would therefore be unenforceable. If the penalty clause is enforceable, it is not normally open to the creditor to ignore the penalty and claim damages. An enforceable liquidated damages clause falls to be construed as being in substitution for damages. The debtor does not have the option of paying the penalty instead of performing the contract.¹ 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.² It has been held that when a penalty is found to be unenforceable its amount does not constitute a limit on the damages which can be claimed. The aggrieved party can recover greater damages.³

Consultation

7.3 The discussion paper⁴ sought consultees' views on whether it was necessary to have legislation on this topic, or whether such questions could be left to be decided by the courts in the light of the new criterion and the agreement of the parties. Our provisional view was that legislation was unnecessary.

7.4 The Glasgow Bar Association, the Aberdeen University Faculty of Law and the Committee of Scottish Clearing Bankers commented that it would be prudent to set out the relationship between a penalty and other remedies in any resulting legislation. The W.S. Society recommended the adoption of section 2 of the South African Conventional Penalties Act 1962 which prohibits the cumulation of remedies and limits recovery of penalties in

¹ *University of Glasgow v Faculty of Physicians* (1840) 1 Rob 397 at 415.

² *British Glanzstoff Manufacturing Co Ltd v General Accident, Fire and Life Assurance Corporation Ltd* 1912 SC 591 affd 1913 SC (HL) 1, *Suisse Atlantique Société D'Armement Maritime SA v NV Rotterdamsche Kolen Centrale* [1967] AC 361.

³ *Dingwall v Burnett* 1912 SC 1097.

⁴ Para 5.24.

respect of defects or delay. Opinions were, however, predominantly in favour of not legislating.

Assessment

7.5 Having taken the comments of consultees into consideration we adhere to the view that legislation would be unnecessary. It is up to the parties to provide in their contract for the relationship between a contractual sum payable on non-performance and other remedies. If they do not so provide, a penalty would be regarded as an agreed substitute for damages so that the aggrieved party could not recover damages instead of, or in addition to, the sum stipulated.⁵ In our discussion paper,⁶ we considered whether the value of an unenforceable penalty should be the limit of recoverable loss. This is a real problem under the present law because a modest and reasonable penalty may be found to be unenforceable merely because it is not a genuine pre-estimate of loss. It is, however, highly improbable that, under the proposed new rules, a court would find a penalty to be manifestly excessive and yet proceed to award a greater sum by way of damages. We are of the view, therefore, that no recommendation is required on this point. This view was shared by consultees.

The onus of proof

Proposal in discussion paper

7.6 In the discussion paper,⁷ we proposed that the onus of showing that there is an unenforceable penalty should lie on the party who makes this allegation.

Consultation

7.7 There was almost unanimous support from consultees for this proposal. The Centre for Research into Law Reform, (University of Glasgow) in agreeing with the proposal, commented that any other solution would provide the defender with an incentive to challenge every clause in the knowledge that the pursuer must prove that it is not manifestly excessive.

Recommendation

7.8 We recommend that:

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

(Draft Bill, clause 2)

Unilateral voluntary obligations

7.9 So far we have talked of penalty clauses in contracts. Penalty clauses may also be found, however, in bonds and other unilateral voluntary obligations. Some of the earliest

⁵ This is the rule in art 5 of the Council of Europe's Resolution on Penal Clauses.

⁶ Paras 5.21 to 5.23.

⁷ Para 5.40.

cases on the control of excessive penalties were concerned with penal provisions in bonds.⁸ The principles and policy considerations are the same as for contracts and we consider that the same rules should apply. We therefore recommend that:

9. **The proposed rules on penalty clauses should apply to penalty clauses in bonds and other unilateral voluntary obligations in the same way as to penalty clauses in contracts.**

(Draft Bill, clause 5)

Transitional provisions

The question

7.10 The final question for consideration is whether any legislation giving effect to the recommendations of this report should apply to claims for contractual penalties made after the legislation comes into force, whatever the date of the relevant contract, or only to penalty clauses agreed after the legislation comes into force. There are two conflicting arguments. On the one hand, if the reason for controlling "manifestly excessive" penalties is that the exaction of such a penalty is unjust and contrary to public policy, the date of the contract should not prevent judicial control from being exercised in accordance with the new law. On the other hand, a person might have been advised under the old law that a proposed clause was clearly unenforceable because it could not be regarded as liquidated damages and that it could therefore safely be accepted. It would be unfair if it were suddenly to become enforceable as a legitimate penalty. We find the latter argument more persuasive.

Recommendation

7.11 We therefore recommend that:

10. **Any new legislation should apply only to penalty clauses agreed after it comes into force.**

(Draft Bill, clause 6(3))

⁸ See para 2.1.

Part 8 Summary of recommendations

1. (1) There should continue to be judicial control over contractual penalties.
 - (2) The criterion for the exercise of that control should be whether the penalty is "manifestly excessive".
 - (3) Penalties which are not manifestly excessive should be enforceable even if they cannot be regarded as based on a genuine pre-estimate of loss.

Para 3.10; Clause 1
2. Judicial control over contractual penalties 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 4.10; Clause 1(3)
3. (1) Judicial control over contractual penalties 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 5.9; Clause 1(3)

 - (2) Without prejudice to the possibility of a systematic review of the law on irritancies of leases of land, the recommended judicial control over contractual penalties should not apply to such irritancies.

Para 5.16; Clause 1(3)
4. In deciding whether a clause comes within the scope of the new law on penalty clauses regard should be had to the substance of the clause rather than to its form.

Para 6.6; Clause 1(3)
5. The enforceability of a penalty should be judged according to all the circumstances, including circumstances arising since the contract was entered into.

Para 6.13; Clause 1(4)
6. A court, or a tribunal or arbiter adjudicating on a penalty clause, should have power to modify a manifestly excessive penalty so as to make it enforceable - by for example, reducing its amount or attaching conditions to the exercise of the relevant right.

Para 6.22; Clause 4

7. In any new law on penalty clauses it should be made clear that parties cannot contract out of the application of that law.

Para 7.1; Clause 3

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

Para 7.8; Clause 2

9. The proposed rules on penalty clauses should apply to penalty clauses in bonds and other unilateral voluntary obligations in the same way as to penalty clauses in contracts.

Para 7.9; Clause 5

10. Any new legislation should apply only to penalty clauses agreed after it comes into force.

Para 7.11; Clause 6(3)

Appendix A

Penalty Clauses (Scotland) Bill

ARRANGEMENT OF CLAUSES

Clause

1. Enforceability of penalty clauses.
2. Onus of proof.
3. Purported evasion.
4. Power to modify a penalty.
5. Application of Act to unilateral voluntary obligations.
6. Short title, commencement and extent.

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Make new provision for Scotland as respects the enforceability of penalty clauses in contracts and in unilateral voluntary obligations; and for connected purposes. A.D. 1999.

BE IT ENACTED by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:-

1.-(1) A penalty clause in a contract is unenforceable in a particular case if the penalty which the clause provides for is manifestly excessive (whether or not having regard to any loss suffered) in that case. Enforceability of penalty clauses.

(2) Any rule of law whereby such a clause is unenforceable if it is not founded in a pre-estimate of damages shall cease to have effect.

(3) In subsection (1) above –

"penalty" means a penalty of any kind whatsoever (including, without prejudice to that generality, a forfeiture or an obligation to transfer); and

"penalty clause" –

(a) does not include a clause of irritancy of a lease of land; but

(b) means any other clause, in whatever form, the substance of which is that a penalty is incurred in the event of breach of, or early termination of, the contract or failure to do, or to do in a particular way, something provided for in the contract.

(4) In determining, for the purposes of subsection (1) above, whether a penalty is manifestly excessive all circumstances which appear relevant shall be taken into account; and without prejudice to the generality of this subsection such circumstances may include circumstances arising after the contract is entered into.

2. The onus of proving that a penalty is manifestly excessive shall lie on the party so contending. Onus of proof.

Purported evasion. 3. Where a term of a contract would (but for this section) have the effect of excluding or restricting the application of a provision of this Act in respect of that or any other contract, the term shall be void.

Power to modify a penalty. 4.-(1) Where a court determines that a penalty provided for in a contract is manifestly excessive in a particular case then on application it may, if it thinks fit, modify the penalty in that case so as to make the penalty clause enforceable in the case.

(2) In subsection (1) above, the reference to modifying a penalty shall be construed as including a reference to imposing a condition as respects the penalty.

(3) Subsection (1) above applies to a tribunal or arbiter as it applies to a court (provided that the tribunal or arbiter has power to adjudicate on the enforceability of the penalty).

Application of Act to unilateral voluntary obligations. 5. This Act applies to unilateral voluntary obligations as it applies to contracts.

Short title, commencement and extent. 6.-(1) This Act may be cited as the Penalty Clauses (Scotland) Act 1999.

(2) This Act shall come into force at the end of that period of three months which begins with the day on which the Act is passed.

(3) This Act applies only as respects a penalty clause agreed to on or after the date on which the Act comes into force.

(4) This Act extends to Scotland only.

EXPLANATORY NOTES

Clause 1

Clause 1 addresses the two main faults in the current law on penalty clauses - the rule that a penalty clause is unenforceable unless the penalty provided for is a genuine pre-estimate of damages and the rule that a penalty not arising on breach of contract is not subject to judicial control. The first rule is unrealistic and difficult to apply. Contractual penalty clauses are most useful in those cases where damages cannot be estimated in advance. The second rule enables judicial control of excessive penalties to be avoided by simple drafting devices.

Subsection 1

This subsection provides that a penalty clause in a contract is unenforceable in a particular case if it provides for a penalty that is manifestly excessive in that case. As all clauses in a contract are enforceable in the absence of some legal rule to the contrary, the effect of this subsection when read with subsection 2 is that contractual penalties are enforceable unless manifestly excessive in the particular circumstances in which they are claimed.

The fact that a claimed penalty is held to be manifestly excessive in the situation in which it is claimed does not mean that the penalty clause is necessarily unenforceable for all time and in all circumstances. Subsection 1 provides that the test of unenforceability in a particular case is whether the penalty for which the clause provides (which may vary depending upon the circumstances) is manifestly excessive in that case, and not whether the penalty clause (which is invariable) is itself manifestly excessive.

The words "whether or not having regard to any loss suffered" are included to make it clear that in assessing whether a penalty is manifestly excessive it is not necessary to compare the amount or value of the penalty with the amount of loss. Penalty clauses are often used in cases where loss is impossible or very difficult to quantify or where damages would not be an adequate remedy.

Subsection 2

This subsection makes it clear that the current rule, that a penalty clause is not enforceable unless it is a genuine pre-estimate of loss, is superseded by the new rule in subsection 1 above. The current rule allows contractual provisions that are in no way oppressive or unreasonable to be struck down as unenforceable penalty clauses. See paragraphs 2.9 – 2.12 of the Report.

Subsection 3

This subsection clarifies the meaning of "penalty" and "penalty clause".

The definition of "penalty" makes it clear that the rule on manifestly excessive penalties applies whatever form the penalty takes. Normally a penalty will take the form of an obligation to pay a stipulated sum of money but a penalty may also take the form of, for example, an obligation to transfer property or a forfeiture of a right to money or property. See paragraphs 5.1 – 5.9 of the Report.

The definition of "penalty clause" serves several functions.

First, it gives effect to the Commission's recommendation that irritancies of leases of land be excluded from the ambit of the Bill. See paragraphs 5.10 – 5.16 of the Report.

Secondly, it replaces the current general rule that only penalties arising on breach of contract are subject to judicial control. This rule is unfair, because the party in breach can seek judicial scrutiny of a penalty whilst the party who, for instance, has terminated a contract early under its own terms cannot. Parties may find that there is benefit in wilfully breaking a contract rather than adhering to its terms. There is also scope for evasion of judicial control of penalty clauses by drafting penalties so as not to arise on breach, or by disguising a penalty as an option for performance, or as a failure to enjoy a bonus from performing in a particular way. See paragraphs 4.1 – 4.6 of the Report.

Thirdly, the definition of "penalty clause" makes it clear that a clause providing for payment, transfer or forfeiture as part of the normal performance of the contract is not a penalty clause. The rules on penalty clauses are not designed to allow bargains to be re-opened merely on the ground that the consideration was manifestly excessive. The penalty must be incurred in the event of a breach or early termination of the contract, or of a failure to do, or to do in a particular way, something provided for in the contract.

Subsection 4

Subsection 4 clarifies that in determining whether or not a contract is manifestly excessive, all relevant circumstances are to be taken into account, including circumstances since the contract was entered into. The current law is that the court puts itself, initially at least, in the position of the parties at the time of contracting. But if the "genuine pre-estimate" test of enforceability is replaced with a rule that a penalty is unenforceable if it is manifestly excessive in all the circumstances, then it would be inappropriate to restrict consideration to the circumstances prevailing at the time the contract was made. See paragraphs 6.7 – 6.13 of the Report.

Clause 2

This clause makes it clear that the burden of proving that a penalty is manifestly excessive lies on the party so contending. See paragraphs 7.6 – 7.8 of the Report.

Clause 3

Clause 3 makes it clear that it is not possible for parties to contract out of the law on penalty clauses. See paragraph 7.1 of the Report.

Clause 4

Clause 4 makes it clear that where a penalty is manifestly excessive the court has the power, on application, to modify, and not just to strike down, the penalty. The court is also empowered to impose conditions on the enforcement of the penalty. See paragraphs 6.14 – 6.22 of the Report.

Subsection 1

This subsection confers a discretionary power on the court to modify, on application, a manifestly excessive penalty so as to make it enforceable. Under the current law the power of a court which finds a provision to be unenforceable is restricted to awarding provable loss. The changes rendered by this Bill make this rule inappropriate. In the first place, if the "genuine pre-estimate" test is replaced with a rule that a penalty is enforceable unless it is manifestly excessive, there is no reason, in principle, why the court should not have the power to modify a manifestly excessive penalty to an amount that is not manifestly excessive, but which is more than the loss actually suffered. Secondly, since judicial control of penalty clauses is to be extended to clauses not arising on breach of contract, and damages for provable loss are not available where there has been no breach, it should be provided that where the court determines that a penalty due under such a clause is manifestly excessive it should have the power to modify it so as to make it enforceable. Otherwise the party in whose favour the clause was drafted might be left without any remedy.

Subsection 2

This subsection provides that modifying a penalty includes imposing conditions. For example, the person seeking to enforce a forfeiture of property might be required to provide reasonable compensation to the other party for improvements made to the property. Or the person seeking to enforce a penalty might be required to allow an opportunity for a breach to be remedied.

Subsection 3

This subsection provides that the reference to a court in clause 4 includes a tribunal or arbiter. The policy is that any body or person empowered to adjudicate on the enforceability of a penalty clause should have the power to modify the penalty in the circumstances of the case. In the absence of this provision an arbiter could decide whether or not a penalty was manifestly excessive but the parties to the arbitration would be forced to go to the ordinary courts to have it modified.

Clause 5

This clause applies the Bill to unilateral voluntary obligations, such as bonds, in the same way as to contracts. See paragraph 7.9 of the Report.

Clause 6

The only subsection requiring explanation is subsection 3 which provides that the Bill is not to affect penalty clauses agreed before the coming into force of the Act. It was considered unfair to provide that the Bill should have retrospective effect since parties who had reasonably believed a particular provision to be unenforceable because it was not a genuine pre-estimate of damages, might suffer prejudice if that provision were now to be held to be enforceable. See paragraphs 7.10 – 7.11 of the Report.

Appendix B

List of those who submitted written comments on discussion paper

Professor J W G Blackie (Contract Law Advisory Group)
The Committee of Scottish Clearing Bankers
The Faculty of Advocates
The Glasgow Bar Association
Professor W M Gordon
Professor G L Gretton
The Law Society of Scotland
The Lord President
Dr H A Patrick (Contract Law Advisory Group)
Professor C T Reid
The Royal Faculty of Procurators in Glasgow (D J Bone Esq)
The Royal Faculty of Procurators in Glasgow (R C Connal Esq, McGrigor Donald,
Solicitors)
The Sheriffs' Association
The Society of Writers to HM Signet (a view of 3 members)
University of Aberdeen, Faculty of Law
University of Glasgow, Centre for Research into Law Reform
W O Wood Esq, Munro & Noble, Solicitors

Appendix C

Members of the Contract Law Advisory Group

Dr E M Clive (Chairman)	-	Scottish Law Commission
Mr J M Arnott	-	Solicitor, Edinburgh
Professor R Black, QC	-	University of Edinburgh
Professor J W G Blackie	-	University of Strathclyde
Mr M G Clarke, QC	-	Edinburgh
The Hon Lord Coulsfield	-	Court of Session
Professor A Forte	-	University of Aberdeen
Mr G Jamieson	-	Solicitor, Paisley
Miss L J Macgregor	-	University of Glasgow
Professor H L MacQueen	-	University of Edinburgh
Professor W W McBryde	-	University of Dundee
Ms C A McLintock	-	Solicitor, Edinburgh
Sheriff Principal C G B Nicholson QC	-	Edinburgh
Dr H A Patrick	-	Solicitor, Edinburgh
Ms L A Patterson	-	Solicitor, Edinburgh
The Hon Lord Penrose	-	Court of Session
Mr D P Sellar	-	Advocate, Edinburgh
Professor J M Thomson	-	University of Glasgow
Mr N R Whitty	-	Scottish Law Commission
Sheriff A B Wilkinson, QC	-	Edinburgh
Mr J Wolffe	-	Advocate, Edinburgh
Mr S Woolman, QC	-	Advocate, Edinburgh
Mrs G B Swanson (Secretary)	-	Scottish Law Commission

Observers

Mr P M Beaton	-	Scottish Courts Administration
Mr H F MacDiarmid	-	Office of the Solicitor to the Secretary of State for Scotland