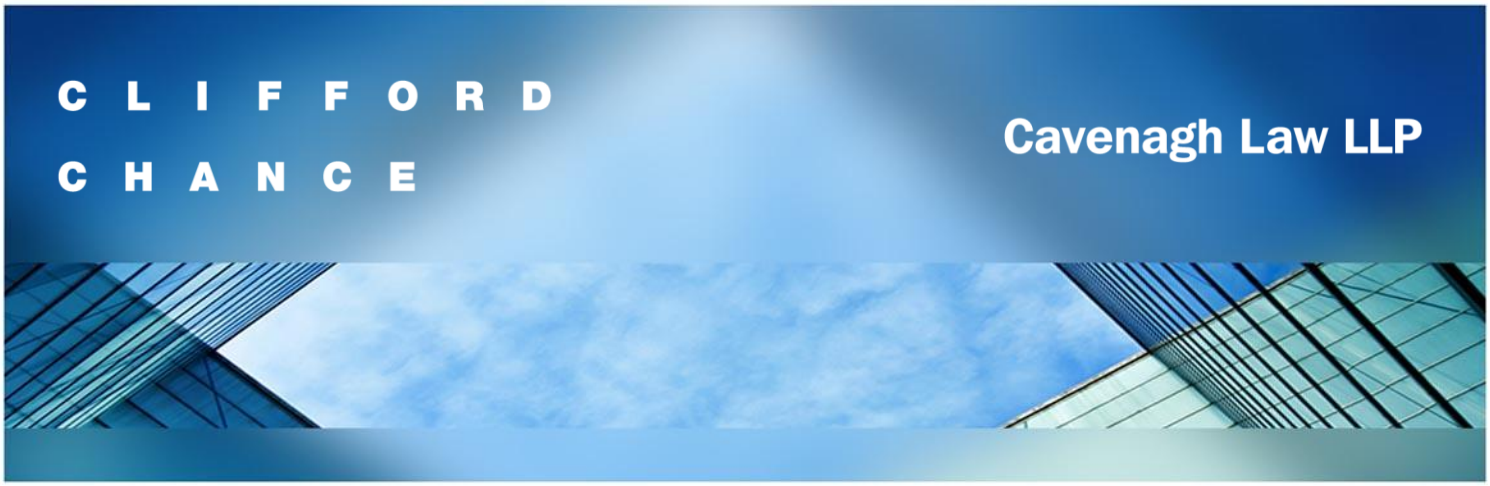

SINGAPORE COURT OF APPEAL AFFIRMS TRADITIONAL *DUNLOP PNEUMATIC* TEST FOR PENALTY CLAUSES AND DECLINES TO ADOPT WIDER LEGITIMATE INTEREST TEST RECENTLY DEVELOPED BY UK SUPREME COURT IN *CAVENDISH*.

Key issues

- In Singapore the rule against penalties applies only to clauses which provide for consequences upon a breach of contract having occurred.
- A liquidated damages clause will not be an unenforceable penalty if the sum payable as liquidated damages does not exceed a genuine pre-estimate of loss. In other words, the traditional Dunlop test continues to apply in Singapore.
- The legitimate interest test recently developed by the UK Supreme Court in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172 does not apply in Singapore.

On 15 December 2020, a five-judge bench of the Singapore Court of Appeal delivered judgment in *Denka Advantech Private Limited & another v Seraya Energy Pte Ltd & another* [2020] SGCA 119 (*Denka v Seraya*). The decision provides important guidance on the distinction between liquidated damages and penalty clauses, the latter being unenforceable at law. In *Denka v Seraya*, the Court of Appeal held that: (i) the correct legal test to be applied is whether the clause provides a genuine pre-estimate of the likely loss as assessed at the time of contracting (i.e. the test articulated by Lord Dunedin in the English case of *Dunlop Pneumatic Tyre Company, Ltd v New Garage and Motor Company, Limited* [1915] AC 79) (the *Dunlop* test); and (ii) the rule against penalties only applies to clauses which are triggered by a breach of contract and not other events.

INTRODUCTION

The dispute primarily concerned the alleged repudiatory breach of three electricity retail agreements (ERAs) between Seraya Energy Pte Ltd (Seraya) on one hand, and Denka Advantech Pte Ltd or Denka Singapore Pte Ltd (collectively, Denka) on the other. Seraya pursued liquidated damages under the liquidated damages (LD) clause contained in each of the three ERAs, and alternatively sought general damages at common law.

Denka mounted several arguments resisting liability, including for example, that its letter stating that it did not wish to continue purchasing electricity did not amount to either a termination or repudiation of the ERAs.

On the question of remedies, Denka contended that the LD clauses in the ERAs were unenforceable penalty clauses, and Seraya's common law damages for two of the ERAs ought to be limited by express provision in those

ERAs that neither party would be liable for indirect or consequential loss, including loss of profits.

On the facts, the Court of Appeal found that Denka was liable under the ERAs, and moreover, the LD clauses in the ERAs were not unenforceable penalty clauses. Seraya therefore succeeded in its claim for LDs.

The case is discussed in more detail below as is the comparative position across the major common law jurisdictions. In summary this is:

	Singapore	**UK**	**Australia**	**Hong Kong**
When the Penalty Rule applies	Only when the clause is triggered by a breach of contract.	Only when the clause is triggered by a breach of contract.	Applies even to clauses that are not triggered by a breach of contract.	Only when the clause is triggered by a breach of contract.
Test to determine whether a clause is an unenforceable penalty clause	Whether the liquidated damages stipulated for are a genuine pre-estimate of loss. *Dunlop* test affirmed.	Whether the impugned provision constitutes a secondary obligation that imposes a detriment on the contract-breaker that is out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. Test in *Cavendish* applies.	No clear single test. However, the inquiry can proceed along the following lines: whether the sum or remedy stipulated is (1) exorbitant or unconscionable or (2) out of all proportion to the interests of the party which it is the purpose of the provision to protect; or (3) whether the stipulated is properly characterised as having no purpose other than to punish.	Whether the liquidated damages stipulated for are a genuine pre-estimate of loss. *Dunlop* test applies, although the Court of Appeal is yet to fully consider and adopt or reject the *Cavendish* test.

THE RULE AGAINST PENALTIES

The central plank of Denka's defence was that the LD clauses in the ERAs were unenforceable penalty clauses. To determine the issue, the Court of Appeal engaged in a comprehensive examination of the legal principles relating to the rule against penalties (the Penalty Rule), primarily focussing on two issues: (1) the scope of the Penalty Rule, and (2) the legal criteria to establish that a clause was a penalty clause.

(1) The scope of the Penalty Rule

The Court of Appeal held that the Penalty Rule should be confined only to clauses that took effect upon a breach of contract.

The Court of Appeal noted that the High Court of Australia had in *Andrews and others v Australia and New Zealand Banking Group Limited* (2012) 247 CLR 205 (*Andrews*) taken a more expansive approach to the penalties jurisdiction, holding that the rule against penalties should not be limited only to clauses that took effect upon a breach of contract. Under the Australian formulation, a penalty is a *collateral* or *accessory* stipulation to a primary

stipulation, which imposes an additional detriment on one party upon the failure of the primary stipulation. Importantly, this primary stipulation *may*, but need not necessarily, amount to a contractual obligation that is breached upon the promisor's failure to perform.

The Court of Appeal examined the extension of the Penalty Rule taken in *Andrews* but declined to follow it for three reasons. First, although it was true that the Penalty Rule had originated in the courts' equitable jurisdiction, it had been applied in the very specific context to provide relief against the enforcement of penal bonds, and there was no reason to apply it to all modern contracts.

Second, extending the Penalty Rule to apply to clauses that were not triggered by a breach of contract would permit the courts to review a wide range of clauses on substantive, and not merely procedural, grounds, which would represent an uncertain and significant legal incursion into parties' freedom of contract.

Third, requiring a breach of contract would ensure that the Penalty Rule applied only to secondary obligations (i.e. the obligation to pay damages upon breach), and would not interfere with the party's primary obligations.

In affirming that the Penalty Rule only applies to clauses triggered by a breach of contract, the Court of Appeal firmly rejected the approach taken by the High Court of Australia in *Andrews* and *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28: see our previous client briefing here.

(2) The applicable legal criteria in relation to the Penalty Rule

The Court of Appeal next considered recent developments in respect of the Penalty Rule, particularly the UK Supreme Court decision in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172 (*Cavendish*), which had stated that the test to be applied to determine whether a clause was a penalty was whether the impugned provision was a secondary obligation which imposed a detriment on the contract-breaker that was out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. Under the *Cavendish* test, a "legitimate interest" could involve considerations other than the desire to recover compensation for breach. Further details about the *Cavendish* decision can be found in our earlier client briefing here.

The Court of Appeal declined to follow the approach in *Cavendish* and instead affirmed the four principles posited by Lord Dunedin in *Dunlop* as representing the correct position in law in Singapore. Under the *Dunlop* approach, the central inquiry is into whether the amount to be paid as LD represents a genuine pre-estimate of loss. The four principles are: (1) a provision is penal if the sum stipulated for is extravagant and unconscionable in comparison to the greatest loss that could conceivably be proved to have followed from the breach; (2) the provision will be penal if the breach consists only in the non-payment of money and it provides for payment of a larger sum; (3) there is a rebuttable presumption that the provision will be penal if the sum stipulated for is payable on a number of events of varying gravity; (4) the provision will not be penal because of the impossibility of precise pre-estimation of the loss.

The Court of Appeal held that the approach in *Dunlop* was to be preferred because it was centrally concerned with whether the clause in question provided a genuine pre-estimate of loss, and therefore focused on the secondary obligation on the part of the defendant to pay compensatory (as

opposed to penal) damages. In contrast, the approach in *Cavendish* was inconsistent with this because it would permit the enforcement of clauses which (a) operate upon a breach, (b) are not genuine pre-estimates of likely loss, but (c) are nevertheless commercially justifiable.

Moreover, the concept of "legitimate interest" as framed in the *Cavendish* approach had a protean character that allowed it to be used too flexibly, and would result in too much uncertainty both prior to the entry into the contract concerned, as well as to the specific result arrived by the court thereafter.

That said, the factors of whether the parties were of equal bargaining power, and the purpose of the underlying transaction and the particular primary obligation that had been breached, which were important in *Cavendish* would similarly be relevant to the application of the *Dunlop* test in Singapore.

APPLICATION TO THE FACTS

The Court of Appeal held that Denka had breached the ERAs. Only one of the ERAs had been terminated as a result of Seraya's common law right to accept a repudiatory breach. However, the other two ERAs which had been terminated pursuant to express termination clauses were based upon or brought about by Denka's repudiatory breach at common law.

The Court of Appeal also considered that the LD clauses in all three ERAs were secondary obligations that took effect upon a breach of contract. Thus, the Penalty Rule was engaged.

Applying the *Dunlop* approach, the Court of Appeal concluded that the LD clauses were not penalties and thus remained enforceable. The amounts to be paid as LD were not extravagant and unconscionable in amount in comparison to the greatest loss that could conceivably be proved to have followed from the breach, having regard to expert evidence and also to the amount of common law damages that could have been claimed.

Although it was true that the LD clauses provided for the same payment formula regardless of the nature of the event resulting in termination, the Court of Appeal considered that this only raised a rebuttable presumption that the clauses were penalties, and the presumption was indeed rebutted, because the LD formula was gradated according to the remaining duration of the contracts from the date of termination. Seraya was therefore entitled to the LD of approximately S$31m it sought.

IMPLICATIONS

The Court of Appeal's decision conclusively settles the position in Singapore that the Penalty Rule applies only to clauses that take effect upon a breach of contract, and that the *Dunlop* test instead of the *Cavendish* approach will be used to determine whether a clause is unenforceable for being a penalty.

Thus, under Singapore law, the focus is whether the clause concerned provides a genuine pre-estimate of the likely loss at the time of contracting. In this regard, the only "*legitimate interest*" which the Penalty Rule is concerned with is that of compensation.

If a party terminates a contract pursuant to an express right of termination, there is a possibility that it will be unable to argue that an LD clause that is triggered by the termination is unenforceable for being a penalty, because the Penalty Rule only applies to clauses that take effect upon a breach of contract.

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Parties need to take care when drafting LD clauses. The sum stipulated as LD cannot be extravagant, having regard to the range of losses that it could reasonably be anticipated it would have to cover at the time the contract was made. Otherwise, there is a chance that the clause will held to be an unenforceable penalty clause.

In the course of contractual negotiations, a party may wish to obtain the contracting counterparty's written consent or acknowledgment that the amount of damages specified in the LD clause is reasonable or represents a genuine pre-estimate of loss based on a range of losses that has been discussed between the parties. Such correspondence can be relied upon in the event that the LD clause needs to be relied upon, to reduce disputes on whether the LD clause in question was a penalty clause or not.

It should be recalled that the mischief that the Penalty Rule ultimately seeks to prevent is the imposition of a remedy that is clearly disproportionate to the loss suffered as a result of the breach. In other words, the purpose of the Penalty Rule is simply to avoid unfairness to the defaulting party when apportioning the extent of their contractual liability – but this does not give the Courts *carte blanche* to substantively re-write contracts.

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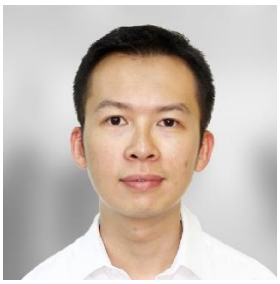

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