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Penalty Rule:

Three Different Approaches in the UK, Australia and Singapore

Summary

The highest courts in Singapore, Australia and the UK cannot agree on a uniform approach to determining if a contractual provision is unenforceable as a penalty. This has significance for the choice of governing law. As a broad summary:

- More provisions are likely to be a penalty under Singaporean law than under Australian or English law
- More provisions are likely to be a penalty under Australian law than under English law

The leading decisions for each jurisdiction are:

- Singapore: *Denka Advantech Pte Ltd v Seraya Energy Pte Ltd* [2020] SGCA 119
- UK: *Cavendish Square Holding BV v Makdessi* [2016] AC 1172
- Australia: *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28 and *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30

There are two aspects to the scope of the penalty rule – the test and the types of obligations to which it applies. Singapore applies a less stringent test to only one type of provision; Australia applies a more stringent test to more types of provisions; and the UK applies a more stringent test to only one type of provision, with the result that a smaller group of sanctions are more likely to be a penalty.

The Test – Damages or Interests?

Singaporean law applies the traditional test of whether the provision is a genuine pre-estimate of the likely damages the innocent party could recover, considered at the time of contracting. If the provision is disproportionate to a genuine pre-estimate of those damages, it is unenforceable as a penalty – the test in *Dunlop Pneumatic Tyre Company, Limited v New Garage and Motor Company Limited* [1915] AC 79.

English and Australian law look to the innocent party's legitimate interests in performing the contract, beyond the mere legal damages that would be recoverable for a breach. It can include things such as encouraging timely performance and deterring any breaches of the primary obligations.

In most cases, recoverable damages will be less than interests in performance. Those interests often will include matters that would not resound in damages, such as an interest of the innocent party in encouraging traffic through a shopping mall. Since damages will generally be less than interests, it will usually be easier for a sanction to be a penalty under Singaporean law (damages) than under English or Australian law (interests).

The Obligations – Primary or Secondary?

Singaporean and English law apply the rule traditionally only to secondary obligations – that is, obligations that arise only after a primary obligation is breached. The classic secondary obligation is liquidated damages, which arises only when a primary obligation, such as to perform on time, is breached.

Australian law applies the rule more broadly to primary and secondary obligations. No breach of contract is required to attract the rule and to strike down the sanction as a penalty. For example, fees charged by a bank for a customer being overdrawn would be primary obligations, as it is usually not a breach of contract to be overdrawn. Australian law would apply the penalty rule to the fees and potentially strike them down, but English and Singaporean law would not.

Similarly, a lender might demand a fee for extending the time for repayment. No breach is involved, as the extension is agreed, so payment of the fee is a primary obligation. The fee would be subject to the penalty rule under Australian law, but not under English or Singaporean law, as in *Holyoake v Candy* [2017] EWHC 3397.

The result is that Australian law applies the penalty to more types of clauses (primary and secondary obligations) than Singaporean or English law, but applies a more stringent test than Singapore (interests rather than damages).

The Test and the Provisions

This table shows the approaches to the test and the types of obligations to which it is applied.

	Test	Obligations
Singapore	Genuine pre-estimate of damages	Secondary only
Australia	Legitimate interests in performance	Primary and secondary
UK	Legitimate interests in performance	Secondary only

The relative level of difficultly of showing that a sanction is a penalty is shown in the following table.

	Test	Obligations
Singapore	More difficult to show penalty	More difficult to show penalty
Australia	More difficult to show penalty	Less difficult to show penalty
UK	Less difficult to show penalty	More difficult to show penalty

The following table compares the test with the obligations for each jurisdiction.

Obligations		Primary Only	Primary and Secondary
Test	**Interest in Performance**	UK	Australia
	Damages for Breach	Singapore	

Result

In most cases, the test might be more important than the type of obligation to which the test is applied, as sanctions are usually applied as secondary obligations when primary obligations are breached (e.g. liquidated damages). It will not be often that the enforceability of a sanction depends on whether it is a primary or secondary obligation.

More often, the issue will be the amount of the sanction. Whether it is a penalty will depend on whether it is compared to the damages that would have been awarded for the breach or to the victim's legitimate interest in performance of the contract. It is more likely to be a penalty if it is compared to the damages rather than the interests, since the interests will usually be higher than the damages.

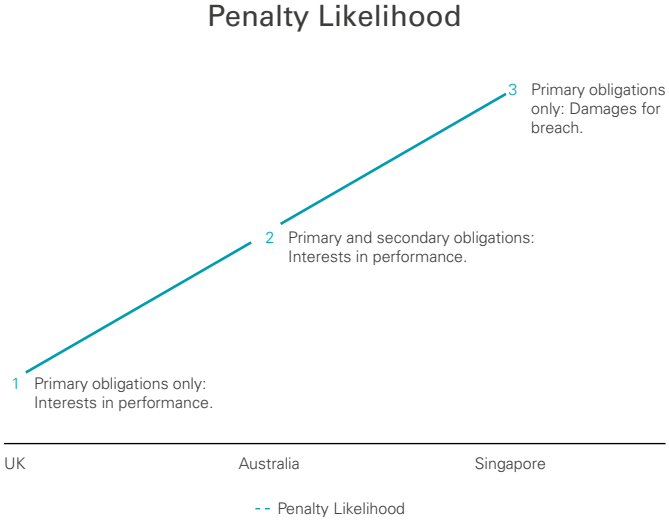
Which Governing Law to Choose?

Singaporean law will be the most likely to declare a secondary obligation to be a penalty, so paying parties could choose this as the governing law, and receiving parties could avoid it.

Australian law is the only law likely to declare a primary obligation to be a penalty, so parties paying sanctions as primary obligations could choose the law of one of the states or territories of Australia as the governing law.

English and Australian law are equally likely to declare a secondary obligation to be a penalty, since they both apply the "interests" test. Since Australian law also applies the penalty rule to primary obligations, English law is the least likely of the three laws to hold a sanction to be a penalty. Paying parties could avoid this law, while those receiving payment might choose it.

These can be represented as on the following graph.



Key Takeaways

- The choice of governing law is important for the enforceability of liquidated damages clauses.
- A clause that is in substance a primary obligation would not be caught by the penalty rule under Singaporean or English law. Clauses drafted as primary obligations intended to avoid the application of the penalty rule may still be unenforceable under Australian law.
- Parties seeking to rely on the liquidated damages clauses would benefit from documenting the broader commercial interests behind such clauses, especially if the governing law of the contract were Australian or English. Where the applicable law is Singaporean law, recording the genuine estimates of the greatest possible loss from breaches at the time of contracting might serve as better protection.

For further information and queries, please do not hesitate to reach out to Cameron Ford, Christopher Bloch, or your usual contact at the firm. Our thanks to Ng Cai Jia Felicia of the National University of Singapore and University of Melbourne law schools for her research and drafting.

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