Singapore Court of Appeal Declines to Adopt Wider "Legitimate Interest" Test for Unlawful Penalties Developed by the UK Supreme Court in *Cavendish Square Holding BV v Makdessi*

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ABSTRACT

In the recent judgment of *Denka Advantech Pte Ltd and another v Seraya Energy Pte Ltd and another and other appeals* [2020] SGCA 119, the Court of Appeal allowed Seraya Energy Pte Ltd's appeal and upheld its claim for liquidated damages on the basis that the relevant provisions were not penalties. The Court declined to adopt the wider legitimate interest standard for contractual penalties developed by the UK Supreme Court in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, opting instead to apply the rule as articulated by the seminal House of Lords decision in *Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Company Limited* [1915] AC 79.

BACKGROUND

The Claimant in the case was Seraya Energy Pte Ltd ("Seraya"), a retailer of electricity. The Defendants were Denka Advantech Pte Ltd and Denka Singapore Pte Ltd (collectively "Denka"). Denka were customers of Seraya under certain electricity retail agreements ("ERAs").

A dispute between the parties arose in August 2014, when Denka wrote to Seraya stating that "the supply of steam and electricity shall cease" under the ERAs. Seraya treated this as evidence of Denka's repudiation of the ERAs. Seraya commenced claims against Denka for damages under the liquidated damages ("LD") clauses contained in each of the ERAs and, alternatively, for common law damages.

With regards to liability, Denka argued that its letter did not amount to either a termination or repudiation of the ERAs. Denka further contended that the LD clauses in the ERAs were unenforceable penalty clauses.

DECISION IN THE HIGH COURT

The trial judge found that Denka was in repudiatory breach of the ERAs, and therefore, the LD provisions in the ERAs were engaged. However, applying the principles in *Dunlop*, the judge found that the LD clauses in each of the ERAs were not genuine pre-estimates of Seraya's losses and were therefore unenforceable. The judge also applied the principles on contractual penalties as articulated in *Cavendish* but held that the LD clauses were unenforceable under the wider legitimate interest standard as well.

Seraya appealed against the judge's decision on the enforceability of LD clauses.

DECISION IN THE COURT OF APPEAL

The Court of Appeal focussed on two issues: (1) the scope of the penalty rule; and (2) the applicable legal criteria to determine whether a clause was a penalty.

Scope of the Rule

The Court recognised that recent decisions in Australia and the United Kingdom had developed the law to a point where there was no longer a uniform approach to determining if a contractual provision was unenforceable as a penalty.

The traditional English position, as summarised in *Cavendish*, is that the rule will only apply to secondary obligations. In other words, the rule will only apply to obligations that arise after a primary obligation has been breached.

Australian law, on the other hand, applies the rule more broadly. Its application is not limited to clauses which impose obligations only upon one party's breach of contract. On the contrary, as the Court noted, in *Andrews and others v Australia and New Zealand Banking Group Limited* (2012) 247 CLR 205, the Australian High Court held that no breach of contract was required to engage the rule and to determine a clause as a penalty. On this basis, provisions for termination on insolvency, for example, would be within the scope of the rule.

Rejecting this Australian formulation, the Court declined to extend the penalty rule to situations outside of breaches of contract. Noting its apparent appeal, the Court opined that adopting the Australian position would grant "both wide as well as uncertain" discretion to the judiciary. Importantly, the Court noted it would permit them "to review a wide range of clauses on substantive (and not merely procedural) grounds, thus constituting a general, uncertain and significant legal incursion into the freedom of contract".

In the Court's opinion, there were persuasive reasons as to why the prerequisite of a breach of contract was to be preferred. In the words of the Court:

> "[T]he concept of a breach of contract means that the Penalty Rule is confined to the sphere of secondary obligations only—specifically, the obligation on the part of the defendant to pay damages to the plaintiff. In this regard, primary obligations between the contracting parties are not interfered with at all, unlike in the broader equitable jurisdiction mooted in Andrews."

The Court reasoned that the prerequisite of a breach of contract, acting as a practically enforceable limit on the rule, reflected common law courts' reluctance to intervene in the contents of the parties' contract.

Applicable Legal Criteria

The Court began by noting that historically, *Dunlop* had been the seminal case on the applicable legal criteria of the rule. As expressed by Lord Dunedin in that case, the critical question a court had to answer was whether the clause provided a genuine pre-estimate of the likely loss at the time of the contract. Additionally, the Court set out Lord Dunedin's further tests which, if applicable, would assist in determining the true nature of a stipulated sum. In summary:

- A clause would be a penalty if the sum stipulated for was extravagant and unconscionable in amount compared to the greatest loss that might conceivably have been proved to have resulted from the breach (greatest loss principle).
- Where a breach was a failure to pay a sum of money that was less than the stipulated sum, the stipulated sum would be a penalty.
- There was a presumption—but no more—that a clause would be a penalty when a single lump sum was made payable by way of compensation, on the occurrence of one or more events, which may each cause very different levels of damage (lump sum principle).
- A sum would not be a penalty simply because the consequences of the breach were such as to make the precise pre-estimation almost impossible.

The Court of Appeal next considered recent developments, particularly the UK Supreme Court decision in *Cavendish*, in which Lord Neuberger and Lord Sumption reformulated the penalty rule, stating:

> "[t]he true test is whether the impugned provision is a **secondary obligation** which imposes a detriment on the contract-breaker **out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation**. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance…" [**Emphasis added**]

Crucially, according to the Supreme Court, compensation was not necessarily the only legitimate interest that an innocent party may have in the performance of the defaulter's primary obligations. In *Cavendish*, the defendant agreed to sell a controlling stake in a leading advertising company. The purchase price was subject to compliance by the defendant with certain continuing obligations and non-compete covenants. On breach of those obligations, the claimant ceased to be liable to pay any further instalments, and had a right to buy out the defendant's remaining shares for a price that excluded the company's goodwill.

The Supreme Court in *Cavendish* ruled that the protection of the company's goodwill, which was critical to its continued success, was central to the claimant's commercial objective in acquiring the business. As explained by Lord Neuberger and Lord Sumption, even though the relevant clause had no relationship with the measure of loss attributable to the breach, "[t]he fact that some breaches of the [the contract] would cause very little in the way of recoverable loss… [was]… beside the point."

However, the Court of Appeal declined to follow the legitimate interest approach taken in *Cavendish* and instead endorsed the statement of principles set out by Lord Dunedin in *Dunlop*. It did so because:

> "the test as to whether or not the contractual provision concerned provided a genuine pre-estimate of the likely loss is wholly consistent with the fact that the focus is on the secondary obligation on the part of the defendant to pay damages by way of compensation."

The Court continued, explaining that:

> "a contractual provision which stipulates for an amount of damages to be paid in the event of breach that is more than the pre-estimate of the likely loss must necessarily be (on a normative level) penal, as opposed to compensatory, in nature–notwithstanding that it might have been in the commercial interests of the plaintiff to have included such a provision or clause on a factual level."

The Court noted that its rejection of the legitimate interest test did not mean that the key considerations of the court in *Cavendish* were entirely irrelevant. For example, the

comparable bargaining power of parties who had been properly advised by counsel would likely lead to a strong presumption that the parties were the best judges of what was legitimate in an LD clause. However, whilst these other factors were open to a party to argue, the Court stressed that they must nonetheless be viewed "in the light of the fact that the focus is on whether or not the provision or clause concerned is a genuine pre-estimate of the likely loss in general and the statement of principles set out by Lord Dunedin in Dunlop in particular."

The Court's Decision

With regards to liability, the Court found that Denka had wrongfully repudiated the ERAs and that Seraya had validly terminated them.

Applying its findings to Seraya's appeal, the Court determined that the LD clauses in all the ERAs were secondary obligations and hence the penalty rule was applicable. The LDs payable under the ERAs were equal to A x B x 40% where "A" was the number of months between the date the Contract Duration was terminated and the Expiry Date and "B" referred to the arithmetic average of the amount payable by Denka to Seraya in a given period.

The Court then set about applying the principles as stated in Dunlop to the LD clauses, namely, the "greatest loss principle". As noted above, this required the Court to ask whether the sum stipulated was "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach". This was, in the Court's opinion, the most important of the principles set out in *Dunlop*. On the facts, and the testimony of experts, the LD formula was not extravagant when compared to Seraya's conceivable loss.

In addition, the Court found that the LD clauses offended the "single lump sum" test as developed in *Dunlop*. However, as the Court explained, the presence of a single lump sum payment in a contract was merely one indication—and not determinative—that the relevant clause was a penalty. In fact, the Court stressed the importance of the "greatest loss principle", maintaining that where a court found that the LD clause was not extravagant or out of all proportion, then the court should conclude that the LD clause was a genuine pre-estimate. Consequently, as the LD clauses did not offend the "greatest loss principle", the Court concluded that the clauses were not penalties.

Accordingly, the Court awarded Seraya $30,829,369.79, the sum owed to it under the LD clauses in the ERAs.

COMMENT

The case highlights what has been described as an unsatisfactory point of distinction in common law jurisdictions for a doctrine so vital to modern commerce.

Nevertheless, the case restores *Dunlop's* status as the leading case in Singapore regarding the penalty rule, notwithstanding the decision of Australian and UK courts to reframe the rule. Therefore, under Singapore law, whilst other factors may not be entirely irrelevant, whether the clause represents a genuine pre-estimate will be the critical consideration.

The rejection of the Australian approach leaves it open to parties to structure a payment of liquidated sums as an alternative method of performance (i.e., a primary obligation) rather than as a remedy for breach of contract. Such a clause should fall outside the scope of the rule provided that liquidated sums fall due upon the occurrence of an event other than a breach of a contractual obligation.

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Please do not hesitate to contact us with any questions.

LONDON

Tony Dymond
tdymond@debevoise.com

Gavin Chesney
gchesney@debevoise.com

Robert Hoose
rhoose@debevoise.com

Sophia Burton
sburton@debevoise.com

Laith Najjar
lnajjar@debevoise.com

Raeesa Rawal
rrawal@debevoise.com

Amina Afifi
aafifi@debevoise.com