SUN MOBILITY
Insurance and Claims Services Limited

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To: Transport Industry Operators

C/P penalty clause

The English Court of Appeal issued a Judgment on 31/7/2009 holding a charterparty clause (concerning late redelivery) as a penalty clause and thereby unenforceable. [2009] EWCA Civ 855;[2009] All ER (D) 35 (Aug)

This appeal arose out of the dismissal by Blair J ('the judge') of an appeal by the owners from an interim award dated 7/5/2008 made by three arbitrators, namely Michael Baker-Harber, Alan Burbridge and Robert Gaisford, in which they decided that a provision in a charterparty was unenforceable on the ground that it was a penalty. The charterparty was dated 23/11/2006 and was on an amended New York Produce Exchange form under which the charterers chartered the vessel Paragon for "about minimum 3 to about 5 months (about means +/- 15 days)". By clauses 4 and 36, the rate of hire was US$ 29,500 "per day or pro rata". The critical clause was clause 101 which was in these terms:

> "The Charterers hereby undertake the obligation/responsibility to make thorough investigations and every arrangement in order to ensure that the last voyage of this Charter will in no way exceed the maximum period under this Charter Party. If, however, Charterers fail to comply with this obligation and the last voyage will exceed the maximum period, should the market rise above the Charter Party rate in the meantime, it is hereby agreed the charter hire will be adjusted to reflect the prevailing market level from the 30th day prior to the maximum period date until actual redelivery of the vessel to the Owners."

It was the second sentence of clause 101 that the arbitrators held to be a penalty. The owners appealed to the High Court but the decision was upheld by Blair J. His order was dated 25/3/2009.

The vessel was delivered under the charterparty at 16.45 GMT on 29/11/2006 and it was common ground that the latest time for redelivery of the vessel to the owners was 16.45 GMT on 14/5/2007. The vessel was redelivered at 20.45 GMT on 20/5/2007, which was 6.166 days after the latest permissible time for redelivery under the charterparty. The last voyage in fact took 77 days. The owners claimed damages for breach of the charterparty by reference to clause 101. They said that the prevailing market rate calculated in accordance with the clause was US $ 46,083.22 per day as compared with the charterparty rate of US $ 29,500 per day. The charterers accepted that the owners were entitled to the normal measure of damages for late delivery, which was the market rate for the period between the last permissible date for redelivery and the date of actual redelivery. On that basis they accepted liability for $ 89,560.87, which they had paid the owners. However, the owners claimed an additional sum of US $ 471,603.32 which was calculated in accordance with clause 101. The owners said that they were entitled to enhanced hire at the market rate, not just for the six or so days the vessel was late but from 30 days before the contractual redelivery date, that was from 14/4/2007.

The Court of Appeal thought the first sentence of clause 101 was indeed a provision similar to the ordinary obligation to give legitimate orders. The second sentence applied on the premise that there was a breach of the obligation in the first sentence, since it begins "if, however charterers fail to comply with this obligation". It was thus an agreement as to what should happen in the case of breach and was thus a classic provision to which the law of penalties applied. It was therefore unenforceable unless the payment stipulated for was a genuine pre-estimate of the amount of loss caused by the breach. The judge correctly set out the relevant principles, he quoted this passage from the speech of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 86-87:

> "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. The question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of the making of the contract, not as at the time of breach. ... 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. 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."

The judge also referred to a passage in *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752 at 762H, where, as Mance LJ put it in *Cine Bes Filmcilik v United International Pictures* [2003] EWCA Civ 1669 at [13], a more accessible paraphrase of the concept of penalty than the use of the expression in terrorem was stated by Colman J thus:

> "whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach. That the contractual function is deterrent rather than compensatory can be deduced by comparing the amount that would be payable on breach with the loss that might be sustained if breach occurred."

The judge further noted the circumspection that the courts showed before striking down a clause when the parties were of equal bargaining power did not displace the rule that the clause must be a genuine pre-estimate of damage: *Jeancharm Ltd v Barnet Football Club Ltd* [2003] EWCA Civ 58 per Jacob J at [15] and *General Trading Company v Richmond Corporation Ltd* [2008] 2 Lloyd's Rep 475 per Beatson J at 498. 34.

In short clause 101 did not entitle the owners to treat the contract as at an end. If there was a breach of the clause, the owners were in principle entitled to damages assessed on the basis which was well known to the parties, namely payment at the market rate after the contractual date of redelivery.

On the authorities, since there was no repudiatory breach accepted by the owners, their loss was simply a figure to be calculated at the market rate for the 6.166 days between the contractual redelivery date and actual redelivery. It was that figure which was to be compared with the figure calculated by reference to clause 101. The arbitrators concluded at paragraph 26 of the award that the primary purpose of the clause was to deter the charterers from failing to make the relevant arrangements and investigations before issuing voyage orders. The judge said this at:

> "Finally, I come to the amount claimed on the basis of clause 101, noting that the award in this case was made by three very experienced maritime arbitrators (Mr Michael Baker-Harber, Mr Alan Burbidge and Mr Robert Gaisford). They were well placed to judge the nature of the provision in its commercial setting. They pointed out that if the vessel was redelivered only one hour late, the amount of the claim of $ 471,602.32 would be payable in full (Award para 27). They were, in my opinion, right to take the view that this would be an "unconscionable" amount within the meaning of the case law, and equally so in the case of a delay in redelivery of just over six days as in the present case. Like the arbitrators, I consider that the primary purpose of the clause was to deter the Charterers from breaching their obligation to redeliver the vessel in time, and whilst such a purpose may in a sense be understandable because of the limits to the Owners' knowledge about the likely length of the final voyage at the time of the order, the clause was in my view a penalty, and not a genuine pre-estimate of damage resulting from a breach of contract. I would dismiss the Owners' appeal, and confirm the Award."

The Court of Appeal thought that a provision for payment, as compensation for late redelivery, of a higher market rate for the period of overrun and also for the last 30 days of the contracted period would be penal. The Court of Appeal upheld the decision of the arbitrators as approved by the judge that the second sentence of clause 101 was indeed penal. The Court of Appeal dismissed the appeal.

Please feel free to contact us if you have any questions or you would like to have a copy of the Judgment.

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The robust freight industry in 2009 did not sustain well to the last quarter of 2010 as worldwide governments were not in unison in their fiscal policies. The worldwide government interference in 2011, such as the U.S. QEII, is likely to impact the worldwide movement of freight even more.

As uncertain as it was the economy in 2010, we believe the number of E&O, uncollected cargo and completion of carriage claims will continue the major concerns for transport operators in 2011. If you need a cost effective professional solution to defend claims against you, our claim team of five are ready to assist. Feel free to call Carrie Chung / George Cheung at 2299 5539 / 2299 5533.