SMIC SUN MOBILITY
Insurance and Claims Services Limited

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To: Transport Industry Operators

Penalty clause

In his Judgment dated 9/11/2004, Judge William Waung of Hong Kong High Court explained the concept of penalty clause.

The modern history of the law on the non-enforceability of a penalty clause starts with Dunlop Pneumatic Tyre Co. Ltd v. New Garage and Motor Co. Ltd [1915] A.C. 79 where the well-known statement of Lord Dunedin appeared at pages 86-88:

"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, judged of as at the time of the making of the contract, not 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 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 single 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 other but trifling damage'...

(d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequence 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…"

The "Dunlop approach" might be said to be the high water mark of modern penalty jurisprudence as thereafter the limited application of the penalty jurisdiction (based on relief granted by the Courts of Equity) was emphasised by the courts.

The modern emphasis on freedom of contract and limitation of unenforceable penalty clauses to cases of oppression is strongly supported in The Report on Penalty Clauses of The Scottish Law Commission Report (18/5/1999). At paragraph 3.2 of the Report this was said:

"...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, that it would be unconscionable to permit it to be exacted."

Then at paragraph 3.8 this was said:

"…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."

The above review of the legal jurisprudence on penalty suggests that the modern approach to penalty clauses is to look at whether in respect of a commercial contract, the disputed provision can be said to be unconscionable or oppressive by reason of its being extravagant, exorbitant or excessive and that the court should be slow to find terms agreed by the parties to be in terrorem rather than genuine agreement providing for fixed formula of loss.

The case in question was about a large loan in relation to the finance of a number of ships covering a long period of time. Under Clause 9.1.1 of the Facility Agreement dated 19/12/1998, interest was payable at the rate of 1.4% above three months LIBOR. By Clause 9.3 of the Agreement, it was provided that in the event of non-payment, additional interest of 2% was payable. Clause 9.3 provided:

> "In respect of the relevant Loan, interest accrued thereon and all sums payable hereunder not repaid or not paid on the due date or dates hereunder, additional interest, which shall accrue from day to day, shall be payable (as well after as before judgment) on demand from the due date or dates for payment hereof until actual payment of such principal, interest or other sums (as the case may be) at the rate of two per centum (2%) over the applicable rate referred to in Clause 9.1. The Borrower acknowledges that the additional interest payable as aforesaid represents a genuine pre-estimate of the loss and damage which the Banks will suffer arising from any failure by the Borrower to observe its payment obligations promptly."

At or around the time of the Facility Agreement, three months LIBOR for Japanese Yen was 0.49141%. The applicable interest rate, by adding 1.4% contractual margin to the three months LIBOR, was therefore 1.89141%. The default interest rate (if applicable in December 1998), when 2% additional rate was added to the applicable rate, would therefore be 3.89141%.

On 17/2/2003, the shipowners failed to pay the instalment amount on that day. By written notice in Chinese dated 15/4/2003 and in English dated 16/4/2003, the banks called the default and required the immediate payment of the entire loan and all other outstanding amounts. On 17/2/2003, the three months LIBOR for Japanese Yen was 0.0625%, namely some 0.43% less than in December 1998 when the Facility Agreement was signed. The case of the banks was that as from 17/2/2003, the shipowners were liable to pay interest on the entire amount at the rate of 3.4625% (0.0625% + 1.4% + 2%). The shipowners' case was that they were only liable to pay from 17/2/2003 interest at the applicable rate of 1.4625% (0.0625% + 1.4%).

The dispute between the parties was whether the shipowners were liable to pay to the banks the default interest at the additional 2% for the period from default until date of judgment on 16/12/2003. The contention of the shipowners was that default interest at the additional rate of 2%was a penalty and that therefore it was not enforceable.

Two authorities involving "default interest" penalty clauses were also cited to the Court. In the first case of Lordsvale Finance v. bank of Zambia [1996] Q.B. 752, it was held by Colman J that an extra 1 % for default interest was not a penalty. In the second case of Hong Leong Finance Ltd v. Tan Gin Huay [1999] 2 SLR 153, the Singapore Court of Appeal held that an extra 11.25% (from 6.75% for the third year onwards increased to 18% after default) was an extravagant increase being in terrorem of the borrower.

It is of course well established that the question of whether Clause 9.3 is a penalty is to be judged at the time of the making of the Facility Agreements namely in December 1998 and not in February or April 2003. The applicable interest rate in December 1998 was 1.89141% and the default interest rate under Clause 9.3 (after adding the 2%) would be 3.89141% in December 1998.

In a large loan, such as this, in relation to the finance of a number of ships covering a long period of time, the range of possible losses consequent upon non-payment by the shipowners of its contractual obligations would be broad, extensive and difficult to visualise, identify or enumerate. It was therefore sensible for the parties to agree beforehand on an agreed formula for interest rate regime covering the time when there was default in payment. Having regard to what Privy Council said in the case of Philips Hong Kong Ltd v. Attorney General of Hong Kong [1993] 1 HKLR 269 about contractual provision not being in any way condemned merely by reason of showing the contractual damage exceeding a possible actual loss, it seemed to the Judge that in a case such as this with a large range of possible losses it was simply impossible to say that liquidated damages under Clause 9.3 were totally out of proportion to the range of losses which might likely be incurred.

The court must bear in mind that this was a commercial contract where the parties on equal terms agreed on the stipulated liquidated damages, the court should not be too ready to find high "degree of disproportion" between the stipulated sum and the loss likely to be suffered. The Judge was clearly of the view that there was no such unacceptable "degree of disproportion". Having regard to the circumstances of this loan, the 2% uplift was clearly not extravagant or exorbitant or excessive. There could be no suggestion that this was a provision made in circumstances of oppression or unconscionability requiring the court to exercise its supervisory role to grant relief.

The Judge's conclusion above against the shipowners was further reinforced by the alternative approach by considering whether the 2% uplift represented a fair "rateable increase charged prospectively" which did not have the dominant purpose of deterring default. In the Judge's view, it was reasonably clear that the 2% uplift in the Facility Agreement did have a proper commercial purpose. It was there not for deterrence but for the commercial reason of providing a different interest rate regime in respect of a borrower which had deteriorated into an inferior credit risk situation. The rate increase of 2% although higher than the 1% increase in the Lordsvale case was really quite modest compared to the 11.25% increase condemned in the Hong Leong case.

In these circumstances, the Judge concluded that Clause 9.3 was not a penalty and was enforceable against the shipowners. The banks were entitled to claim the additional default interest under Clause 9.3

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

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