

**The 'Penalty' Clause in English Law: A Critical Analysis and  
Comparison with Jordanian Law**

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## **Abstract**

This thesis discusses the penalty rule in English law. Pre-arranged provisions concerning the estimation of due damages in event of the promisor's breach are of considerable practical importance. When such provisions are enforceable they are called liquidated damages clauses. However, English law courts will not enforce these provisions where they are categorised as penalty clauses. A penalty clause is a contractual provision which provides that in the event of a breach of contract the defaulting party shall pay to his contractual partner a sum which is unconscionable and extravagant in relation to the loss that is likely to result from breach. Despite the fact that the non-enforcement of penalties seemed to be well recognised at least by the seventeenth century the penalty rule remains elusive and controversial. This thesis tentatively suggests a New Approach which in some circumstances would involve a different solution than the application of existing law. The thesis also builds upon a comparison with Jordanian law.

This thesis has been divided into six chapters. The first chapter examines the historical development of penalty clauses and also introduces the New Approach. The second chapter critically examines the existing test, i.e. the sum being extravagant and unconscionable, for the invalidity of penalty clause. Chapter three considers the principle that the penalty rule is only applicable on breach and the loss to be estimated for application of this rule. The general principle under English law, which gives a court no power but to declare the invalidity of a penalty is dealt with in chapter four. The circumstance where the injured party's actual loss exceeds the stipulated sum is the object of examination in chapter five. Chapter six discusses whether the penalty rule should be applied to a provision that requires a forfeiture of money already paid taking into consideration that the only difference between a forfeiture clause and a stipulated damages clause is that under a forfeiture clause the sum is paid before breach. In the last part of this thesis a summary of the thesis including suggestions for the improvement of the current law are put forward.

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## Introduction

Asquith LJ stated that:

“As has often been pointed out, parties at the time of contracting contemplate not the breach of the contract but its performance”<sup>1</sup>

However commercial contractors often seek to plan for breach. In light of this some contracts go so far as to include a predetermined sum of money as "agreed damages" in case such breach arises. Such plans are acceptable to the courts as long as the amount of agreed damages is a genuine estimation of the loss that would be done by the breach. An agreed damages clause is urged because the clause serves numerous goals. Such clause averts the often-difficult tasks of assessing the promisee's loss and of determining how much of that loss is legally recoverable<sup>2</sup>. It avoids any uncertainty and delay resulting from relegating the matter to court to specify the damages and it reduces expenses of using judicial process where the parties determine that the costs of negotiation are less than the contemplated costs of litigation upon breach. It serves the promisor in enabling him with some degree of certainty to know beforehand what the extent of his liability would be in the event of breach. Finally, a party concerned foremost with performance, especially a timely performance, may use such a clause in the hope that it will provide a further inducement for performance.

For hundreds of years courts of equity have dealt carefully with a contractual stipulation, which requires from the defaulting party to pay a certain sum of money to the injured party in the event of breach. As such the courts have always given a relief against such stipulation where it was operating as in terrorem of the defaulting party rather than as a genuine pre-estimate of the loss likely to be suffered on the occurrence of breach. Sir

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<sup>1</sup> *The Victoria Laundry Ltd v. Newman Industries Ltd* [1949] 2 KB 528 at 540 per Asquith LJ

<sup>2</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, at 54-55 per Lord Woolf. See also Geest, Gerrit and Wuyts, Filip. "Penalty Clauses and Liquidated Damages". In Elgar, Edward. "Encyclopedia of the Law and Economics". 2000. Vol. 3. P141 where it is pointed out that: "Such clauses avoid that judges have to compute damages *ex post*. It is well known that judges may have serious difficulties in finding out the true losses. This holds especially for subjective harm. It is impossible for a judge to know the promisee's preferences precisely. Nor can he rely on what the promisee tells him, because the latter has no incentive to reveal his preferences in an honest way. This kind of preferences revelation problem does not arise when the loss is determined *ex ante*. At that time the parties are still free to enter the contract or not...An *ex ante* estimation is also useful for other forms of damage which are

Thomas More first pointed out this approach when he attempted unsuccessfully to persuade the court to give relief with regard to money bonds<sup>3</sup> and its effect has been re-stated in a modern form by Lord Diplock in *Photo Production Ltd v. Securicor Transport Ltd*<sup>4</sup>. His Lordship referred to this approach as “The equitable rule against penalties” and stated confirming that the agreement on damages in advance:

“...Must not offend against the equitable rule against penalties; that is to say, it must not impose upon the breaker of primary obligation a general secondary obligation to pay to the other party a sum of money that is manifestly intended to be in excess of the amount which would fully compensate the other party for the loss sustained by him in consequence of the breach of the primary obligation”<sup>5</sup>

It seems that the reason for making a penalty clause in contract unenforceable is that it is used as a mean of applying pressure on the promisor so as to compel him into fulfilling the principal contractual obligations. Enforcing such a stipulation may have the effect of entitling the promisee to recover far more than compensation for the loss caused by the failure of performance. The principle is that parties must not punish each other by imposing a penalty but might lawfully contract that one will be bound to compensate the other for losses caused by not fulfilling his undertakings under the contract. Thus the object of penalty conflicts with the compensatory principle adopted by the English case law in which the purpose of damages is to merely compensate the injured party rather than to punish the breaching party, as English law has always denied any role for the punishment in the enforcement of contracts<sup>6</sup>. Therefore “The rule...that the court will not enforce a penalty clause so as to permit a party to a contract to recover in an action a sum greater than the measure of damages to which he would be entitled at common law is well established”<sup>7</sup>

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difficult to prove. The costs of foregone chances are one example. Lacking clear evidence, courts will underestimate such losses”.

<sup>3</sup> This is what has been indicated by Lord Mansfield in *Wyllie v. Wilkes* (1780) 2 Doug KB, 522-523. See also for that *Jobson v. Johnson* [1989] 1 WLR 1026, at 1032.

<sup>4</sup> *Photo Production Ltd v. Securicor Transport Ltd* [1980] AC 827.

<sup>5</sup> *Ibid.* At 850 per Lord Diplock. See also *Scandinavian Trading v. Flota Ecuatoriana* [1983] 2 AC 694, at 702.

<sup>6</sup> Downes, T. Antony. “A Textbook On Contract “. 5ed. 1997, reprinted 1999. P 324.

<sup>7</sup> *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128, at 142.

This stance of the unenforceability of penalty clauses is enforced by well known distinction between liquidated damages clauses and penalty clauses<sup>8</sup>. The historical origins of this principle shed some light on its original rationale. It developed from equitable interference to grant relief against the harshness of penal bonds where the legal rules permitted double recovery through penalty bond under seal. This principle of equity was later adopted by courts of common law and still constitutes the base for the penalty doctrine, which makes penalty clause void and unenforceable. However courts later began to realise, that, in certain situations where actual damages could not be readily ascertained, promises to pay a stipulated sum in the event of a breach were a valid alternative to the uncertainty of a jury's award<sup>9</sup>. Therefore, it should be noted that this intervention by courts to grant relief against penalties would not be possible if the assessment of damages was impossible. This distinction constituted the starting point for the discrimination between penalties and liquidated damages.

The development of precise rules for this distinction culminated in the *Dunlop* case<sup>10</sup> where the following definition introduced. When an agreed sum represents a genuine pre-estimate of damages it is regarded as a valid liquidated damages clause and should be awarded irrespective of actual loss suffered. While on the other hand, where the sum fixed by the contractors bears no reasonable relation to the anticipated loss, it is an exorbitant and excessive, and will be treated as an invalid penalty. Indeed in the leading case of *Dunlop*<sup>11</sup> Lord Dunedin distinguished penalty from liquidated damages saying that "the essence of a penalty is a payment of money stipulated as in terrorem of the offending party...". However cases applying this definition do not rely on this statement and they focus on a definition of a liquidated damages clause and a penalty clause is simply defined as its negative counterpart<sup>12</sup>. This is to say that a penalty is a clause that

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<sup>8</sup> This is what has been incorporated by the leading case *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>9</sup> Harwood, William. "Comments: Liquidated Damages: A Comparison of The Common Law and the Uniform Commercial Code". *Fordham Law Review*, (1977) 45, 1349.

<sup>10</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>11</sup> *Ibid.* At 86 per Lord Dunedin. This phrase was also found in by lord Halsbury where said (at 10) that "...it is simply a penalty to be held over the other party in terrorem" [1905].AC 6, at 10.

<sup>12</sup> Halson, Roger. "Contract Law". First published in Great Britain. Longman. 2001. P 509.

provides for something in excess of a “genuine...pre-estimate of damage”<sup>13</sup>. It is suspected that the above statement is able to draw the distinction between liquidated damages and penalty, as there are cases in which the sum stipulated might be a penalty in spite of the fact that there has been no intimidation or threat against that party<sup>14</sup>. This doubt was clearly raised by Lord Radcliffe in an important statement that:

“ I do not myself think that it helps to identify a penalty to describe it as in the nature of threat “to be enforced in terrorem”...I do not find that that description adds anything of substance to the idea conveyed by the word “penalty” itself, and it obscures the fact that penalties may quite readily be undertaken by parties who are not in the least terrorised by the prospect of having to pay them and yet as I understand it, entitled to claim the protection of the court when they are called upon to make good their promises”<sup>15</sup>.

Once the court refuses to enforce a “penalty clause” the injured party is relegated to his right to claim unliquidated damages action for the breach actually committed if there was no agreement on damages in advance. The above common law rule, rule against penalties, is the subject of this research.

It was said that:

“Many more complex and intrinsically less tractable subjects have been reduced in order; this one, from the struggles of the English Judges with it before the Revolution to the present time, remains oddly elusive”<sup>16</sup>

Despite the fact that the non-enforcement of penalties seemed to be well recognised at least by the seventeenth century this rule remains elusive, puzzling and always subject to controversy. The penalty jurisdiction is associated with an enormous labyrinth of much criticised<sup>17</sup> distinctions and obscure jurisprudence. Its real scope of operation is also perceived to be in decline, as recognised by the fact that the penalty jurisdiction is “the anomaly, not the rule”<sup>18</sup>. Apart from the separate point of whether court’s intervention to

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<sup>13</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 86 per Lord Dunedin.

<sup>14</sup> This is illustrated in providing for a single lump sum made payable upon breach of several events. See *infra*. P 135.

<sup>15</sup> *Bridge v. Campbell Discount Co* [1962] AC 600, at 622 per Lord Radcliffe.

<sup>16</sup> *Callanan Road Improvement Co. v. Colonial Sand & Stone Co.*, (1947) 190 Misc 418, at 419.

<sup>17</sup> See for example, Muir, Garry. “Stipulations for the Payment of Agreed Sums”. *Sydney Law Review*. (1985) 10 503. Kaplan, Philips R. “A Critique of the Penalty Limitation on Liquidated Damages”. *Southern California Law Review*. (1977) 55 1055.

<sup>18</sup> McKendrick, Ewan. “Contract Law”. 5<sup>th</sup> ed. Macmillan. 2003. p 444.

render a penalty clause unenforceable is justified at all, there are many unsatisfactory aspects of applying the penalty doctrine itself. As the penalty jurisdiction is only applicable where there has been a breach of contract, it excludes from its scope some contractual provisions which may be oppressive and disproportionate penalty clauses, as they are carefully drafted by a professional in such a way as not to arise on a breach of contract<sup>19</sup>, striking down a clause for technical reasons though it may be regarded as a genuine pre-estimate of actual loss<sup>20</sup> and, evading the penalty jurisdiction by changing in form rather than in substance and the accuracy of the current test for invalidating penalty clause are all an object of debate.

In spite of its very long history, there remains enough ambiguity in the law to make it worth the effort for the defaulting party to challenge the agreement in order to avoid his contractual undertakings. Clearly reform of the law of penalty clauses in contract is necessary to reduce this uncertainty which defeats the purpose of agreeing on damages in advance from the outset. How, then, could the operation of penalty clauses be more effective? Or rather what policy should the law pursue, particularly if the current position of English law is unsatisfactory itself and for international purposes where penalty clause is recognised in most jurisdictions whilst it is not in English law? Consequently the writer has tentatively suggested a New Approach, which is a step on the right direction of removing or rather reducing the controversial aspects in this area of the law. This New Approach, as a theoretical case, is presented in the first chapter.

Furthermore this thesis is not only confined to the law of penalties, but also included an important study regarding the application of penalty clause rules to the forfeiture of money already paid by way of deposit and instalments. There is doubt as to how far the penalty jurisdiction extends to forfeiture of a sum of money already paid. It seems that a deposit is a guarantee for performance by the payer and can not be recovered and its retention and the retention of the whole pre-paid instalments may effectively act as the imposition of penalty. The law fluctuated in dealing with forfeiture clauses particularly

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<sup>19</sup> This can be observed in the problem of breach in Hire-Purchase contract. *Infra*. P 92.

<sup>20</sup> This is the case where there is a single lump sum payable on breach of one or different obligation of varying significance. *Infra*. P 141.

where these clauses were of penal nature. Moreover it follows from the nature of the penalty clause that the agreed sum will normally be more than the loss suffered by the injured party as a result of breach. However, it might be less than the loss suffered especially where the sum is provided for to be payable on the occurrence of one of several breaches of different significance. Shall such an agreed damages clause be subject to the legal controls imposed upon limitation clause? And what is the possibility of the application of penalty clause rules to clause that accelerates undue instalments to be payable forthwith?

This thesis extends to an examination of Jordanian law. English law relies on the case law. This gives the judges flexibility to construe and change the law according to what constitutes the public interest. In contrast Jordanian law relies entirely on legislation enacted by the House of Parliament without giving any role to the judges other than the application of legal rules. Jordanian civil law considers the penalty clause valid from the outset. A penalty clause is legitimate and court should uphold the validity of a penalty clause so long as the terms of the clause are met. However, courts have the power to adjust the amount of penalty clause. A comparison has been introduced when it was necessary.

Therefore, it is hoped that the following objectives have been achieved in this research:

- 1- A comprehensive study of the penalty clause jurisdiction in English case law<sup>21</sup> including an examination of when a court is justified in interfering with the freedom of contract otherwise enjoyed by the parties.
- 2- To develop a New Approach to the existing distinction between penalties and liquidated damages.
- 3- To analyse the forfeiture of deposits and instalments. Though they have a common origin penalty and forfeiture clauses have evolved separately. An attempt to apply penalty clause rules to those clauses has been made, as there is no ostensible theoretical reason why those clauses are treated differently from penalty clauses. Also

to consider the relation between penalty clause rules and acceleration and limitation clauses.

- 4- Despite the importance of the subject under consideration from the point of view of present-day international commercial contracts, the literature on the subject from the comparative aspect in both England and Jordan, as opposed to materials on each legal system, is not plentiful<sup>22</sup>. This scarceness has prompted the writer of this research to attempt to make, when necessary, some comparisons with Jordanian civil law to indicate the differences between fairly different legal systems and the way that each can better the other.

This thesis has been divided into six chapters. Chapter one addresses the historical development of penalty clauses since the fourteenth century until the establishment of the modern law of penalties. This chapter also deals with the introduction of New Approach that the writer developed as a theoretical case for the improvement of existing law. It examines the criticism of judges and commentators of the current rule. The demise criterion, i.e. intention of parties and whether the parties wording concludes the matter as to the nature of agreed damages clause and the existing test, i.e. the sum being extravagant and unconscionable in comparison with the loss that likely to be suffered on breach at the time of making the contract, for the invalidity of penalty clause and all issues related to its application are dealt with in chapter two. This includes the effect of hypothetical situation, effect of the inequality of bargaining power and the time for determining the invalidity of penalty clause and whether actual loss has any effect on that.

Chapter three is devoted to the scope of operation of penalty clause jurisdiction. Rule against penalty clause is only applicable where there has been breach of contract and this principle is capable of causing difficulties in case of early termination in hire purchase contract. Two situations, i.e classifying a term into condition and acceleration clause, are capable of giving the promisee a chance to evade penalty clause rule were also

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<sup>21</sup> Some indications to the legislative intervention have been showed, when essential, by considering some statutory provisions where they were necessary to extenuate the unsatisfactory aspects of case law.

<sup>22</sup> Rather no attempt was made in this regard in Jordan. This research will be of great and magnificent importance for the development of legal rules of penalty clauses in Jordan.

approached. In addition this chapter sought to examine the pre-estimated loss as the loss which should be assessed for the purpose of activating the test for the invalidity of penalty clause. Chapter four focuses on the power given to the court under existing English case law. It deal with the general principle under English law, which gives the court no power but to declare the invalidity of agreed sum as a penalty and relegate the injured party to an unliquidated damages action in order to claim his compensation for the loss he has suffered on breach.

Where the injured party's actual loss exceeds the stipulated sum in contract, two cases were distinguished. Where the sum is upheld as liquidated damages the injured party is limited to the amount agreed upon, no less no more. This situation seems to resemble a limitation clause, however the rules of limitation provision were never applied to the situation above and therefore a distinction was made between a limitation clause and a liquidated damages clause. While on the other hand there is some doubt whether the injured party is limited to claim up to the amount agreed upon when the amount is held to be a penalty. These issues are looked at in chapter five. Chapter six discusses whether the penalty clause rules could be applied to a provision that requires a forfeiture of money already paid taking into consideration that the only difference is that under forfeiture clause the sum is paid before breach. This chapter firstly dealt with forfeiture of paid instalments where two kinds of relief were approached: extension of time to the promisor to make the payment and recovery of paid instalment. It also deals with the forfeiture of deposit where a detailed analysis is introduced to answer the following questions: how can relief against forfeiture of a deposit be granted? And what is the possibility of the application of penalty clause rules to forfeiture of the sum paid by way of deposit? Lastly a summary, conclusions, the outcomes of New Approach and suggestions for the improvement of the current law were put forward.

# **Chapter One: Historical Outline of Penalty Clauses and the New Approach**

## **0-Introduction**

Penalty clauses have a very long history in English case law. This area of the law has developed from Equity, which granted relief against the harshness of penal bonds. Although it could be said that the question in relation to penal bonds could be traced back to the fourteenth century, the penalty rule emerged in the seventeenth century. Thus the equitable principle of granting relief against such bonds was adopted by courts of law and remains today as the foundation for the rule that penalties are unenforceable. This rule and the development of liquidated damages clauses were well established in the beginning of twentieth century. The evolution of penalty clause jurisdiction over the centuries until it reached the point of the modern case law, which culminated in *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>23</sup>, where rules for distinguishing penalties from liquidated damages were set out by Lord Dunedin, will now be examined. It would seem that the existing English case law as to penalties is unsatisfactory for the reasons, which will be observed when analysing the subject matter in the next chapters. Therefore, a New Approach, which raises a presumption in favour of the enforcement of penalty clauses, is introduced and exposed as a new perspective to the penalty clauses in the next section of this chapter.

Thus this chapter is devoted to deal with the following issues:

- 1- Penalty bond
- 2- Evolution of penalty clause jurisdiction over centuries
- 3- The New Approach

## **1-Penal bond**

### **1:1 what is a penal bond?**

The history of the penalty rule was originally associated with the penal bond subject to conditional defeasance and also with the obligation to pay a greater sum in the event of

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<sup>23</sup>*Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

failure to pay a smaller amount. In medieval times the majority of actions on contract brought in the common law courts were actions of debt *sur obligation*. In such an action the injured party (creditor) had to produce a sealed instrument wherein the defaulting party (debtor) had confessed himself to be obliged to the creditor. This sealed instrument had been called “obligation” or “bond”<sup>24</sup>.

In reality such a bond was used by the parties to a transaction to enforce unilateral or bilateral promises. It contained a promise by a debtor to pay a certain sum of money to a creditor if another promise was not fulfilled by a certain date. If the undertaking was performed by the appointed date the bond would become void. In other words, the bond was conditioned of defeasance (the condition is usually written on the back of the bond) in the event that the terms of the promise were not fulfilled. The essential language<sup>25</sup> of the money bond was as follows: Suppose, for instance, that A proposed to lend B £1000. B would execute a bond in favour of A for a larger sum, normally twice the sum lent, i.e. £2000, to be paid on an appointed day. The bond would be made subject to a condition of defeasance that if A paid the £1000 before the appointed date, the bond would be null. As well as the ordinary conditional bond there was a more sophisticated method, which was commonly used in the case of bilateral agreements. In these agreements the parties could make an indenture under seal setting in it the terms of the agreement. They would then each execute a bond of even the same date binding each other to pay what was usually a penal sum in the event of non-performance of the terms of the agreement.

It should be noted from the above discussion that in spite of the fact that the common bond frequently acknowledged the existence of a debt due to the creditor, it was not a device to prove the debt, but was the method, which created the debt that owed by the debtor. Consequently, the creditor should show the bond to the court to have the right of action; if it was lost or ruined the creditor’s right was also lost. On the other side, once

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<sup>24</sup> Baker, J H. “An Introduction to English Legal History”. 3<sup>rd</sup> ed. 1990. P 368-370. Simpson, A.W.B. “A History of a common Law of Contract”. Clarendon Press. Oxford. 1987. P 88. Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. Sydney Law Review. (1985) 10 503, at 504.

<sup>25</sup> Henderson, Edith G. “Relief from bonds in the English Chancery: Mid-Sixteenth Century”. American Journal of Legal History (1974) 18 298.

the debt in the bond was paid, it should be taken or destroyed by the debtor; otherwise he would be at some risk as that the main method to show that he paid the debt<sup>26</sup>.

What made the penal bonds appropriate to be used as a security for the performance of different contracts is its flexibility where it is capable of casting all transactions in its form (such as money transaction, i.e, loan and sale of land)<sup>27</sup>. Furthermore, the bond received its popularity from the unambiguous imposition of the obligation. By performing the main obligation of the penal bond the debtor can keep himself safe and secure and avoid the penal sum stipulated in the bond. This is to say unless the condition of the bond was strictly performed, the entire amount of the principal obligation under the bond would remain due and payable. On top of that, the common use of penal bonds<sup>28</sup> in medieval times was because of the obvious attraction from a creditor's point of view in contract, which is fixing a penalty in advance instead of its estimation by the juries. Also it made suing on a bond easier for the creditor, as it puts the burden of proof of performance of the condition upon the debtor<sup>29</sup>.

### **1:2 Penal bond and general rule against usury**

Before the evolution of the penalty rule at common law where the court began to distinguish between liquidated damages and penalties<sup>30</sup>, the penalty stipulated by private agreement and imposed by the bond was first viewed with some suspicion by the court as tending to be usurious. However, the general rule against usury in medieval common law<sup>31</sup> did not apply to the penal bond since the penalty was in the nature of compensation for non-payment or non-performance. The difference between the transaction that involved usury and that involved penal bond was in determining the purpose of the sum taken in excess of the principal. Suppose that A bound himself as a debtor to pay £3000 in case he did not pay £1500. Therefore if he paid the £1500 on time the bond, which

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<sup>26</sup> Simpson, A.W.B. "A History of a common Law of Contract". Clarendon Press. Oxford. 1987. P 95.

<sup>27</sup> Ibid. P 112-113.

<sup>28</sup> Although agreements under seal could have been used by an action of covenant. So the unpopularity of the action of covenant led to a proper development of action of debt.

<sup>29</sup> Simpson, A.W.B. "A History of a Common Law of Contract". Clarendon Press. Oxford. 1987. P 117.

<sup>30</sup> *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6.  
*Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79

<sup>31</sup> At this time the usury was sin and crime.

compels him to pay the double, would be void. However if he did not pay on time, he would be bound to pay the £3000 as compensation for the loss suffered by the creditor. On the other side, the usury is a sum of money that a debtor is bound to pay for the use of money lent by a creditor. In this situation the creditor was certain at the time of making the loan of money that he would be paid the sum of money stipulated for the use of the principal and not in case of the penal bond<sup>32</sup>.

## **2-Evolution of penalty clause over centuries**

### **2:1 Penal bond in the fourteenth century**

The court of chancery had been established in the latter half of the fourteenth century as a result of the petitions which had been raised to the chancellor asking for relief from wrongs not granted by the common law or where the common law remedy had been insufficient. Equity was seen as “a ruled kind of justice”, which tended to mitigate the harshness and danger of the common law that resulted from the traditions of consistency, which were growing around the courts. In other words, as the common law was inflexible at that time the chancery was an obvious forum for redress<sup>33</sup>. In *Umfraville v. Lonstede*<sup>34</sup> Beresford J. showed his unwillingness to enforce the penal stipulation. In this case the defendant Lonstede bound himself to pay the sum of £100 to the claimant Umfraville in the event that he had not delivered a written document by a certain day. The defendant failed to do so. The claimant claimed that the condition had not been fulfilled and demanded the penalty, while the defendant insisted that the claimant had suffered no loss and was ready to deliver the writing. Beresford J. said to the claimant:

“You demand this debt because the writing was not delivered, and he says that before now he has tendered it, and that he tenders it now. Therefore it is well that you receive it. Moreover, this is not, properly speaking, a debt, it is a penalty, and with what equity (look out!) can you demand this penalty”

It is clear that by the end of the fourteenth century, the idea of giving any relief against penalties was rejected by the courts of common law. They insisted on the enforceability of the penalty clauses. In other words, the common law courts insisted on giving the

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<sup>32</sup> Simpson, A.W.B. “A History of a Common Law of Contract”. Clarendon Press. Oxford. 1987. P 114.

<sup>33</sup> Jones, WJ. “The Elizabethan Court of Chancery”. Clarendon Press. Oxford. 1967. P 447. Baker, J H. “An Introduction to English Legal History”. 3<sup>rd</sup> ed. 1990. P 372.

parties the freedom to make their agreement and perform its terms. The law governing bonds was a tough law, inspired by the general philosophy that it is not the business of the courts to remake private contracts; having made their bed the contracting parties must lie in it<sup>35</sup>. This means that the common law courts were still not giving any consideration to the fact that any penalty might not have been reflecting the true losses suffered upon breach.

## **2:2 Fifteenth and sixteenth century**

It would appear that during the fifteenth century the courts of equity granted relief in the case of common money bond in cases of fraud, mistake or against the lost or destroyed instrument. Therefore the chancellors had started to intervene in relation to bond and grant relief in different circumstances<sup>36</sup>. First: the case where the debtor may have paid the debt however because he had left the bond in the creditor's hand was subject to another demand to pay the debt again. In other words, the chancellor intervened where the debtor had satisfied the bond on time and failed to take a formal acquittance by which the debtor could have proved the satisfaction of the sum of money stipulated in the bond<sup>37</sup>. In addition to this case the debtor prayed for more time as in spite of the fact that he had been willing and able to pay, some unexpected accident had hindered him doing so by the nominated date<sup>38</sup>. However in this century there had been no clear general jurisdiction to relieve against penalties, as such.

In sixteenth century the jurisdiction to grant relief had blossomed and the chancery began to grant relief against penal bonds. It was established that the penal bonds had a compensatory function and so it was inequitable for the creditor to be overcompensated. *Viz*, the creditor should not be allowed to recover compensation in excess of the loss

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<sup>34</sup> YB 2&3 Edw II Selden Society. P 58.

<sup>35</sup> Simpson, A.W.B. "A History of a Common Law of Contract". Clarendon Press. Oxford. 1987. PP 112-113.

<sup>36</sup> At Common law courts, the debtor had been still liable for the entire amount of the bond in these circumstances.

<sup>37</sup> Baker, J H. "An Introduction to English Legal History". 3<sup>rd</sup> ed. 1990. P 372. Marsh, Norman. "Penal Clauses in Contract: A Comparative study". Journal of Comparative Legislation and International Law. [1950] 32 66, at 69.

<sup>38</sup> Jones, WJ. "The Elizabethan Court of Chancery". Clarendon Press. Oxford. 1967. P 439. Holdsworth, Sir William. "A History of English Law". Methuen & Co Ltd. 1923. Vol. V . P 330.

suffered as a result of breach<sup>39</sup>. However, it was only in the mid-sixteenth century that chancery was prepared to make a serious effort to apply the theory of compensatory function. Chancery had become ready to go behind the form and put the theory in practice by asking in each case whether the penalty ought to be forfeited if the general purpose of the law was to compensate rather than to punish<sup>40</sup>. It should be noted that all these efforts were from the side of chancery courts and not from the common law courts where the creditor could still have the right to recover the entire penal sum in the bond. However, the chancellors did not also intervene to grant relief against paying the amount of penal bond on the ground that the sum due was simply a penalty as such.

## **2:3 Penal bond in the seventeenth century**

### **2:3:1 The decline of penal bond**

The attitude of the court of chancery towards penal bonds from the end of sixteenth century and the beginning of the seventeenth century demonstrated the decline of the penal bond and extension of the relief granted by the court itself. Sir George Cary summed up the practice of the chancellors at that time in a work based upon notes taken by William Lambard (d. 1601) who became a Master in Chancery in the year 1592. Sir George Cary said<sup>41</sup> that:

“If a man be bound of a penalty to pay money at a day or place, by obligation, and intending to pay the same, is robbed by the way; or hath intreated by some other respite at the hands of obligee, or cometh short of the place by any misfortune; and so failing of the payment, doth nevertheless provide and tender the money in short time after; in these, and many such like cases, the Chancery will compel the obligee to take his principal, with some reasonable consideration of his damages, (*quantum expedit*) for if this was not, men would do that by covenant which they now do by bond.”

He carried on pointing out the case where the obligor has satisfied the most part of money bond and tendered the residue after the due date. He stated that: “If the obligee have received the most part of the money, payable upon the obligation at the peremptory time and place, and will nevertheless extend the whole forfeiture, immediately refusing soone

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<sup>39</sup> Baker, J H. “An Introduction to English Legal History”. 3<sup>rd</sup> ed. 1990. P 370.

<sup>40</sup> Simpson, A.W.B. “A History of a Common Law of Contract”. Clarendon Press. Oxford. 1987. P 123.  
Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. Sydney Law Review. (1985) 10 503, at 505.

after the default, to accept of the residue tendered unto him, the obligor may find aid in Chancery”<sup>42</sup>.

Sir George Cary made it clear in the above quotation that relief should not be granted unless hardship is suffered by the debtor. In other words, by the end of sixteenth century and the beginning of seventeenth century the jurisdiction of relief was available on the same grounds that settled from the fifteenth century: mistake, accident and hardship. For example, where an accident prevented a debtor to pay on time, i.e. the payment after the due date, or if the greater part of the debt was paid before the due date, he received the Chancery’s relief . However, it was clear that the chancellors had not yet begun to grant relief against penalties simply on the ground that they were penalties<sup>43</sup>.

### **2:3:2 Reception of rule against penalties**

The basis for the relief, which had been evolved by the end of sixteenth century and, the beginning of seventeenth century, had been extended later in the seventeenth century. The extension was embraced with the reception of the penalty rule. It had become established that the court of chancery would relieve against money penal bonds on the payment of principal, interest and costs. In other words, by the aforementioned time, which was the time in which rule against penalties was received, equity started to prevent the recovery of penalty. This jurisdiction had been well illustrated in *Friend v. Burgh*<sup>44</sup> where it was said that: “the plaintiff being in execution, the defendant would not discharge him without payment of the penalty of the bond, which he having done, the court decreed the defendant to refund all, except the principal, interest and costs.”

Also relief was given against penalties due and payable for non-performance of covenant on payment of costs and damages. In this case the practice of the jurisdiction was for the Chancery to grant relief against penalty on condition that the debtor had paid damages. This had been made by sending the matter to a trial at law to estimate the damages on a

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<sup>41</sup> See for that Simpson, A.W.B. “A History of a Common Law of Contract”. Clarendon Press. Oxford. 1987. P 118-119.

<sup>42</sup> Ibid. P 119.

<sup>43</sup> Ibid.

*quantum damnifictus*.<sup>45</sup> This case was illustrated in *Wilson v. Barton*<sup>46</sup>. The form of relief, which was granted in this case, was the grant of an injunction against the enforcement of the penal bond and sending the case at trial for assessing the damages on a *quantum damnifictus*.

However, it should be noted that this intervention by the courts to grant relief against penalties (either against money penal bond or money performance bond) would not be possible if the assessment of damages was impossible. Thus, if the amount agreed upon between the parties was appropriate damages for the loss suffered, the court would not intervene. That is, the test, which had come to be applied to distinguish penalties from liquidated damages, was based on the feasibility of compensation<sup>47</sup>. In *Tall v. Ryland*<sup>48</sup> the agreement was between two fishmongers. The claimant gave the defendant a bond for £20 “conditioned to behave himself civilly and like a good neighbour and not to disparage his goods”. Later on, the claimant asked one of the defendant’s customers why he went to the defendant whose fish, the claimant said, stunk and so the defendant lost his customer. Because of this the defendant sued on bond and received a judgment. The claimant appealed to the Chancery to be relieved against penalty claiming that there was no substantial loss suffered by the defendant to recover the money penal bond and the defendant claimed also that there was no way to measure the damages. The court of Chancery declared that the demurrer of the defendant should be allowed by accepting the penalty stipulated as reasonable damages for him.

As a result it can be said that where the assessment of compensation was possible the court would intervene to grant relief against penalties. However, Lords Keeper at the same time declared that: “this was not to be a precedent in the case of a bond of £100 or the like”<sup>49</sup>. This indicated the fact that the court might not have relieved where the

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<sup>44</sup> *Friend v. Burgh* [1679] Rep T Finch 437; 23 ER 238.

<sup>45</sup> Yale, DEC. “Lord Nottingham’s Chancery Cases”. Vol. 11, 79 Selden Society. 1961. P 15.

<sup>46</sup> *Willson v. Barton* (1671-2) Nels. 148; 21 ER 812.

<sup>47</sup> Yale, DEC. “Lord Nottingham’s Chancery Cases”. Vol. 11, 79 Selden Society. 1961. P 16.

<sup>48</sup> *Tall v. Ryland* (1670) 1 Ch. Ca. 183; 22 ER 753. *Small v. Lord Fitzwilliams* [1699] Prec. Ch. 102; 24 ER 49.

<sup>49</sup> *Ibid.* At 184 and 753 respectively.

assessment of damages was impossible, however the court would not allow the recovery of a penalty where it would be extravagant, i.e. if it would have been £100.

What became clear is that by the end of the seventeenth century the established jurisdiction to relieve against penalties by the courts of Chancery had become settled and rules for distinguishing penalties from liquidated damages began to emerge. The jurisdiction which equity had thus established over bonds in which a penalty had been inserted to secure the payment of principal and interest, and over the bonds and covenants conditioned on the performance of a particular act, was a serious challenge to the common law courts. This challenge was met not by prohibiting equitable modification of penalties but by giving the common law courts via acts of parliament the powers, which the court of chancery already enjoyed<sup>50</sup>. Therefore, what was the effect of the legislative intervention on the matter of relief against penalties?

### **2:3:3 Legislative Intervention**

In the late seventeenth century the common law courts started to adopt the approach of the courts of Chancery in granting relief against the penal money bond. Consequently, the legislator, by enacting 1696-97 Act and 1705 Act, intervened to declare the jurisdiction of the common law courts to grant relief against penal bonds. The (1696-97) Act<sup>51</sup> gave the claimant, upon any bond or any penal sum for non-performance of any covenants, the right to assign as many breaches as he would think fit. Then it was the jury's duty to assess the damage suffered as a result of the breach or breaches concerned. The judgment could be entered for the whole penalty but the claimant could only recover the damages as the jury has assessed them<sup>52</sup>.

It should be noted that the 1696-97 Act regulated the situation where the penal bond was conditioned for the non-performance of any covenant or agreement. This is to say that the act had not encompassed the situation where the penal bond was conditioned for the

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<sup>50</sup> Marsh, Norman. "Penal Clauses in Contract: A Comparative Study". *Journal of Comparative Legislation and International Law*. (1950) 32 66, at 69.

<sup>51</sup> Statute of 8 & 9 Will. III.

<sup>52</sup> *Ibid.* Section 8.

payment of a certain sum on an appointed date. This is because as it can be inferred from the stipulation of the statute, where the obligation was a payment of sum of money the damages suffered would be precisely determined and so there is no need for the intervention of the jury to determine that. However, in the event that the bond was for non-performance of any covenant the damage would need to be assessed by the jury to achieve equity.

By the 1705 Act<sup>53</sup> the common law courts were granted the jurisdiction to relieve against a penal bond if the debtor paid the amount of money, interest and cost due on the money bond even though the payment was late. Furthermore, the practice of the common law courts had been not to consider the debtor discharged if he had not taken a formal acquittance or release. As a result he would be subject to another action by the creditor. However, under the 1705 Act if the debtor paid the principal, interest and costs to the court he would be discharged. In other words, the payment would be considered as evidence of the satisfaction of the debt even though there was no formal acquittance taken<sup>54</sup>.

The enactment of the statutes did not entail termination of the jurisdiction of the Chancellors. Though relief against penalties had been obtainable by the common law courts at the provisions of the statutes (1696-7 and 1705), the debtor had still had the right to seek relief from the courts of Chancery<sup>55</sup>. The jurisdiction that was given to the common law courts by the above two statutes did not deprive the courts of chancery of granting relief against penalties where the debtor could not receive any help at law<sup>56</sup>. Thus, the debtor sought relief in equity when he was unable to tender the principal, interest and costs at the time when the action was brought before the common law courts.

## **2:4 Eighteenth Century**

The position, which equity had reached by the end of the seventeenth century for distinguishing penalties from liquidated damages was dependant on whether the

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<sup>53</sup> Statute of 4 & 5 Anne, c. 16.

<sup>54</sup> Ibid. Sections 12 and 13.

<sup>55</sup> In cases when the provisions of statutes were not applied.

assessment of damages was possible or not. The difficulty and impossibility of assessing damages meant equity would not grant relief as the compensation here was thought to be liquidated damages. However it would grant relief where the assessment of damages was possible as the estimation in this instance was thought to constitute a penalty. This principle continued to develop into equity at eighteenth century. In *Peachey v. The Duke of Somerest*<sup>57</sup> Lord Macclesfield had declared the jurisdiction of relief against penalties where it was inserted to secure money. He said that: “The true ground of relief against penalties is from the original intent of the case, where the penalty is designed only to secure money and the court gives him all he expected or deserved”<sup>58</sup>

What is noticeable in this case is that the jurisdiction to relief against penalties was narrow, as it was not applied unless the penalty was stipulated in the deed to secure a sum of money. Subsequently, this limit upon relief had attracted the attention of equity since the penalty may serve to secure some obligations other than the payment of money. Therefore, in *Sloman v. Walter*<sup>59</sup> the jurisdiction was restated in a wider terms to include granting relief where the penalty was to secure the performance of a covenant. This case was concerned an agreement to run a coffee-house in which the claimant had the right to run the business and the defendant to use the room. The claimant gave the defendant a bond of £500, a penalty to secure his right of the enjoyment of using the room as agreed. When the court came to decide whether the £500 was in reality intended as a penalty or not, Lord Thurlow held the bond was unenforceable as it was a penalty. His Lordship had extended a wider scope for the jurisdiction of granting relief to include the case where the penalty was inserted to secure an object other than money. He stated that:

“The only question was, whether this was to be considered as a penalty, or as assessed damages. The rule, that where a penalty is inserted merely to secure the enjoyment of a collateral object, the enjoyment of the object is considered as the principal intent of the deed, and the penalty only as accessional, and, therefore, only to secure the damage really incurred, is too strongly established in equity to be shaken”<sup>60</sup>

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<sup>56</sup> *Codd v. Wooden* (1790) 3 Bro CC 73; 29 ER 415

<sup>57</sup> *Peachey v. The Duke of Somerest* (1721) 1 Strange 447; 93 ER 626

<sup>58</sup> *Ibid.*

<sup>59</sup> *Sloman v. Walter* (1784) 1 Bro. C.C. 418; 28 ER 1213.

Accordingly, where the sum stipulated as a penalty was to secure another obligation, such as in this case the enjoyment of using the room, relief against penalty would be granted to the claimant.

It can be concluded that the principle distinguishing penalties, which the court would relieve against, and liquidated damages, which the court would not do so, had become settled by the end of the eighteenth century as follows: “if the sum fixed represented an agreement by the parties as to the amount of the damages, in a case where it would be otherwise difficult to ascertain the quantum, the sum fixed was not a penalty, and could be recovered as liquidated damages”<sup>61</sup>.

## 2:5 Nineteenth Century Developments

The modern law of penalties and liquidated damages doctrine emerged at the beginning of nineteenth century when the court chose to disregard the intention of the parties as expressed in the contract<sup>62</sup>. At this time the courts developed the principle of the unenforceability of the penalty clause. This development has been established after the common law courts dealt with *Astley v. Weldon*<sup>63</sup> which was “the spark” and *Kemble v. Farren*<sup>64</sup> which was the “flame”<sup>65</sup>.

In *Astley v. Weldon*<sup>66</sup> there was an agreement between an owner of a theatre and an actress in which the latter was paid a small salary and required to observe a number of covenants including to perform and attend at the theatre subject to the fines established at the theatre. It was provided for in the agreement that each party would be responsible to pay the other £200 in the event of any default. This sum was neither described in the agreement as liquidated damages nor a penalty. When the actress defaulted, the owner of

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<sup>60</sup> Ibid. At 419 and 1214 respectively.

<sup>61</sup> *Fletcher v. Dycbe* (1787) 2 TR 32, at 36-37; 100 ER 18.

<sup>62</sup> See for details about the intention test, which was adopted first by the English case law to distinguish between liquidated damages and penalties. See infra. P 47.

<sup>63</sup> *Astley Weldon* (1801) 2 B & P 346; 126 ER 1318.

<sup>64</sup> *Kemble v. Faren* (1829) 6 Being 141; 130 ER 1234.

<sup>65</sup> Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. *Sydney Law Review*. (1985) 10 503, at 508.

<sup>66</sup> *Astley Weldon* (1801) 2 B & P 346; 126 ER 1318.

the theatre brought an action to recover the sum stipulated. It was held that the sum stipulated was a penalty. Chambre J. said that: “there is one case in which the sum agreed for must always be considered as a penalty, and that is, where the payment of a smaller sum is secured by a larger”

In *Kemble v. Farren*<sup>67</sup> the facts were not unlike the facts of *Astley* case. However, in the former the parties to the agreement had stipulated that in the event of not performing the contractual obligations either party should pay £1000. This sum was described in the agreement as liquidated damages. In reality this case was considered as a milestone in the law of penalties where the court refused to apply the intention of the parties as expressed and held the sum stipulated as a penalty. From this case onward the description given by the parties in the contract was no longer conclusive in determining the nature of the stipulated sum either as a liquidated damages or penalty.

## **2:6 Establishment of rules that distinguish penalties from liquidated damages in the twentieth century**

The rule against penalties had become established at the beginning of the twentieth century. At this time the state of the modern English case law has been clarified by the House of the Lords. After the courts had decided to disregard the intention of the parties as the test for determining the nature of the agreed damages, the House of Lord introduced the new test. The new test was based on the notion that if the sum stipulated is extravagant and unconscionable in comparison with the greatest loss that might be suffered as a result of breach, it will be struck down as a penalty<sup>68</sup>. This is what has been firstly put forward in *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda*<sup>69</sup>, and marked then in Dunedin in *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>70</sup>, which is regarded as the milestone of the current law of penalties. In the latter case the House of Lords were required to determine the fate

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<sup>67</sup> *Kemble v. Farren* (1829) 6 Bing 141; 130 ER 1234.

<sup>68</sup> *Infra*. P 52.

<sup>69</sup> *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6.

<sup>70</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

of the distinction between penalties and liquidated damages and to state the principles upon which the relief against penalties would be granted<sup>71</sup>.

### **2.7 Jordanian civil law**

Jordanian civil law is described as one of the Roman law family, which was not, in general, averse to penal damages in excess of the actual loss suffered. Penalty clause was the appropriate method of guaranteeing the performance of a particular contractual obligation and providing pre-estimate of damages in the event of the non performance of the chief undertaking<sup>72</sup>. Though one of the objects of the enforcement of penalty clauses was to compensate the promisee for his actual losses, their enforcement was mainly to compel the promisor to perform and penalise him in case of non performance<sup>73</sup>. Therefore in classical Roman law all penalty clauses were enforceable irrespective of their excessiveness.

Unlike in English law, the provision, which required one of the parties to a contract to pay a sum of money by way of penalty for the non-performance of the principal obligation<sup>74</sup>, has not a very long history in Jordanian Law.

Although Majalt Al-Ahkam Adlieh as a law of contract was applied in Jordan, it had no indication or stipulation with regard to penalty clauses. Therefore it should be noted that the rules governing penal stipulations were first codified in Law of civil procedures of 1952<sup>75</sup>. In this law it was remarkable that the incentive of the makers of the law was to introduce solutions for the developments in transactions between the people and to avoid any difficulties they might encounter in enacting a modern civil law. This was the

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<sup>71</sup> This case will be an object of explanation throughout the work.

<sup>72</sup> Marsh, Norman. "Penal Clauses in Contract: A Comparative Study". *Journal of Comparative Legislation and International Law*. [1950] 32, p 66.

<sup>73</sup> Ibid. Benjamin, Peter. "Penalties, Liquidated damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law". *The International and Comparative Law Quarterly*. (1960) 9, 600. At 607.

<sup>74</sup> It should be mentioned that the principal method to fulfill the obligations under Jordanian civil law is to compel the debtor to carry out his contractual undertakings in accordance with the terms set out in that contract. This issue will be approached in the second chapter.

<sup>75</sup> Published in the formal Journal No. 1113. 1952. P 288.

position until the enactment of the Jordanian civil law of 1976, which replaced the civil procedures law 1952 in regulating penalty clauses in contracts<sup>76</sup>.

Thus Jordanian civil law and also the regulation of principles of agreed penalty stipulations have a recent birth in almost late twentieth century. This law contains article 364, which controls the rules of penalty clauses as follows:

- 1- Contracting parties may stipulate, in their contract, the amount of damages in advance. This contractual term is called “liquidated damages or penalty clause”.
- 2- The courts may, upon the request of either party, increase or decrease such damages to make it equal to the actual damage sustained by the injured party. Any agreement to the contrary shall be null and void.

It is interesting to note that Jordanian law still abides by Roman law and enforces penalty clauses in contracts. Therefore there is no reason to distinguish penalty clauses from liquidated damages so long as they are both enforceable. However as the other legal civil systems Jordanian law has shifted from the literal enforcement of penalty clauses to the position of granting courts the discretion to adjust these clauses if asked by the parties. The rule of adjustment is of public policy whereas the parties cannot stipulate in their agreement that the amount of penalty cannot be reduced or increased by the court. This is to say that any agreement to expropriate the power of adjustment from courts is null and void. It is sufficient to indicate the words of the above two parts of article 364, as it will be an object of comments and analysis in following parts of this thesis.

### **3- A New Approach**

#### **3.1 Introduction**

The current position of English case law regarding penalty clauses is open to criticism. The mechanical application of the current rules may lead to the invalidation of many of stipulated damages clauses<sup>77</sup> leaving the injured party to resort to the court again to prove

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<sup>76</sup> Civil Cassation. No. 391/87. Bar Association Journal. 1990. P 234.

<sup>77</sup> Where they are penalties.

his actual loss. As a result some of the advantages gained in agreeing on damages beforehand are lost. Therefore this section seeks to develop a new approach to the enforceability of stipulated damages clauses.

Numerous judges and commentators have expressed their exasperation and criticism of the current penalty rule and called for reform. The confusion of the courts and commentators about the distinction between an enforceable liquidated damages clause and an unenforceable penalty clause arises from an irrational legal rule. In *Robophone Facilities Ltd v. Blank*<sup>78</sup>, Lord Justice Diplock remarked that the English case law rule against penalties has defied rationalism. He pointed out that the court always refuses to enforce penalty clauses in contracts stating that: "I make no attempt, where so many others have failed, to rationalise this common law rule"<sup>79</sup>.

Criticism can also be observed in some American cases<sup>80</sup>. In 1854 a New York Court of Appeal remarked that even: "The ablest judges have declared that they felt themselves embarrassed in ascertaining the principle on which the decisions [distinguishing liquidated damages from penalties]...were founded"<sup>81</sup>. This comment has remained remarkably effective. Therefore it was subsequently commented that "It is not to be denied that there is some conflict, and more confusion, in the cases; judges have been long and constantly complaining of the confusion and want harmony in the decisions upon this subject"<sup>82</sup>. In *Evans v. Moseley*<sup>83</sup> it was said about the law of penalties that: "There is no branch of the law on which a unanimity of decision is more difficult to find, or on which more illogical and inconsistent holdings may be found". Also in *Sanders &*

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<sup>78</sup> *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128.

<sup>79</sup> *Ibid.* At 142.

<sup>80</sup> See for these cases Harwood, William. "Comments: Liquidated Damages: A Comparison of The Common Law and the Uniform Commercial Code". *Fordham Law Review*, (1977) 45, 1349. Clarkson, Kenneth, Miller, Roger and Muris, Timothy. "Liquidated Damages v. Penalties: Sense or Non Sense?" *Wisconsin Law Review*. [1978] 351. Coopersmith, Jeferey. "Comments: Refocusing Liquidated Damages Law for Real Estate Contracts: Returning to the Historical Roots of the Penalty Doctrine". *Emory Law Journal*. (1990) 39 267.

<sup>81</sup> *Cotheal v. Talmage* (1854) 9 N.Y. 551, 553.

<sup>82</sup> *Jaquith v. Hudson* (1858) 5 Mich 123, at 132.

<sup>83</sup> *Evans v. Moseley* (1911) 84 Kan, 322, at 324

*Ables v. Carter*<sup>84</sup> it was stated that: “What construction should be placed on contracts [where damages are liquidated], is a question which has long vexed and perplexed the courts both of this country and of England”. Therefore it was observed that: “No branch of the law is involved in more obscurity by contradictory decisions than whether a sum specified is an agreement to secure performance will be treated as liquidated damages or a penalty”<sup>85</sup>.

Another well-known contract law academic, Treitel G H observed in his book that:

“The COMMON LAW rules for distinguishing between penalties and liquidated damages manage to get the worst of both worlds. They achieve neither the certainty of the principle of literal enforcement, since there is always some doubt as to the category into which the clause will fall, nor the flexibility of the principle of enforcement subject to reduction, since there is no judicial power of reduction. On the other hand, they place an undue premium on draftsmanship...the chief danger is to “home-made” clauses which may be invalidated even though they are not intrinsically unfair”<sup>86</sup>

Attention should also be paid to the English Law Commission proposal of 1993<sup>87</sup>. The Commission recommended the revision of the English law of liquidated damages. It included new rules to replace the current distinction between liquidated damages and penalties. It establishes a strong presumption in favour of the enforceability of all agreed damages clauses. It however gives the court the power to reduce the amount of agreed damages in certain cases. The proposal recognizes a manifestly disproportionate criterion as a basis for claiming the reduction of the stipulated sum. However where the court, after taking all the circumstances<sup>88</sup> into consideration, is satisfied that “it is reasonable for the stipulated sum to be recovered, the court shall award the stipulated sum”<sup>89</sup>. This proposal is further evidence that the law in this area is in need of revision.

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<sup>84</sup> *Sanders & Ables v. Carter* (1893) 91 Ga 450, at 451.

<sup>85</sup> *Giesecke v. Cullerton* (1917) 117 N.E 777, at 778.

<sup>86</sup> Treitel, S. H. “Remedies for Breach of Contract: A Comparative Account”. Clarendon Press. Oxford. 1988. P 233.

<sup>87</sup> See McGregor, Harvey. “Contract Code”. Drawn up on behalf of the English Law Commission. 1993. P 132-135.

<sup>88</sup> At the time of contracting, breach and trial.

Therefore the current law needs new rules to govern the agreement of parties to a contract on damages beforehand. In essence there is a need to adopt a New Approach supporting the idea of freedom of contract, whilst achieving justice which the current law seeks to meet under the existing position relating to penalties. However removing all penalty clauses out of a contract is not the best solution to achieve fair treatment and a fair deal between parties. Thus there should be a better policy to follow, which makes the English Law meets the international demands where in most legal systems penalty clauses are legally enforceable while in others notably in English Law they are not.

### **3.2 What is the New Approach**

The New Approach runs as follows:

- 1- When the contract provides that a party who fails to perform is to pay an agreed penalty<sup>90</sup> as damages, the court shall award the specified sum no greater no smaller and irrespective of the actual loss suffered<sup>91</sup>.
- 2- However, notwithstanding any agreement to the contrary, the court will have the power to reduce the amount of penalty where it is manifestly disproportionate to the actual loss.
- 3- The court will also have in a very limited case the power to increase the penalty<sup>92</sup> where it is manifestly derisory in comparison with the actual loss provided such penalty was a result of domination of defaulting party over the injured one.

### **3.3 Exposition of the New Approach**

#### **3.3.1 Enforcement of all penalty clauses subject to courts' power of modification**

While, not denying all judicial intervention over penalty clauses, the New Approach<sup>93</sup> calls for the enforcement of all penalty clauses without proof of loss and irrespective of

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<sup>89</sup> The proposal gives example of this case any relevant commercial or trade practice. See article 445 (a) of the proposal.

<sup>90</sup> Or whatever it is called in the contract: stipulated sum, agreed damages, liquidated damages or any term indicates the agreement on damages between the parties in advance.

<sup>91</sup> Without proof of loss and irrespective of the amount of the provable loss, however the party seeking to avoid the clause should prove the sum being manifestly disproportionate to the actual loss.

<sup>92</sup> This point will be dealt with when approaching the situation where penalty turns out to be less than actual loss suffered. *Infra*. P 187.

the amount of the provable loss, and that any judicial intervention to reduce the sum stipulated should be seen as an exceptional measure. In other words, the New Approach establishes a strong presumption in favour of the injured party that the amount estimated under the penalty clause is the proper recovery<sup>94</sup>. However, to enforce all penalty clauses, regardless of their harshness, would be inequitable<sup>95</sup>. What is therefore suggested is that the court may, in certain circumstances, have the power to reduce an agreed penalty clause in line with the actual loss<sup>96</sup>. It is only where the sum stipulated is manifestly disproportionate<sup>97</sup> to the actual loss suffered upon breach<sup>98</sup> that the court will be able to

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<sup>93</sup> To see how the New Approach differs from alternative approaches see *infra* P 169-173.

<sup>94</sup> Fenton, James. "Liquidated Damages as Prima Facie Evidence". *Indiana Law Journal*. (1975) 51 189, at 197.

<sup>95</sup> They are arbitrary liquidated damages set high enough in order to compel performance and deter breach without the genuine assent of the defaulting party and without relation to the actual damages. In such a case there is no real agreement between the parties concerning the penalty clause. See for this note Hatzis, Aristides. "Having the Cake and Eating it Too: Efficient Penalty Clauses in Common and Civil Contract Law". *International Review of Law and Economics*. (2003) 22 381, at 393.

<sup>96</sup> However in order to determine whether the agreed penalty is manifestly disproportionate to actual loss the court is to take into account all circumstances existing at the time of contracting, at breach and at trial.

<sup>97</sup> Under the existing law as to penalties the courts will not intervene to strike down penalty clauses in contracts unless the requisite degree between the sum stipulated and likely actual loss, as cases describe it, is "Unconscionable", "Extravagant", "out of all proportion" and "exorbitant". The Principles of European Contract Law use the term "grossly excessive". Article 9.509 provides that:

(2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is *grossly excessive* in relation to the loss resulting from non-performance and the other circumstances."

However under the New Approach to rebut the presumption raised in favour of the enforceability of the penalty clause the defaulting party should show evidence that the amount agreed upon in the clause is manifestly disproportionate to the actual loss. Put another way, the New Approach recognises a *manifestly disproportionate* criterion as the basis for claiming a reduction of the stipulated sum. It could be said that the selection amongst the different alternatives of "*Manifestly disproportionate*" as the preferred criterion makes little difference to the outcome. It only emphasises that the court will have the power of reduction when the stipulated sum is too great to represent a just compensation. Therefore the mere fact that the sum stipulated is in small way in excess of actual loss will not excite courts intervention. "But it is thought that "manifestly disproportionate" is to be preferred as a more sober term, free from the emotive overtones of the others" (See McGregor, Harvey. "Contract Code". Drawn up on behalf of the English Law Commission. 1993. P 132-135)

The verbal formula, i.e. manifestly disproportionate, adopted in the New Approach is the same as in Contract Code (CC). It is the term "grossly excessive" which the Principles of European Contract Law (PECL) adopt. In the end the words used may make little practical difference. Both CC and PECL make all penalty clauses enforceable and so support the idea of raising a presumption in favour of the enforceability of all penalty clauses adopted under the New Approach. However the substantial difference between these systems and the New Approach is that in the provisions relevant to the exercise of power of reduction in the CC and PECL are not to some extent clear. Article 445/b of CC provides the court a power to "award any lesser sum that it considers reasonable". Article 9.509 of the PECL provides that: "the specified sum may be reduced to a reasonable amount". It appears that the PECL directs the court to only consider the actual loss without any reference to the circumstances envisaged at the time the contract is made. Therefore Both CC and PECL simply leave the matter to the discretion of the court to reduce the stipulated sum to a

control and exercise its power to reduce it. However what does the actual loss mean in this context?

### 3.3.1.1 The actual loss<sup>99</sup>, which is relevant under the New Approach

It is well established that the agreed damages clause is inserted in contract in favour of the injured party as a protection against the losses he might suffer upon breach. It should be noted that in the event that the defaulting party proves that the amount of penalty is manifestly disproportionate to actual loss<sup>100</sup>, the reduction of the agreed penalty is still a policy working in favour of injured party. The court's power of reduction will not destroy the protection the parties sought to give the injured party under the penalty clause. The injured party may quite probably recover (under the New Approach) more by way even of a reduced penalty than he would have recovered by way of damages in the absence of a penalty clause. This is because it is the *actual loss* rather than the recoverable loss, which is relevant to the exercise of the power of reduction. Accordingly the court should take into consideration every legitimate interest of the injured party. The court therefore might consider not only the pecuniary losses but also the non-pecuniary losses<sup>101</sup>, which are not always recoverable by the ordinary way of damages. This means that the actual

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reasonable amount and only CC directs the court to only consider that if custom and trade practice indicates that penalty clauses are appropriate in certain cases then the clauses should be enforced. In contrast under the New Approach the court would reduce the sum to actual loss. The approach explicitly directs the court to consider all the lawful interests of the injured party. (See for the meaning of actual loss *infra* P. 28). Furthermore under the New Approach the court will take into consideration that a manifestly disproportionate penalty clause might still be enforceable as demonstrated in the three circumstances below. In other words, the New Approach directs the court to consider the circumstances as envisaged at the time of making the contract. See *infra* P. 30-36.

<sup>98</sup> This means that when the stipulated sum is merely in excess of the loss actually sustained does not give the court the right to modify it.

<sup>99</sup> To know how it differs from the recoverable loss see *infra* P 108-109 which includes the meaning of the recoverable loss under the existing law.

<sup>100</sup> The amount of reduction under the new approach should be in line with actual loss. This is because if it was the recoverable loss that is relevant there would be no point at all for the agreement on damages in advance since the matter would be always of estimating the damages by the court. For the advantages of estimation of damages beforehand see the introduction (p 1) of the thesis.

<sup>101</sup> For example the courts have consistently refused to allow recovery of damages for distress from a breach of a commercial contract. However recent case suggested that such recovery may be expanding. *Farley v Skinner* [2001] 3 WLR 899. See for this Halson, Roger, Bradgate, Robert and others. "The Law of Contract". 2<sup>nd</sup> ed. Butterworth. 2003. P 1448-1450.

loss, for the purposes of reducing the agreed penalty in the event that the defaulting party has proved it was manifestly disproportionate to loss, might include:

- 1- What the injured party can recover under unliquidated damages, i.e. recoverable loss under the so-called rule in *Hadley v. Baxendale*<sup>102</sup>.
- 2- Damages for losses which are too remote under the so-called *Hadley v. Baxendale* rule as suggested by Diplock LJ in *Robophone* case, but not for losses that could be mitigated under the rule of mitigation<sup>103</sup>.
- 3- The court might consider the pure speculative losses and non-pecuniary losses that are not recoverable at law when it exercises its discretionary power of reduction.

By accepting the New Approach the notion of making a distinction between liquidated damages and penalties will no longer exist as according to the suggested approach the penalty clause will no longer be struck out of the contract. The court will not wholly disregard such kinds of clauses. Rather it will have the authority to reduce their amounts in line with the actual loss. This test enables full compensation to the injured party since the clause will be enforced as long as the defaulting party is unable to show that actual loss is substantially less than the amount of penalty.

### **3.3.2 Advantages of the New Approach**

The New Approach will promote the advantages that derive from the prior agreement of damages beforehand. The parties often draft agreed damages clauses in the hope that such clauses will prevent the need for future litigation with its attendant costs. Such costs could be avoided if the law calls for the enforcement of all agreements on damages in advance. The New Approach will go some way to achieving this purpose through the following advantages.

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<sup>102</sup> *Hadley v. Baxendale* (1854) 9 Exch 341; 156 ER 145.

<sup>103</sup> See the remoteness and mitigation rules explained infra. P 109-113.

### **3.3.2.1 The New Approach leads to greater respect for the doctrine of freedom of contract**

The New Approach will be preferable to the existing law as a way to reconcile agreed damages clauses with the doctrine of freedom of contract. One approach for bringing the agreed damages clause into conformity with freedom of contract rules is to re-establish the basis of the bargain. This could be done by giving the court a power to reduce and not strike down manifestly disproportionate agreed damages clause. If the parties truly intended to provide an alternative to litigation through the incorporation of an agreed damages clause, then this intention should be recognised. Instead of invalidating the provision as the existing law of penalties has a tendency to favour, courts should be given a discretionary power to reduce its amount in line with actual loss suffered. This is to say granting courts authority to reduce the sum stipulated when it is manifestly disproportionate to actual loss<sup>104</sup>. Therefore it is a valuable reason to say that: the general rule that contracts should be respected. This has been pointed out in *Export Credits Guarantee Department v. Universal Oil Products Co*<sup>105</sup>:

“It is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an onerous or possibly even a commercially imprudent bargain”

The courts appear to be reluctant to free parties from a bad bargain and are keen to uphold freedom of the parties to a contract in the way they choose. What the parties have agreed should be normally enforced. “Any other approach will lead to undesirable uncertainty especially in commercial contracts”<sup>106</sup>. Courts should not intervene to reduce, under the New Approach, agreed penalty clauses in contracts unless the substantive unfairness is manifest. This is because the court should not easily use equity to grant relief against penalties but instead will give effect to the express terms of the contract. Any relief granted by the court should be seen as an exceptional measure.

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<sup>104</sup> DiMatteo, Larry A. “A Theory of Efficient Penalty: Elimination the Law of Liquidated Damages”. *American Business Law Journal*. (2001) Vol. 38. Part 4 633, at 728.

<sup>105</sup> *Export Credits Guarantee Department v. Universal Oil Products Co* [1983] 1 WLR 399.

<sup>106</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, at 59. See also *Robophone Facilities Ltd v. Blank* [1966] All ER 128, at 142 per Diplock LJ.

### **3.3.2.2 The New Approach will give courts a power to consider the matter at the time of contracting and at breach**

Courts will not be restricted to the time of contracting in order to examine whether or not a penalty clause is manifestly disproportionate to actual loss. In the event of litigation court will be entitled to make a thorough investigation to ensure whether or not it is appropriate to intervene and exercise its power of reduction. Enabling the court to reduce the amount payable under a penalty clause facilitates the way to enforcing as closely as possible what the parties have agreed in advance. Parties to a contract may have had different reasons to stipulate for a penalty manifestly disproportionate to the recoverable loss. Therefore it does not suffice for the defaulting party in order to claim a reduction to prove that the sum stipulated is manifestly disproportionate to the recoverable loss if the court is satisfied that in the circumstances and particular facts of the case the clause should be enforceable. Put another way, the clause might seem a manifestly disproportionate in comparison with the recoverable loss. But under the New Approach the clause would still be enforceable as it should be compared with the actual loss suffered. Therefore the sum stipulated should be manifestly disproportionate to the actual loss in order to excite the courts' intervention. This might occur in the following situations:

Firstly, a manifestly disproportionate penalty might have been included in the contract because the parties knew that in the event of non-performance the injured party would not be properly or satisfactorily compensated through an unliquidated damages action. In other words, the enforcement of the parties' agreement would permit them to correct for undercompensation by the conventional remedies for breach<sup>107</sup>. Undercompensation may occur when the damages can not be recovered for disappointment and distress that might result from a breach of a commercial contract<sup>108</sup>. It may also arise in many commercial contracts where the rule against recovery of uncertain damages prevents full

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<sup>107</sup> This is already supported by the remarks of Diplock LJ in *Robophone Facilities v. Blank* [1966] 3 All ER 128. According to this view it can be said that the actual loss and not recoverable loss which will be considered to the exercise of the power of reduction. By doing this the injured party would recover more than he would have recovered under the normal way of damages. See the difference between recoverable loss and actual loss above.

<sup>108</sup> *Hayes v. James and Charles Dodd* [1990] 2 All ER 815. In this case Staughton LJ stated (at 823) that: "I would not view with enthusiasm the prospect that every shipowner in the Commercial Court, having

compensation for breach<sup>109</sup>. For example, when actual loss is in the nature of predicted profits, recovery may be refused on the ground that such loss is purely speculative<sup>110</sup>, i.e. the claimant can not show that any profit will be made<sup>111</sup>. Consequently although these losses may be expected and predictable at the time of making the contract, they may be difficult to prove at the time of breach, and so contribute to undercompensation for a breach<sup>112</sup>. Without an enforceable penalty clause intending to liquidate damages, the injured party may fear that the defaulting party will have insufficient incentive to perform, if he realises that the damages he has caused will not be provable and so escape from his liability to compensate for the losses sustained<sup>113</sup>.

Secondly, the injured party may also have paid a price higher than the normal one under the contract to obtain the other party's agreement in order to stipulate for penalty greater

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successfully claimed for unpaid freight or demurrage, would be able to add a claim for mental distress suffered while he was waiting for his money”.

<sup>109</sup> Kaplan, Phillip R. “A Critique of the Penalty Limitation on Liquidated Damages”. *Southern California Review*. (1977) 55 1055, at 1058-1059.

<sup>110</sup> There is no substantial chance to make the profits. A clear example, in which the court refused to award damages as the loss was so speculative, can be found in the classic example of this principle in the Australian case of *McRae v. Commonwealth Disposals Commission* (1951) 84 CLR 377. In this case the court was able only to award damages to the claimants to compensate them for their expenses incurred in making an attempt to fulfill their contractual duties.

<sup>111</sup> However it should be noted that where the loss is not purely speculative, but there is a real loss of chance the court will attempt the measurement of the loss and award damages accordingly. The court will attempt to put some value on an expectation even what is lost is no more than an opportunity to take the risk of making a profit, rather than a certain loss of a speculative profit. A clear example for that can be found in *Chaplin v. Hicks* [1911] 2 KB 786. In this case the claimant made a contract to enter a beauty contest. She won the earlier stages and prevented from competing in the final stages of the contest contrary to the terms of the contract. She was able to recover damages for that lost opportunity, although there was no certainty that she would have been successful. It can be said that despite the opportunity to succeed was something uncertain (likely), the loss of it was certain damage and the claimant should be compensated for. The court could not assess the likelihood of the claimant winning the contest but they awarded her damages of £100 to represent her loss of a chance to win the contest. The distinction in here is made between the cases in which there is a real or tangible loss of a chance of obtaining the prize in the case and where the loss is mere speculative when the claimant could not show that any profit would be made. This distinction was clearly confirmed in *Allied Maples Group Ltd v. Simmons & Simmons* [1995] 4 All ER 907 where the Court of Appeal held that the claimant was entitled to succeed in its action since it had established on the balance of possibilities that there was a substantial chance of negotiating a better deal and not merely a speculative chance. This was reaffirmed in *Bank of Credit and Commerce International SA (in liquidation) v. Ali* [1999] 4 All ER 83 which was concerned of loss of chance of employment. See for this Poole, Jill. “Textbook on Contract”. 7<sup>th</sup> ed. Blackstone Press. 2004. P 417-418.

<sup>112</sup> An example in wartime procurement contracts it may be impossible to establish the losses caused by delay or defective performance by the promisor.

<sup>113</sup> Sweet, Justin. “Liquidated Damages in California”. *California Law Review*. (1972) 60 84, at 86.

than the actual loss that might be suffered as a result of breach<sup>114</sup>. If the injured party can feel secure that a contractual penalty will be enforced, he will benefit by certainty and adequacy of compensation. This can not be achieved under the existing penalty rule, as the invalidation of penalty clause in this situation ignores the risk allocations that have been made at the time of making the contract. The fairness inquiry should, as a first step, address itself to the fairness of the entire contract process from the negotiation until the time of breach. If the negotiation process works properly then it can be said that the penalty clause reflects the fact that the parties have capitalised the risk of breach and included this value in the price<sup>115</sup>. This is to say that the defaulting party might have agreed on the amount of penalty clause, as the injured party in return agreed to a price higher than the usual price. It would be improper to refuse the enforcement of a penalty clause in such a situation. In other words, the non-enforcement of penalty clause may be seen as a reverse penalty. The defaulting party profited from receiving a higher price for stipulating illusory insurance by way of an unenforceable agreed damages clause. If a court drops the penalty clause out of the contract, there remains a possibility that the unliquidated loss recognised by the court may not completely recompense the injured party for the losses he insured against by way of higher contract price.

In the two situations just discussed if non-performance arises and there is an absence of judicial power of reduction, the penalty may be struck down as unconscionable and the injured party's only way would be to resort to a claim for unliquidated damages. It was seen that the parties may agree on damages beforehand to avoid such a remedy as it would sometimes be insufficient to compensate the injured party and operate to the advantage of the defaulting party who breached the contract. However, granting the courts a power to reduce the stipulated sum would, in the event of litigation, prevent the

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<sup>114</sup> DiMatteo, Larry A. "A Theory of Efficient Penalty: Elimination the Law of Liquidated Damages". *American Business Law Journal*. (2001) vol. 38. Part 4 633, at 697. Kaplan, Phillip R. "A Critique of the Penalty Limitation on Liquidated Damages". *Southern California Review*. (1977) 55 1055, at 1072.

<sup>115</sup> For instance, suppose that X agreed to sell his building, which was worth £400,000, for £500,000. Y in order to accept this higher price inserted in the contract an agreed penalty clause of £900,000 and X agreed to contract on this. Thus why such an agreement on damages in advance should not be respected and enforced?

defaulting party from achieving unfair advantages<sup>116</sup>. In other words, the new approach helps to preclude the defaulting party from taking advantage in the event that he ensures penalties will be struck down. This is because under the existing law he will pay less than the damages payable if the agreed penalty is upheld and no burden of proof is cast upon him, but the injured party who should furnish proof of his actual loss. Thus, in order to avoid the risk of systematic undercompensation to the injured party, it is preferable to give effect to the contractual penalties accompanied with the courts' authority to reduce their amount in line with the actual loss suffered.

Thirdly: where the usual practice of a certain trade adopts a policy of inserting penalty clauses negotiated at arm's length, it would seem that the intention of the parties is preferable to be applied<sup>117</sup>. Put another way, if custom and trade usage indicate that a high agreed damages clause is appropriate in certain situations then it should be enforced. This is clearly illustrated in charterparty cases in the event of improper detention of ship by charterer. A demurrage clause<sup>118</sup> is sum of money agreed by the charterer to be paid as liquidated damages for delay beyond a stipulated or reasonable time for loading or unloading. In some old cases this extra time has been referred to as 'lay days that have to be paid for'<sup>119</sup>. However in the modern cases it has been authoritatively stated that the provisions as to demurrage quantify the whole of the damages resulting from the charterer's breach of contract<sup>120</sup> in detaining the vessel beyond the stipulated time<sup>121</sup> and the charterer's liability for such damages is to pay the amount of demurrage, no less no

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<sup>116</sup> Mattei, Ugo. "The Comparative Law and Economics of Penalty Clauses in Contracts". *The American Journal of Comparative Law*. (1995) 43 427, at 441.

<sup>117</sup> McGregor, Harvey. "Contract Code". Drawn up on behalf of the English Law Commission 1993. P 132-134.

<sup>118</sup> See *Suisse Atlantique Societe D'Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361, at 415 per Lord Hodson. *The President of India v. Lips Maritime Corporation* [1988] AC 399, at 422 per Lord Brandon.

<sup>119</sup> *Lilly v. Stevenson* (1895) 22 R 278, at 286 per Lord Trayner.

<sup>120</sup> See *The President of India v. Lips Maritime Corporation* [1988] AC 395, at 422 per Lord Brandon: "I deal first with what demurrage is not. It is not money payable by the charterer as the consideration for the exercise by him of the right to detain a chartered ship beyond the stipulated lay days. If demurrage were, that, it would be a liability sounding in debt. I deal next with what demurrage is. It is a liability in damages to which a charterer becomes subject because, by detaining the chartered ship beyond the stipulated lay days, he is in breach of contract". Halson, Roger, Bradgate, Robert and others. 'The Law of Contract'. 2<sup>nd</sup> ed. Butterworth. 2003. P 1499.

<sup>121</sup> See for details Mocatta, Alan, Mustill, Michael and Boyd, Stewart. "Scrutton on Charterparties and Bills of Lading". 19<sup>th</sup> ed. Sweet & Maxwell. 1984.P 305-308.

more. Hence under the current law as a matter of commercial practice and habit demurrage clauses are normally considered valid liquidated damages<sup>122</sup> since the sum is payable on breach and graduated in line with the size of that breach<sup>123</sup>.

Therefore the court does not uphold or accept the claim that the sum stipulated is inadequate one for demurrage, as it is, as Lord Hodson stated in *Suisse* case “quite clear on the authorities<sup>124</sup> that the parties need not agree on a true estimate of damage. They are perfectly entitled to agree on a low rate”<sup>125</sup>. However attention should be paid to the case of *Aktieselskabet Reidar v. Arcos*<sup>126</sup>. In this case an owner chartered his vessel to a charterer to load a full and complete cargo of sawed timber for the United Kingdom. The charter provided for loading in a fixed time and if the vessel were detained beyond this time, demurrage was to be paid at so much a day. The charterer exceeded the stipulated time and the court held the owner to be entitled to demurrage and damages for the loss he has incurred. Thus, it might be asserted<sup>127</sup> that the outcome of this case supports any owner to claim that his damages are not limited to demurrage. However it seems that this argument is unsound. It should be noted that damages were given in addition to demurrage in *Aktieselskabet* case, as delay there gave rise to breaches of further obligations, i.e. to load a full and complete cargo, for which damages are recoverable.<sup>128</sup> This is clearly clarified in *Suisse Atlantique Societe D’Armement Maritime v. N.V Rotterdamsche Kolen Centrale*<sup>129</sup> where Lord Hodson stated that: “I do not find that the [shipowners] can find support from the decision of the Court of Appeal in the case of *Aktieselskabet Reidar v. Arcos*<sup>130</sup>”<sup>131</sup>. The verdict in this case was based on the fact that

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<sup>122</sup> *Chandris v. Isbrandtsen-Moller Co Inc* [1951] 1 KB 240. *Suisse Atlantique Societe D’Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361.

<sup>123</sup> For more details about graduated sum as valid liquidated damages when it slides on the right direction, i.e the stipulated sum graduates in line with the seriousness of the breach, see *infra*. P 148.

<sup>124</sup> *Cellulose Acetate Silk Co. Ltd v. Widnes Foundry (1925) Ltd* [1933] AC 20. *Chandris v. Isbrandtsen-Moller Co Inc* [1951] 1 KB 240.

<sup>125</sup> *Suisse Atlantique Societe D’Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361, at 421.

<sup>126</sup> *Aktieselskabet Reidar v. Arcos* [1927] 1 KB 352.

<sup>127</sup> This was argued by the appellant in *Suisse Atlantique Societe D’Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361.

<sup>128</sup> See for details Mocatta, Alan, Mustill, Michael and Boyd, Stewart. “Scrutton on Charterparties and Bills of Lading”. 19<sup>th</sup> ed. London Sweet & Maxwell. 1984. P 308.

<sup>129</sup> *Suisse Atlantique Societe D’Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361.

<sup>130</sup> *Aktieselskabet Reidar v. Arcos* [1927] 1 KB 352.

“damages were payable as for dead freight beyond the sum due for demurrage”<sup>132</sup>. This is because if the ship had been loaded within the stipulated time, the ship would have loaded and earned freight on a summer deck load. In fact as the delay took place, the vessel sailed with a winter deck load only, i.e. with 306 standards short of the 850 standards of timber which could have been loaded in summer deck<sup>133</sup>. Therefore there was a breach in respect of which the damages in addition to demurrage were granted, which was separate from the delay.

Therefore the fact that the New Approach depends on the actual loss rather than the probable loss as pre-estimated does not change the reality that as a matter of custom and commercial convention demurrage clauses should normally be paid by the charterer. Thus where the charterer is in breach<sup>134</sup> the court will not accept his claim<sup>135</sup> that the owner’s loss was much smaller than the stipulated sum. This situation is well illustrated in the existing law in the case of *Suisse Atlantique Societe D’Armement Maritime v. N.V Rotterdamsche Kolen Centrale*<sup>136</sup>. In this case a charterparty fixed a certain periods of time for the loading and unloading of cargo and £1000 payable on delay. The charterer under a consecutive voyage charter deliberately delayed the ship beyond the agreed lay-days and the shipowner therefore claimed for the lost freight. However his damages were held to be limited to the amount of demurrage. Lord Wilberforce stated that: “as a matter of commercial opinion and practice demurrage clauses are normally regarded as liquidated damages clauses”. Nothing changes under the New Approach as a charterer can not avoid paying demurrage payments to a shipowner and without having the latter to prove the loss he suffered in consequence.

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<sup>131</sup> *Suisse Atlantique Societe D’Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361, at 407.

<sup>132</sup> *Ibid.*

<sup>133</sup> The difference in loading between summer and winter was a compliance with law down to the winter marks which should be less than summer one.

<sup>134</sup> That he did not use the ship as contracted but refused to perform the contract.

<sup>135</sup> For example to show evidence of the availability of another charterer and the freight might increase or any other justification that the owner has suffered no loss. See *Hayes v. James and Charles Dodd* [1990] 2 All ER 815.

<sup>136</sup> *Suisse Atlantique Societe D’Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361, at 436.

### **3.3.2.3 The New Approach will put the burden of proof on the defaulting party if he claims reduction**

It is submitted that where the amount of actual damage is difficult or complex to prove, putting the onus of proof that the stipulated sum is in line with such damage upon the injured party will destroy the protection that the parties have given to him under the contract<sup>137</sup> when entering into contract and agreeing on damages beforehand. Therefore where “the nature of the damage is such that proof of it is extremely complex, difficult and expensive”<sup>138</sup> is the very situation where failure to enforce the agreed penalty clause is an infringement of the power of the contract. Under the New Approach in the event that the amount of penalty clause appears to be manifestly disproportionate in the light of the actual loss, the onus of proof will not be upon the injured party. Rather the approach raises a presumption in favour of the injured party that the amount agreed upon is the proper recovery. Then the party seeking to avoid the clause has the opportunity to rebut this presumption by persuading the court that the amount selected is manifestly disproportionate to the loss actually sustained<sup>139</sup>. That is, according to the proof provided by the defaulting party, it is for the court to intervene and investigate and only enforce, by its power to reduce the penalty amount, the penalty clause to reflect accurately the injured party’s actual loss.

In this connection it is interesting to note that in spite of the fact that the reduction of penalty amount favours the defaulting party, the inclusion of such a clause would still to the benefit of the injured party in the following aspects:

1-The mere existence of penalty clause in a contract will affect the burden of proof. The injured party will not be asked to provide proof of the damage he has sustained. Rather it

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<sup>137</sup> As a result it was said that basing the intervention of the court in penalty clauses on the actual loss sustained affects the main importance of agreeing on damages in advance, which is to avoid the difficulty and costs of proving the actual loss at the time of breach. See for this argument Macneil, Ian R. “Power of Contract and Agreed Remedies”. *Cornell Law Quarterly* (1962) 47(4) 495, at 508.

<sup>138</sup> *Clydebank Engineering and shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6, at 11 per Lord Halsbury.

<sup>139</sup> See Fenton, James. “Liquidated Damages as Prima Facie Evidence”. *Indiana Law Journal*. (1975) 51 189, at 204-205. Sweet, Justin. 60 “Liquidated Damages in California”. *California Law Review*. (1972) 84, at 143-144.

is the defaulting party who will be asked to prove that the injured party has not sustained any loss or that the loss was very much less than the stipulated sum.

2-It is not sufficient for the defaulting party to prove that the assessment of damages contained in penalty clause is simply more than the damage actually suffered. Rather he must show evidence that the agreed penalty is manifestly disproportionate to the damage in order for the court to reduce its amount. Even in this situation the court may not reduce the amount of penalty to be in line with the recoverable loss, but to be in line with the actual loss.

### **3.3.3 Support for the New Approach**

#### **3.3.3.1 Historical background of penalty clause**

English case law was not always reluctant to enforce penalty clauses stipulated by the contracting parties<sup>140</sup>. Until at least the late seventeenth century and the development of the rule by Court of Chancery, which branded them as unconscionable, penal bonds were readily enforced by common law courts. In other words, the common law courts insisted on giving the parties the freedom to make their agreement and perform its terms. The parties were given the right to make jointly their bond, which was a sealed instrument proving the debt of a creditor and including a condition of defeasance. This bond was strictly enforced and in order to secure performance it always contained a promise to pay a specified sum of money in case of breach irrespective of the actual loss suffered. The law of bond was inspired by the general philosophy that it is not the business of the courts to restructure private agreements; as they made bed the contracting parties should lie on it<sup>141</sup>. This means that the common law courts did not give any consideration to the fact that the penalty might not have been reflecting the true losses suffered as a result of breach. Furthermore the reason why the penal bond was enforceable until the

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<sup>140</sup> Hatzis, Aristides. "Having the Cake and Eating it Too: Efficient Penalty Clauses in Common and Civil Contract Law". *International Review of Law and Economics*. (2003) 22 381, at 384. Hillman, Robert. "The Limits of Behavioral Decision Theory in Legal Analysis: the Case of Liquidated Damages". *Cornell Law Review*. (2000) 85 717, at 727.

<sup>141</sup> Simpson, A.W.B. "A History of a Common Law of Contract". Clarendon Press. Oxford. 1987. P 112-113.

development of the rule against penalties was that in theory their function was to compensate the injured party.

### **3.3.3.2 European and international developments**

The New Approach will operate in conformity with and respond to the European and international developments which call to provide some degree of unification in the rules regarding penalty clauses.

Agreed damages clauses are widely used in international trade transaction. However, the way in which these clauses are dealt with varies between different legal systems, which result in considerable uncertainty regarding the right of parties until it is decided which law is applicable. Many attempts have been made to deal with this situation in order to pave the way for unification at an international level. All attempts clearly confirm the presumption that penalty clauses are enforceable and the court may reduce the amount payable under them. It has been remarked that the differences in dealing with penalty clauses between different legal systems need a greater degree of harmonization, however achieving such a degree of reconciliation is not an easy task. In spite of this fact moves to improve the situation have been made and can to a large extent overcome the problems standing in the way.

The first attempt made within the European Council culminated in the formation of the Resolution (78) 3 on "penalty clauses in civil law"<sup>142</sup>. It is noted that most of European states uphold the rule of classical Roman law under which all penalty clauses were enforceable even the most excessive clauses. However such classical doctrine of literal enforcement was shifted from to give the courts a power to adjust penalty clauses<sup>143</sup>. Therefore there is no sense to differentiate penalty clauses from liquidated damages since they are both enforceable. In contrast English law penalty clauses are by no means enforceable. The council noted that England and Belgium are the only countries in Europe that do not grant courts a power to rewrite penalty clauses. In order to provide

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<sup>142</sup> This Resolution was adopted by the Committee of Ministers on January 20, 1978.

<sup>143</sup> Though it prevailed in France until it was amended as late as 1975.

some uniformity<sup>144</sup> between the common law's concept of penalty and the civil law, which tends not to examine liquidated damages clauses, the council adopted this resolution. This Resolution assumes that penalty clauses are, in general, enforceable, and also provides for the reformation of such clauses. It states that "The sum stipulated may be reduced by the court when it is manifestly excessive"<sup>145</sup>. It made this provision as a rule of public policy when it carried on stating that "any stipulation contrary to the provisions of this article shall be void"<sup>146</sup>. Furthermore, the Resolution recommended that the governments of the member states should take into consideration the principles in the appendix to their Resolution when preparing new legislation on this subject. Also the *Principles of European Contract Law* provides that:

- "(1) Where the contract provides that a party which fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of its actual loss.
- (2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from non-performance and the other circumstances."<sup>147</sup>

International developments, which called for some degree of harmonization in the area of penalty clause, were embodied in 1983 via UNCITRAL<sup>148</sup> that embraced "uniform rules on liquidated damages and penalty clauses"<sup>149</sup> for international contracts and gave the court the power to reduce the amount of penalty. This authority was incorporated in article F where it provided that:

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<sup>144</sup> For international law comparison with regard to penalty clauses, see DiMatteo, Larry A. "A Theory of Efficient Penalty: Elimination the Law of Liquidated Damages". *American Business Law Journal*. (2001) vol. 38. Part 4 633, at 651-655.

<sup>145</sup> Article 7 of European Council Resolution (78)3 on "Penalty clauses in civil law". The Committee of Ministers on January 20, 1978. This position was confirmed again 1996- by the Commission of European Contract Law which has recently produced a text with a clause (article 4.508) on "Agreed Payment for Non-Performance" in the *Principles of European Contract Law*. This article also dealt with the agreement on damages in advance and confirmed the enforceability of such agreement in favour of the injured party for non performance by the defaulting party. However it provides that: "despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances". Also the *Unidroit Principles* have a virtually identical provision in article 7.4.13.

<sup>146</sup> *Ibid*.

<sup>147</sup> Article 9.509. See also article 7.4.13 of *Unidroit Principles for International Commercial Contracts*, which includes the same provision of *European Contract Law*.

<sup>148</sup> United Nations Commission on International Trade Law. *Yearbook*. Vol. XIII: 1982. United Nations, New York, 1984. Another attempt was made by the UNCITRAL when produced principles of *International Commercial Contracts (Rome 1994)*, which contained an article on penalty clauses.

<sup>149</sup> *Ibid*. P 27.

“The agreed sum may be reduced if it is shown to be grossly disproportionate in relation to the loss that has suffered by the obligee, and if the agreed sum cannot reasonably be regarded as a genuine pre-estimate by the parties of the loss likely to be suffered by the obligee”.

As a result the General Assembly of the United Nations recommended that states should give serious consideration to the rules and where appropriate implement them in the form of either a model law or a convention.

It would seem that all attempts either at a European or International level support what has been suggested in this work. At both levels there is a call to unify the rules governing penalty clauses by accepting their enforceability, whilst giving the power to the court to reduce their amount if it is evidently excessive in relation to the loss actually sustained. This is another reason suggests that the current law of penalties is in need of reform.

### **3.3.3.3 The decision of the *Jobson v Johnson* case**

The *Jobson v. Johnson*<sup>150</sup> case is one of the strongest supports to this perspective where the court decided not to strike the penalty down and reduce its amount to be compatible with the actual loss. In this case the defendant contracted with the claimants to purchase ordinary shares in a football club for £350,000 payable in instalments. It was provided that if the defendant (purchaser) failed to pay any of the instalments he would be required to retransfer the shares for £40,000. This amount was neither a genuine pre-estimate of the claimants' loss in the event of the defendant's breach on paying any of the instalments nor a true reflection of value of the shares. The defendant defaulted after he had paid £140,000 towards the purchase price and subsequently the claimant sued for the application of the agreement's provision of retransferring the shares back to him. The defendant counterclaimed that the retransfer clause was a penalty. The court of appeal held that the clause was not a genuine pre-estimate of the loss suffered by the claimants and so unenforceable. Although the court of appeal decided that the clause was a penalty, it has been held that the penalty clause can be enforced to the extent that it does not exceed the loss suffered. It was clearly stated in this case that:

“It is important in the present case to note that...the strict legal position is not that such clause is simply struck out of the contract...remains in the contract and can be sued upon, but will not be enforced by the court beyond the sum which represents, in the events which have happened, the actual loss of the party seeking payment”<sup>151</sup>.

This is to say that the court can assess the losses suffered by the injured party and enforce the stipulated sum to the extent that injured party can be compensated for his actual loss. This case can be regarded as a landmark where the court used to strike the penal provisions out of the contract and leave the injured party to prove his damages in the ordinary way of damages. The conclusion of this case declared that the penalty clause would remain in the contract however would not be enforceable beyond the actual loss of the injured party. This make a nice distinction between a claim for enforcing a penalty clause with limited effect compatible with the actual loss suffered by the injured party, and a claim for ignoring the penalty clause and suing for the damages suffered in the ordinary way. In reality the result will be the same in the above two ways to obtain damages for the loss sustained on breach<sup>152</sup>. Such distinction was raised in *Jobson v. Johnson*<sup>153</sup> because the object of the penalty clause in this case was not a payment of money but the transfer of a certain item of property (shares). The significance of this case being that the court decided to take effect to the clause provided that the value of the property concerned did not exceed the claimant's loss.

Reflecting on the situation under the English case law it can be inferred that after the court decides the unenforceability of the stipulated sum as a penalty, the injured party is directed to get his damages in the ordinary way of unliquidated damages action. In doing so the court will look at the actual loss as the injured party can prove it. This result can be achieved by giving the court the right to adjust the amount of penalty to make it in line with the actual loss. The Jordanian civil law already gives such power to the court though it is criticised from different aspects in the following chapters.

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<sup>150</sup> *Jobson v. Johnson* [1989] WLR 1026.

<sup>151</sup> *Ibid.* At 1040 per Nichollas LJ.

<sup>152</sup> McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 430.

<sup>153</sup> *Jobson v. Johnson* [1989] WLR 1026.

#### **3.3.3.4 Saving trial expenses and time of the parties and courts**

It is well established that contracting parties always agree on damages in advance to avoid the negative consequences of going through the judicial process. This object is the same in enforcing the penalty clause and reducing its amount in line with the actual loss without leaving the injured party to demand his damages in another claim, which costs extra time and money. It can be said that English case law denies and invalidates the provisions involved with punishment in contracts to the defaulting party. However, this can be achieved by giving effect to the penal stipulations and denying any force to them by reducing their amount to the extent that compensates the injured party for his loss. The injured party, as it was said before, will still profit by this via the court reducing the amount of penalty to be in line with actual loss and not the recoverable loss.

Therefore, when the parties agree on damages in advance their aim is to avoid the court's assessment of damages<sup>154</sup>, which may take more time and money.<sup>155</sup> This means that the penalty doctrine undoubtedly increases transaction costs at the time when it rules that agreed damages clause is a penalty and so should be struck out of the contract. The threat of subsequent judicial interference to assess the damages for the loss suffered means that the parties as well as the court should spend extra time, money and effort to do so. Upholding penalty clause and reducing its amount where it is manifestly disproportionate to the actual loss would result in reducing the litigation expenses and time for both parties and courts. This would also lead to a further positive result, as it would reduce court congestion, which benefits the whole society at the end. It is believed that if penalty clauses are enforced, at least in theory the power to reduce agreed penalty will result in fewer breaches, fewer lawsuits and thus fewer and easier trials. On top of this it will

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<sup>154</sup> The court grants the injured party under the unliquidated damages action the recoverable loss. In contrast he receives damages for his actual loss under the New Approach.

<sup>155</sup> See for that Clarkson, Kenneth, Miller, Roger and Muris, Timothy. Liquidated damages v. Penalties: sense or non sense? *Wisconsin Law Review*. [1978] 351, at 366-368. Kaplan, Phillip R. A Critique of the penalty limitation on liquidated damages. *Southern California Review*. (1977) 55 1055, at 1057.

reduce transaction costs where the parties determine that the costs of negotiation are less than the contemplated costs of litigation upon breach<sup>156</sup>.

### 3.3.3.4 Efficient breach

Efficient breach occurs where the promisor anticipates that paying compensation will make him better off than performing his contractual obligations<sup>157</sup>. At the present in penalty doctrine under English case law if the situation becomes such that the cost of performance to the promisor is greater than the compensation, he will find that it will be better for him if the contract is not performed. This is the effect of the (efficient breach) as the present case law to penalties has a tendency to favour. As a result this induces the promisor to breach the contract whenever he hopes to make a better profit from a new opportunity.

However this research does not go to reject efficient breach theory but prefers to run the argument as follows: Efficient breach works in favour of one party is unacceptable. However it is more acceptable if it works for both parties. It should be distinguished between two situations where there is or there is no agreement between the parties on damages. **First**, where there is no agreement on damages between parties<sup>158</sup>, the injured party is compensated by resorting to court and all efficiency gains go to the breaching party<sup>159</sup>. The consequences of efficient breach can be illustrated in the following example.

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<sup>156</sup>See Sweet, Justin. Liquidated Damages in California. *California Law Review*. (1972) 60 84, at 88. Goetz, Charles J. and Scott, Robert E. "Liquidated Damages, Penalties and the Just Compensation Principle: some notes on an Enforcement Model and A Theory of Efficient Breach". *Columbia Law Review*. (1977) Vol. 77 554, at 578.

<sup>157</sup> See for this theory Goetz, Charles and Scott, Robert. "Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach". *Columbia Law Review*. (1977) 77 554, at 558-560. Warkol, Craig S. "Resolving the Paradox between Legal Theory and Legal Fact: the Judicial Rejection of the Theory of Efficient Breach". *Cardozo Law Review*. (1998) 20 321. Craswell, Richard. "Contract Remedies, Renegotiation, and the Theory of Efficient Breach". *Southern California Law Review*. (1988) 61 part 3 629. Clarkso, Kenneth, Miller, Roger and Muris, Timothy. "Liquidated Damages v. Penalties: Sense or Nonsense". *Wisconsin Law Review*. [1978] 351, at 359. Harris, Donald, Campbell, David and Halson, Roger. "Remedies in Contract and Tort". 2<sup>nd</sup> ed. Butterworths. 2002. P 139.

<sup>158</sup> This is also the result of applying the penalty doctrine where the promisor can claim the unenforceability of penalty clause, which the court knocks out of the contract and leave the promisee to prove his actual loss through unliquidated damages action.

<sup>159</sup> Goetz, Charles and Scott, Robert. "Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach". *Columbia Law Review*. (1977) 77 554, at 567.

Suppose that *V*, a vendor, agreed to sell a machine to *P1*, a purchaser, for £20,000. Assume further that *V* gets another offer from *P2*, a second purchaser, who values the subject matter more. *V* will only breach the contract with *P1* if the offer from *P2* is more than the contract price and the damages due to *P1* (suppose that the damages due to compensate *P1* for his losses are £2000 and so he values performance £22,000). In other words, breach is efficient if the *P2* values the machine more than *P1*. Thus, if *P2* offers £25,000 for the subject matter, *V* will be better off if he breaches, as he will gain £3000<sup>160</sup>. This means that all gains (£3000) from the second contract go to the breaching party.

Accordingly one might argue that since the injured party will be compensated for the defaulting party's breach, then efficient breach will be better to be recognised and upheld. The argument is that this theory makes a result superior to performance, so long as one party receives the same benefits as performance while the other is able to do even better. The allocation of the gains from breach is, therefore, largely a question of wealth transfer between the contracting parties. In response, efficient breach in this case works in favour of the breaching party and therefore there is no distribution of gains which is the central aim of efficient breach. The injured party will not be fully compensated, as the theory claims because this party will be prevented from receiving damages for some kinds of losses. Therefore he will not be fully compensated. Under the common law damages the injured party is confined to damages awarded under what so called the rule of *Hadley v. Baxendale*. As was pointed out above he has no right to be compensated fully for pure speculative losses, non-pecuniary losses and the losses which are too remote under the second rule of *Hadley v. Baxendale* rule. This non-recognition of these losses challenges the notion of efficiency of common law damages. If common law damages are seen as inefficient and inadequate, then the concept of efficient breach becomes less compelling. The basis for efficient breach is shattered if one believes that the unliquidated damages systemically under-compensates the injured party<sup>161</sup>. Thus, the injured party will be better off in the event of performance than claiming the damages under unliquidated damages action, which will under compensates him.

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<sup>160</sup> 25000 – (20000 the contract price + 2000 damages due to *P1*)

<sup>161</sup> Sebert, John. "Punitive and Non-pecuniary Damages in Actions Based upon Contract: Towards Achieving the Objective of Full Compensation". *UCLA Law Review*. (1986) 33 1565, at 1566-1584.

However what is the situation where there is an enforceable agreed penalty clause in the contract between *V* and *P1*?

**Second:** the existence of agreement on damages allows efficient breach gains to be divided between the parties<sup>162</sup>. This situation can be achieved under the New Approach suggested. The New Approach makes penalty clause in contract enforceable and court does not intervene to reduce by its own motion but upon the request of injured party. Therefore the existence of a high penalty clause is never per se indication of an efficiency obstacle. Two situations are examined as follows: where the price offered by *P2* is more than the performance value plus penalty of *P1* and where the price is less than them.

1- Where the price offered by *P2* is more than the performance value plus penalty of *P1*: Assume in the example above that the parties agree that in the event of breach *V* shall pay £3,500 as a penalty to *P1*. The enforcement of penalty clause will not accordingly hinder the distribution of efficiency gains between both parties, as *P1* understands that his penalty £3500 might be reduced if *V* claims and proves that the sum is manifestly higher than the actual loss suffered and therefore the breach becomes also of his interest. A large penalty clause does not preclude efficient breaches for the extra price of a contract with penalties probably also covers the risk of having to waive another subsequent offer. Therefore, to get the consequences of efficient breach the subsequent offer should be higher than the price as reflected in the contract<sup>163</sup>. In the above example *P2* therefore should offer more than what is due to *P1* under the contract (£20,000 the contract price and £3,500 the penalty clause). As was said above that if *P2* offers £25,000, the breach will be efficient and the gains will be divided between both parties. This is to say that £3,500 will go to the injured party, *P1*, who still receives more from breach than from performance of contract and £1,500 to the breaching party, *V*.

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<sup>162</sup> Goetz, Charles and Scott, Robert. "Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach". *Columbia Law Review*. (1977) 77 554, at 567.

2- Where the price is less than the performance value and penalty due to *P1*: Where the price offered by *P2* is, for example, £22,500, which is less than £23,500, which is due to *P1*. The “obstinate insistence on the enforcement of certain penalties may result in a failure to exploit potential efficiency gains by inducing the penalised party [*V*] not to breach”<sup>164</sup>. The very presence of such unexploited gains represents an incentive to the injured party, *P1*, to renegotiate the penalty clause in question<sup>165</sup>. In this case if the concept of renegotiation is introduced, then it can be argued that even the surplus (£2,500) below the amount (£3,500) that is needed to pay the penalty may be enough to induce breach. It is in the interest of the *P1* to increase its net utility by negotiating a payment somewhere between its actual damages and the penalty amount. The whole process generates an efficient penalty given the amount of surplus to be created by the breach<sup>166</sup>. Therefore, in the example given, if the parties (*P1* and *V*) agree after the negotiations to reduce the amount of penalty clause to be higher than the performance value of *P1* (£22,000) and less than the price offered by *P2* (£22,500), *P1* can still receive more from breach than from performance and thus the breach is still efficient. Suppose that they agreed<sup>167</sup> on £2,250 as agreed penalty, then the result of the efficient breach is to distribute the gains as follows: £250 to *P1* and the rest of £250 is to *V*. Hence it is submitted that:

“The existence of an overcompensation provision is never per se evidence of an efficiency impediment...as noted above the just compensation formula gives all of the gains to the breacher. Why should this end result be regarded as any “fairer” than one which split the gains fifty-fifty or gives them all to the non-breacher?”<sup>168</sup>

It might be said that in the event that the negotiation between the promisor, *V*, and the promisee, *P1*, to cancel the contract fails, it is not certain that the efficiency gains<sup>169</sup> from

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<sup>163</sup> Mattei, Ugo. “The Comparative Law and Economics of Penalty Clauses in Contracts”. *The American Journal of Comparative Law*. (1995) 43 427, at 429.

<sup>164</sup> Goetz, Charles and Scott, Robert. “Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach”. *Columbia Law Review*. (1977) 77 554, at P 567-568.

<sup>165</sup> *Ibid*.

<sup>166</sup> DiMatteo, Larry A. “A Theory of Efficient Penalty: Elimination the Law of Liquidated Damages”. *American Business Law Journal*. (2001) vol. 38. Part 4 633, at P 696-687.

<sup>167</sup> After the negotiations.

<sup>168</sup> Goetz, Charles and Scott, Robert. “Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach”. *Columbia Law Review*. (1977) 77 554, at 568.

<sup>169</sup> The contract price plus the amount of damages that fully compensate the promisee (*P1*).

the deterred breach will necessary be lost. The promisee may be able to gain the breach surplus by way of a later resale. Thus, the efficiency gains are the same whether obtained by a party through breach or by a resale. However, in response to these two points could be observed. Firstly, efficient breach leads to a positive result that the subject matter goes to the party who values it more than the other. Secondly, efficient breach allows resources to flow freely to the party who values it more at the lowest possible cost<sup>170</sup>. Put another way, in the event that the promisee rejects to negotiate with the promisor a way out of the contract by efficient breach, though the outcome may be the same on a resale that will be at the expense of time and cost. In case of efficient breach the promisee does not take any action but to accept the cancellation of the contract and the promisor who makes all necessary steps to contract with the new *Purchaser* (*P2* in the example) and gives the promisee (*PI*) his allocation.

The effect of the New Approach will be noticed throughout and its outcomes will be considered in the conclusion of this research.

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<sup>170</sup> Clarkso, Kenneth, Miller, Roger and Muris, Timothy. "Liquidated Damages v. Penalties: Sense or Nonsense". *Wisconsin Law Review*. [1978] 351, at 359.

## **Chapter Two: What is the Test for the invalidity of penalty clause?**

### **0-Introduction**

The history of penalty clause and liquidated damages doctrine shows that the courts have applied more than one test in ascertaining the validity of agreed damages clause in contracts. Thus, the question is: how will the court ascertain the difference between a valid liquidated damages clause and an invalid penalty clause? The courts first adopted the intention test for determining the invalidity of penalty clause. The application of this test meant that the words used by the parties in the contract were conclusive. Subsequently the judicial approach shifted towards focusing on whether the sum stipulated is a genuine pre-estimate of damages. The application of the new test is based on measuring the amount of the sum stipulated in view of the likely actual loss suffered by the breach. If the courts decide that the proposed damages are significantly greater than the probable actual loss at the time when the contract is made, the sum stipulated is generally considered as an invalid penalty clause. Therefore how does the new test operate in determining the invalidity of penalty clause? Should the sum stipulated be disproportionately high to constitute a penalty? What is the role of disparity of bargaining powers in penalty jurisdiction?

This chapter will now consider the following issues:

- 1- The demise test: Parties' intention
- 2- Is the words used by the parties still of great importance
- 3- The current test: disproportion principle

### **1-Demise Test: Parties' intention**

#### **1:1 The substance of the test**

Parties to a contract may at the time when the contract is entered into use a terminology to express their intention. It might be stipulated that if one of the parties fails to perform its contractual obligations a sum of money will be payable by way of liquidated damages

or penalty. However how much attention should be paid to these words used by the parties to determine whether a sum provided for is an enforceable or not?

In light of the old law on this area, the courts justified their intervention in the agreement by declaring that they performed the intention of the parties. This means that the courts chose to give the terminologies used by parties to a contract the credit in holding whether the sum stipulated was valid liquidated damages or an invalid penalty. The intention referred to by the courts was usually the actual intention of the parties. However, the court sometimes invoked a presumption of parties' intention<sup>171</sup>. For example, the court might presume that parties to a contract intended that the stipulated sum to be a penalty. In *Astley v. Weldon*<sup>172</sup> the court invoked a presumption that where a sum was payable in the event of occurrence of many breaches (one of them involved the non-payment of a lesser sum) the parties would have intended a penalty. Rooke J. stated that:

“The determination of the court in construing this instrument must be guided by the intention of the parties. Now it appears very clearly from the stipulation that small sums of money should be paid in certain cases, that the parties considered the larger sum as a penalty<sup>173</sup>”

Therefore the courts in some cases held the sum as a penalty<sup>174</sup> or liquidated damages<sup>175</sup> according to the terms used in the contract without considering the other circumstances, which might have impact on the judgment. In other words, if parties to a contract labeled the sum stipulated as liquidated damages, it would not be possible for the courts to hold that the sum should not be recovered by the injured party and vice versa. In *Reilly v. Jones*<sup>176</sup>, it was said that no case had been adduced in which the sum stipulated had been described as liquidated damages by the parties while the court had held that that sum to be an unenforceable penalty<sup>177</sup>. Conversely, in *Smith v Dickenson*<sup>178</sup>, there was a

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<sup>171</sup> Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. Sydney Law Review (1985) 10. 503, at 508.

<sup>172</sup> *Astley v. Weldon* (1801) 2 B&P 346, at 352-354; 126 ER 1318 at 1322-1323.

<sup>173</sup> *Ibid.* 353 and 1323 respectively.

<sup>174</sup> *Smith v. Dickenson* (1804) 3 B&P 630; 127 ER 639.

<sup>175</sup> *Reilly v. Jones* (1823) 1 Bing 302, at 306; 130 ER 122.

<sup>176</sup> *Ibid.*

<sup>177</sup> *Ibid.* At 306; 130 ER 122, at 123. per Park J. who stated that: “No case has been adduced in which after the parties have themselves employed the expression liquidated damages, the court has held the plaintiff should not recover, on breach of the agreement, the sum named as Liquidated damages”

<sup>178</sup> *Smith v. Dickenson* (1804) 3 B&P 630; 127 ER 639.

stipulation in the contract to the effect that a sum of money was to be paid by way of penalty. The court confirmed the intention of the parties where it held the clause to be a penalty because the use of the term penalty foreclosed the court from holding that the stipulated sum was for liquidated damages. However did the court continue to rely on the parties' own words to determine the nature of agreed damages clause?

## 2-The importance of the word used by the parties

### 2:1 The terms used are not decisive

The juridical reliance on parties' own terminologies was apparently undermined since *Kemble v. Farren*<sup>179</sup>. This case was the beginning of a new era in the subject matter. It was a strong call not to depend only on the parties' intention to determine whether the stipulated sum is a penalty or liquidated damages. Rather all terms of the contract should be taken into consideration. In other words, labeling the stipulated sum in a contract liquidated damages should not conclude the matter for the court should look at the intention of the parties and all terms and circumstances surrounding the contracting. By doing so the court may find that that sum is unenforceable penalty, despite the fact that the parties used the term liquidated damages to indicate the nature of the stipulated sum and vice versa. In English case law a new tendency has thus appeared. The fact that the sum stated in the contract to be payable in the event of breach is named as liquidated damages or penalty might be, prima facie, evidence that the sum is as described by the parties, but is by no means conclusive. This principle was first stated in *Willson v. Love*<sup>180</sup> and then reaffirmed in the leading case in the subject matter by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v. New Garage and Motor Co Ltd*<sup>181</sup>, where stated that:

“Though the parties to a contract who used the words penalty or liquidated damages may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The court must find out whether the payment stipulated is in truth a penalty or liquidated damages<sup>182</sup>”

<sup>179</sup> *Kemble v. Farren* (1829) 6 Bing 141; 130 ER 1234.

<sup>180</sup> *Willson v. Love* [1896] 1 QB 626.

<sup>181</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>182</sup> *Ibid.* At 86 per Lord Dunedin. See also at 100 per Lord Parmoor. This rule has been confirmed in many cases. *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), Weslaw 116995. [2003] EWCA Civ 58. Jacob J stated in this case that: “It is to be noted that the parties agreed that [the clause] was a penalty clause and described it as such. That is of course, not conclusive”. *Clydebank Engineering and Shipbuilding Co. v. Don Jose Romos Yzquierdo Y*

Under this principle the court uses its power to strike down the words used by the parties if the sum stipulated is not described in the contract in its true nature. There have been many cases in which the courts have interfered with contracts though the parties have agreed on a specified sum in the nature of liquidated damages. The courts, having looked at the language used in the contract and all circumstances surrounding it, reached the conclusion that the stipulated sum was not a genuine pre-estimate of the loss suffered. Consequently, the courts held that the amount was inserted to be paid as a punishment on the defaulting party irrespective of the loss suffered and therefore an unenforceable penalty. The case of *Kemble v. Farren*<sup>183</sup> is considered one of the milestones in the area of liquidated damages and penalty doctrine for the court struck down the words used by the parties. In this case although the parties described the agreed sum as liquidated damages, the court, after examining all the circumstances surrounding the contracting process, decided that the provision for the payment of that sum of money was a penalty. Equally, while the parties might have called a clause as a penalty clause, it could still turn out, on analysis, to be a liquidated damages clause. Put another way, in some cases the courts ignored the description of the parties to the sum as a penalty<sup>184</sup>.

One might argue that in some cases the courts upheld the sum stipulated as the parties described it. In response, it should be noted that since adopting this approach by the courts, no cases have been found in which the terms used by the parties had turned the

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*Castaneda* [1915] AC 6. *Sparrow v. Paris* (1862) 7 H&N 594, 599; 158 ER 608. At 610 Bramwell B stated "The names the parties give the money, Penalty or Liquidated damages are immaterial". *Pagnan & Folli v. Coprosol SA.* [1981] 1 Lloyd's R 283, at 287". *Ariston SRL v. Charly Records* (1990) The independent Law Report. 13 April.

<sup>183</sup> *Kemble v. Farren* (1829) 6 Bing 141; 130 ER 1234. See also to the same effect *Magee v. Lavell* (1870) LR 9 CP 107. *Bradley v. Walsh* (1903) 88 LT 737. *Commissioner of Public Workers v. Hill* [1906] AC 368. In hire Purchase contract the phrase "by way of agreed compensation" has frequently been ignored. E.g. *Bridge v. Campbell Discount Co* [1962] AC 600. *Cooden Engineering Co. Ltd v. Stanford* [1953] 1 QB 86. *Landom v. Hurrell* [1955] 1 All ER 839.

<sup>184</sup> In *Robert Stewart & Sons Ltd v. Carapanayoti* [1962] 1 WLR 34, the court held that "Although condition 33a imposed a penalty of between 2 and 10 per cent over the market value that was not an extravagant or unconscionable payment, but was a genuine pre-estimate of damages". There are many cases to this effect, See for example. *Crisdec v. Bollon.* (1827) 3 C&P 240; 172 ER 403. *Sparrow v. Paris* (1862) 7 H&N.294; 158. ER. 608. *Clydebank Engineering Co. v. Dos Jose Ramos Yzquierdo Y Castaneda,* [1905] AC 6. *Diestal v. Stevenson* [1906] 2 KB 345. *Cellulose Acetate Silk Co. Ltd v. Widnes Foundry (1925) Ltd* [1933] AC 20. *Alder v. Moore* [1961] 2 QB 57.

scales<sup>185</sup>. It might have been held that the sum stipulated to be as the parties have described in the contract. But in fact the judgment was not decided according to the description of the parties. In *Ariston SLR v. Charly Records*<sup>186</sup>, the parties agreed upon a sum of money to be paid in the event of breach by way of penalty. However, Lord Justice Beldam, who delivered the judgment, placed little reliance on the fact that the clause had been described as a penalty. The conclusion was reached that the sum stipulated was a penalty, as it was disproportionate to some items and thus did not depend on the word used by the parties. Beldam LJ concluded that: “the only sensible construction is that this clause would apply even though the items retained were few in number and would not cause any particular damage to Charly [the claimant]”<sup>187</sup>. However, does that mean that the terms used of no significance?

## 2:2 “Not decisive” does not mean unimportant

Though the terminology used by parties to a contract is not decisive in determining the nature of agreed damages, it is not, however, unimportant. Rather the expression inserted in the contract by the parties raises a presumption in favour of it<sup>188</sup>. In *Willson v. Love*<sup>189</sup>, Lord Esher M.R., made this clear by stating:

“Therefore the parties have themselves called this sum a penalty. That circumstance is not in itself decisive of the question. A succession of judges has held that the use of the term penalty or liquidated damages is not conclusive, but no case, I think, decides that the term used by the parties themselves is to be altogether disregarded”<sup>190</sup>

A clause is assumed<sup>191</sup> to be as the parties have called it until the opposite is proved<sup>192</sup>. Where the parties call the sum stipulated a penalty the onus lies upon the party who seeks to establish that it is to be payable as liquidated damages. And if the defendant claims

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<sup>185</sup> McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 432.

<sup>186</sup> *Ariston SLR v. CharlyRecords* (1990) The independent Law Report. 13 April.

<sup>187</sup> Ibid. per Lord Justice Beldam.

<sup>188</sup> *Robophone Facilities Ltd v. Blank*. [1966] 3 All ER 128, at 140 Where Diplock, LJ stated that: “The terms of the clause may themselves be sufficient to give rise to the inference that it is not a genuine pre-estimate of damage likely to be suffered but is a penalty...it is an inference only and may be rebutted.”

<sup>189</sup> *Willsons v. Love* [1896] 1 QB 626.

<sup>190</sup> Ibid. At 630 per Lord Esher M.R.

<sup>191</sup> It is a weak presumption.

<sup>192</sup> *Robophone Facilities Ltd v. Blank*. [1966] 3 All ER 128.

that the stipulated sum is a penalty, he should provide an evidence to prove that. As for example, in *Alder v. Moore*<sup>193</sup>, Devlin LJ said that:

“Since it has appeared from this case that underwriter have now adopted a new form of undertaking which does not use the word penalty and which may in the future come up for consideration, I think it wise to say that I have not formed any opinion about the construction of the new form. Clearly, it places underwriters in a better position...the burden will then be on the assured to show that the payment is in truth a penalty though not so described<sup>194</sup>”

It is appropriate to conclude that the statements used by the parties should not have a conclusive effect but that all circumstances surrounding the contracting process and the terms of the contract should be taken into account<sup>195</sup>. This is because in some cases, for instance, there might be domination from one side over the other and thus the correct nature of the agreed sum could be hidden. As a result of this a sum stipulated might be labeled as liquidated damages despite the fact that it could not represent a genuine pre-estimate of loss at the time of entering into the contract.

Since the judicial approach shifted from relying on the intention test the courts have had to introduce a new criterion with new rules to ascertain the compensatory nature of the sum stipulated.

### **3- The current test: the disproportion principle (extravagant and unconscionable sum)**

#### **3:1 Generally**

Lord Dunedin stated<sup>196</sup>:

“The criterion of whether a sum... is truly liquidated damages... or is truly a penalty...is to be found in whether the sum stipulated for can or can not be regarded as a “genuine pre-estimate of the creditor’s probable or possible interest in the due performance of the principal obligation.”

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<sup>193</sup> *Alder v. Moore* [1961] 2 QB 57.

<sup>194</sup> *Ibid.* At 75 per Devlin LJ. See also *Willsons v. Love* [1896] 1 QB 626. See also *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, at 59 per Lord Woolf. In this case Lord Woolf said that: “In seeking to establish that the sum described in...contract as liquidated damages was in fact a penalty, Philips has to surmount the strong inference to the contrary resulting from its agreement to make the payments as liquidated damages”.

<sup>195</sup> Beatson, J. “Anson’s Law of Contract”. 28<sup>th</sup> ed. Oxford University Press. 2002. P 624.

<sup>196</sup> *Commissioner of Public Workers v. Hill* [1906] AC 368, at 375 per Lord Dunedin.

Under this new test the court tended to consider the extent of disproportion between the stipulated sum and the loss likely to be suffered on breach as it is envisaged at the time of making the contract. Therefore an agreed damages clause is regarded as a valid liquidated damages clause if the stipulated sum is a genuine pre-estimate of loss, otherwise it will constitute a penalty clause<sup>197</sup>. Put another way, the agreed damages clause is a power given to the parties of the contract as such agreement achieves some purposes that could not be done by resorting to the court. Such a power should not be abused, as the sum stipulated might not represent a genuine pre-estimate of damage. Therefore it would be excessive and improper to allow the injured party to get such a sum as compensation, particularly if it was, at the time of making the contract, extravagant and unconscionable in comparison with the greatest loss which might be suffered as a result of the breach<sup>198</sup>. In all cases<sup>199</sup> concerned, their lordships did not pay any attention to the expressed intention of the parties to label an agreed sum as liquidated damages or penalty. This approach was clearly consolidated in the recent case<sup>200</sup> when Chadwick LJ has clearly declared that:

“The correct approach to the question whether a provision of this nature (agreed damages clause) is to be treated as a genuine pre-estimate of damages or as a penalty remains the set out in the speech of lord Dunedin in *Dunlop Pneumatic Tyre Company Ltd v. New Garage and Motor Company Ltd*”<sup>201</sup>

This means a birth of a new principle and an appreciated and gladly received overthrow of an old one.

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<sup>197</sup> See for that, Hock-Lai Ho. “The Privy Council on Liquidated Damages”. *Journal of Contract Law*. (1995) Vol.8, No.3 280.

<sup>198</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79. This rule was rather recently affirmed in *Philips Hong Kong v. The Attorney General of Hong Kong*. (1993) 61 BLR 41.

<sup>199</sup> For example, *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6. Also, *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*, [1915] AC 79.

<sup>200</sup> *Duffen v.FRA. BO SP* (1998) *The Times*. 15 June.

<sup>201</sup> *Ibid.* Per Chadwick LJ. In the most recent case of *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), *Weslaw* 116995. [2003] EWCA Civ 58 this rule was confirmed when Jacob J said that: “There was no abandonment of the rule that the clause must be a genuine pre-estimate of damage”.

### 3:2 Analysis of the current test

#### 3:2:1 Extravagant sum and not *merely* in excess of likely actual loss<sup>202</sup>

The underlying assumption of the current test must be that the law shall not approve any agreement between parties to a contract that varies from the general principle of contract law which asserts that damages for breach should be compensatory in nature. Any stipulation for a sum of money to be paid on breach exceeds what is considered as a just compensation is extravagant and thus unenforceable. However it is impossible to determine the cases in which the sum stipulated will be extravagant in comparison with the likely actual loss that might be sustained as a result of breach. Each individual case must be examined with reference to its particular facts and circumstances<sup>203</sup>. Furthermore, it has been submitted that the terminology “extravagant and unconscionable” is ambiguous for it may have been used merely to allow the courts to intervene when there was such an imbalance of the benefits and burden under the contract<sup>204</sup>.

It might be thought that it is adequate to regard the stipulated sum as a penalty clause merely because it is in excess of the likely actual loss which might ensue from breach at the time of drafting the contract. In *Cooden Engineering Co. Ltd v. Stanford*<sup>205</sup>, there was a hire-purchase agreement to hire a motor-car for 30 months to the defendant, who agreed to pay in respect of the hire a sum of money payable by monthly instalment. The contract stipulated that the hirer could at any time return the car to the owners provided that he must pay all the instalments then falling due and unpaid until that moment. The hirer also agreed to pay by way of compensation for depreciation at 40 per cent of the amount of the remaining instalments. The court held the clause to be a penalty rather than liquidated damages, and thus unenforceable, although that that sum might have been less than the actual loss if the car had become valueless. Lord Somervell L.J. pointed out that<sup>206</sup>: “Although it can not be said that the amount exceeds the greatest loss that could

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<sup>202</sup> This is also the core of the New Approach suggested in this work in which it is suggested to grant the court to reduce the agreed penalty where it is greatly higher than the actual loss suffered.

<sup>203</sup> *Clydebank Engineering and Shipbuilding Co v. Don Jose Romos Yzquierdo Y Castaneda* [1915] AC 6, at 10 per Lord Halsbury.

<sup>204</sup> Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. *Sydney Law Review*. (1985) 10 503, at 514.

<sup>205</sup> *Cooden Engineering Co. Ltd v. Stanford* [1953] 1 QB 86.

<sup>206</sup> *Ibid.* At 98.

possibly follow on the breach... it will exceed it in all except the exceptional case where the car has become of no value”

However, this judgment is open to criticism. The law regarding penalties mirrors a conflict between the penalty doctrine and the traditional doctrine of freedom of contract. On one hand public policy calls for penalty clauses to be dropped and on the other the doctrine of freedom of contract presses to limit interference with contracts freely made between the parties<sup>207</sup>. Public policy is expressed in the compensatory principle via the idea that compensation for loss is adequate relief and that punishment is not a role of contract law. For this reason the mere fact that the sum stipulated is in excess of the likely actual loss sustained does not prejudice the compensatory principle. Also as the penalty jurisdiction is a blatant interference with doctrine of freedom of contract the court should strike a balance between this doctrine and protection of weak contracting parties to achieve fairness. If the court tends to regard a clause entered into by the parties as an unenforceable penalty clause merely because the sum stipulated is more than the likely anticipated loss, it will make the agreement on damages by parties to a contract “impracticable”<sup>208</sup>. Hence, the court should apply the test in “pragmatic way” and should not be astute in declaring a provision as to agreed damages to be a penalty in order not to defeat its intended effect<sup>209</sup>. In *Philips Hong Kong v. The Attorney General of Hong Kong*<sup>210</sup> Lord Woolf confirmed that: “The court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld. Any other approach will lead to undesirable uncertainty especially in commercial contracts”<sup>211</sup>. Therefore courts should not intervene to strike down penalty clauses in contracts unless the requisite degree between the sum stipulated and the likely actual loss,

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<sup>207</sup> Hock-Lai Ho. “The Privy Council on Liquidated Damages”. *Journal of Contract Law*. (1995) 8(3) 280.

<sup>208</sup> Having regards the fact that: “it is good business sense that parties to a contract should know what will be the financial consequences to them of a breach...Not only does it enable the parties to know in advance what their position will be if a breach occurs and so avoid litigation at all, but, if litigation cannot be avoided, it eliminates what may be the very heavy legal cost of proving the loss actually sustained which would to be paid by the unsuccessful party” *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128, at 142.

<sup>209</sup> Halson, Roger. “Contract Law”. First published in Great Britain, Longman. 2001. P 508.

<sup>210</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>211</sup> *Ibid.* At 59. See also *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128, at 142 per Lord justice Diplock who stated that: “the court should not be astute to descry “penalty clause” in every provision of a contract which stipulates a sum to be payable by one party to the other on the event of a breach by the former”

as cases describe it, is “Unconscionable”, “extravagant”<sup>212</sup>, “out of all proportion”<sup>213</sup> and “exorbitant”<sup>214</sup>.

Therefore it can be asserted that the term ‘extravagance’ indicates the idea that the degree of disproportion between the stipulated sum and the likely actual loss at the time of making the contract is very high and out of all proportion. Put another way, the sum must be too great whereby it would not simply be just compensation. This fact is clearly verified in *Robophone Facilities Ltd v. Blank*<sup>215</sup>. This case concerned a contract to hire a telephone answering machine. The rental agreement stipulated that if the agreement was terminated for any reason whatsoever, the hirer was not entitled to any credit or allowance in respect of any payments made by him under the terms of the agreement. However, under clause 11 of the agreement, the hirer was to pay to the claimants all rentals accrued and also by way of liquidated damages a sum equal to fifty per cent for that would be due thereafter. In its decision, the Court of Appeal, took into account all the circumstances and particular facts surrounding the contracting, leading to the decision that: “... yet on the evidence cl. 11 of the agreement was not unenforceable as providing for a penalty, but the fifty per cent of the rentals, for payment of which cl. 11 provided, was a proper estimate of the damage and was recoverable as liquidated damages”<sup>216</sup>.

As a consequence the court established the principle that where the degree of disproportion between the agreed sum and likely actual loss is low it will not establish the essential proportion of extravagant sum subject to penalty jurisdiction. In other words, it is not sufficient to hold the agreed damages as an invalid penalty to show that the sum was merely more than the loss suffered<sup>217</sup>. Lord Diplock confirmed that the fifty per cent chosen by the parties as compensation was a “readily ascertainable figure” so long as it

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<sup>212</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 87. *Jobson v. Johnson* [1989] WLR 1026.

<sup>213</sup> *Philips Hong Kong LTD v. The attorney General of Hong Kong* (1993) 61 BLR 41, at 59.

<sup>214</sup> *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6, at 10. *Imperial Tobacco Co v. Parslay*, [1936] 2 All ER 515, at 523.

<sup>215</sup> *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128.

<sup>216</sup> *Ibid.* At 128,129.

<sup>217</sup> It will often be virtually impossible to anticipate accurately the damages for the loss sustained.

was close to the probable actual loss, which might be sustained by the claimants<sup>218</sup>. Thus the mere fact that fifty percent had been regarded in excess of the probable actual loss did not prevent the court from holding the sum as a valid liquidated damages clause on the ground that:

“It is capable of prediction, and, if this figure will tend to operate slightly to the advantage of the plaintiffs if the contract is terminated early in its life, it will tend to operate rather more heavily to the advantage of the defendant if it is terminated late in its life. I see no reason in public policy why parties should not enter into so sensible an arrangement under which each know where they stand, in the event of the breach by the defendant and can avoid a heavy costs of proving the actual damage if litigation ensues, and I see no ground in the authority which would permit –much less compel– me to hold that this clause is a penalty clause and so unenforceable by the courts...<sup>219</sup>”

### **3:2:2 A doubt on the current test rebutted: extravagant amounts cannot be included in liquidated damages clauses**

A doubt has been recently cast over the correctness of the existing test. An attempt was made to assert that the test included in 1915 case of *Dunlop*<sup>220</sup> is not the correct approach since it was weakened in 1993 case of *Philips*<sup>221</sup>. This argument was consolidated with the idea that *Philips* case suggested that the correct test now is the one that looks at the contract as a whole and the risks being undertaken by both parties and ask whether the clause was an appropriate clause, having regard to the risk undertaken by the opposite party. This is to say that extravagant amounts can be included within liquidated damages provisions. In response, this argument is hardly to be sound. Nothing can be found in *Philips* case to indicate that the courts departed from the test laid down in *Dunlop* case or it had virtually abandoned. Rather it was confirmed that the test remains one of making certain whether the amount of agreed damages is a genuine pre-estimate of damages or not as was established in *Dunlop* case. In 2003 case of *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited*<sup>222</sup> Mr. Justice Jacob made it clear that *Philips* case boils down to this, that: “since *Dunlop* the courts have continued to apply the

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<sup>218</sup> *Robophone Facilities Ltd v Blank* [1966] 3 All ER 128, at 144 per Lord Diplock.

<sup>219</sup> *Ibid.*

<sup>220</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>221</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>222</sup> *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), Westlaw 116995. [2003] EWCA Civ 58.

rule in *Dunlop*<sup>223</sup> and the only added matter was that the court should not be keen to drop penalty clause when the parties are of equal bargaining power.

In *Jeancharm* case<sup>224</sup>, which was concerned of a contract to supply football kit, Barnet Football Club Ltd agreed to purchase replica shirts from Jeancharm. The agreement stipulated that in the event of delay in payment the purchaser should pay interest at 5% per week and if the seller did not supply the entire order the purchaser had the right to receive a penalty for late delivery at rate of 20 pence per garment per day. Almost from the beginning there were difficulties in performing the contract. The purchaser, having complained about late delivery and the quality of goods supplied, brought an action claiming his 20 pence per garment per day clause. The judge accepted some of his claims and after making a set off ordered him to pay nearly £5000 to the seller. The latter claimed afterwards that the interest clause, which effectively operated as liquidated damages for late payment, should be activated at the rate of 5% in accordance to the term of the contract. The purchaser (Barnet) contested on that but the judge rejected the counterclaim and ordered him to pay the amount as liquidated damages.

On appeal, the purchaser claimed that the clause was a penalty, as the 5% per week amounts to an annual rate of about 260% percent, namely it is enough to take his liability from £5000 to nearly £20,000. Therefore, the sum stipulated of £20,000 was extravagant and unconscionable, and thus unenforceable penalty clause under the English case law. However when the seller counterclaimed he attempted to draw the Court of Appeal to the fact that the simple *Dunlop* case test of looking at the amount of agreed damages (260%) is no longer ruling the matter of enforceability of agreed damages clause. This is because, as claimed, that the court should fully examine the whole contract and the risks being undertaken by both sides<sup>225</sup> to ask whether the sum stipulated is enforceable or not. This was based on the fact that the law has moved on from what was stated by Lord Dunedin

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<sup>223</sup> Ibid.

<sup>224</sup> *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), *Weslaw* 116995. [2003] EWCA Civ 58. See also for this case "Penalty Causes and Liquidated Damages Clauses". *The Buyer*. (2003) Vol 25 Number 4 1-6.

<sup>225</sup> The claim was that the seller was at very considerable risk if he was in late delivery, having regard to the 20 pence per garment per day clause, and that should be balanced against the interest for late payments.

to be ruled by the conclusion of *Philips* case<sup>226</sup>. The Court of Appeal concluded that nothing in *Philips* case supports this allegation. Jacob J, rejecting the argument of the seller, stated:

“There was no abandonment of the rule that the clause must be a genuine pre-estimate of damage...on any basis, 260% is an extraordinarily large amount to have to pay for the suggested administrative cost, even if the sums involved were relatively small. It is purely a matter of speculation, and certainly the clause goes wider than that and covers comparatively large debts too. What we have in this case alone takes a bill of £5000 to £20,000. I think this is a penalty clause in the Dunlop sense and unenforceable”<sup>227</sup>

The courts have always intervened in what the parties have agreed and struck down the agreed damages clause as a penalty on the basis of the existence of unfairness. It is now evident that the power to strike down a penalty clause is an obvious interfering with freedom of contract and is designed for the sole object of providing relief against a payment of a sum disproportionately higher than the likely actual loss. Therefore this power has no application unless disproportion is clear. It was plain that in this case the extravagance of the interest clause is too clear, as it much goes beyond whatever thing that could constitute a genuine pre-estimate of the actual loss and therefore amounts to a penalty. However how could the court decide whether the sum fixed forms a genuine attempt by parties to assess in advance the loss, which might ensue in the event of breach?

### **3:2:3 Objective test or subjective one?**

When parties to a contract attempt to fix in advance the damages due in the event of breach such an attempt should be considered a “genuine pre-estimate of damage” to be upheld<sup>228</sup>. However how can that attempt be decided whether it was a genuine pre-estimate? Is it the actual attempt of parties to a contract in good faith to assess the loss, which might arise on the occurrence of breach?

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<sup>226</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>227</sup> *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), Weslaw 116995. [2003] EWCA Civ 58. See also Lord Peter Gibson who stated that: “it is plain that in this case the interest clause far exceeds anything that could be said to be a genuine pre-estimate of actual loss and amounts to a penalty”. See also *Duffen v.FRA. BO SP* (1998) The Times. 15 June.

It should be noted that the only attempt to construe the word genuine is in support of the subjective test when it is presumed that the word genuine in this context means “A serious attempt to estimate loss, one made in good faith, however unreasonable it might appear to others”<sup>229</sup>. This means that if the injured party can establish that he and the defaulting party, with good faith, made every attempt to appraise the actual loss, the agreed sum would be regarded as a genuine pre-estimate and thus valid liquidated damages clause. In *Law v. Local Board of Rdditch*<sup>230</sup>, Lopes J supported this view saying:

“The distinction between penalties and Liquidated damages depend on the intention of the parties to be gathered from the whole of the contract. If the intention is to secure performance of the contract by the imposition of a fine or penalty, then the sum specified is a penalty, but if on the other hand, the intention is to assess the damages for breach of the contract, it is Liquidated Damages<sup>231</sup>”

However, the view that the enforceability of a stipulated damages clause still depends on the intention of the parties to a contract is being doubted. The courts are not concerned with whether or not the parties have honestly believed that they made every possible bid to make a genuine pre-estimate of actual loss likely to be sustained on breach at the time when the contract is entered into. The sum stipulated might be disproportionately higher than the likely actual loss however the parties might have intended it as compensation. It is remarkable that Lord Dunedin in the leading case<sup>232</sup> did not indicate the intention of the parties when he stated: “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”<sup>233</sup>. Although it can be suggested that this statement is cast in subjective terms Lord Woolf, in *Philips Hong Kong v. The Attorney*

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<sup>228</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 86.

<sup>229</sup> Chitty on contract. 29<sup>th</sup> ed. Vol.1 General Principles. Sweet & Maxwell. 2004. P 1491-1492.

<sup>230</sup> *Law v. Local Board of Redditch* [1892] 1 QB 127.

<sup>231</sup> *Ibid.* 132 per Lopes J. see also, see *Pye v. British Automobile Commercial Syndicate* [1906] 1 KB 425. In this case it was held that: “in deciding whether a sum made payable by way of compensation for breach of a contract is to be treated as liquidated damages or as a penalty, the Court must take all circumstances into consideration, in order to ascertain the intention of the parties”.

<sup>232</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>233</sup> *Ibid.* At 86-87.

*General of Hong Kong*<sup>234</sup>, has frankly indicated that “the test is objective”<sup>235</sup>, because “the issue has to be determined objectively judged at the date the contract was made”.<sup>236</sup>

Therefore, it is clear from the relevant cases that it is the objective standard which should be taken into consideration in determining whether or not the attempt of the parties has been a genuine attempt at the time of contracting<sup>237</sup>. In other words, the matter should be examined objectively at the time of contracting in order to ensure that the sum fixed is not extravagant and unconscionable. In order to do so regard must be paid to the whole terms of the contract and all inherent circumstances, as the parties understand them at the time when the contract is made regardless of the words used by them. This might be supported also by the fact that English case law in matters of contract formation adopts the objective test of agreement<sup>238</sup>. This means that the whole contracting agreement does not rely upon what parties wrote, but rather upon what the court should decide having examined the matter objectively. In an important passage Peter Pain J. in *Thake v. Maurice*<sup>239</sup>, stated: “The test as to what the contract in fact was, doesn’t depend on what the plaintiff or the defendant thought it meant, but on what the court objectively determines that the word used meant”<sup>240</sup>.

Therefore the true operation of the agreed damages provision must be determined as a question of substance, which could not be foreclosed by statements of the parties in the contract<sup>241</sup>. The parties to a contract might have subjectively intended to make a pre-

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<sup>234</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>235</sup> *Ibid.* At 60.

<sup>236</sup> *Ibid.* At 59.

<sup>237</sup> Hosie, Jonathan. “The Assessment of Damages for Delay in Construction Contracts: Liquidated and Unliquidated Damages”. *Construction Law Journal*. (1994) 10(3).

See: [web2.westlaw.com/result/text.w1?](http://web2.westlaw.com/result/text.w1?)

<sup>238</sup> Anne De Moor. “Intention in the Law of Contract Elusive or Illusory?”. *Law Quarterly Review*. (1990) 106 632.

<sup>239</sup> *Thake v. Maurice* [1986] QB 644.

<sup>240</sup> *Ibid.* At 657 per Peter Pain.

<sup>241</sup> This principle had been confirmed in the leading case *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 86 per Lord Dunedin. He stated that: “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 as at the time of the breach”.

estimate of damages in the event of breach. If however the pre-estimate turns out, on analysis, to be extravagant the clause will be a penalty.

### **3:2:4 What is the meaning of “unconscionable”?**

#### **3:2:4:1 The word unconscionable has no reference to the fact of the disparity of parties’ position**

The notion of disparity of bargaining powers was first approached by Lord Wright M.R in *Imperial Tobacco Co v. Parslay*<sup>242</sup>. His Lordship discussed it when attempted to give the meaning of the word unconscionable contained in the leading case<sup>243</sup>. In this instance his Lordship examined the disparity between the positions of two parties and whether it must be taken into consideration to determine the nature of an agreed damage clause. Lord Wright explained that this proposition should not have any importance for this issue, whereby he stated that<sup>244</sup>:

“I do not think the word unconscionable there has any reference to the fact that the parties were on an unequal footing. It does not bring in at all the idea of an unconscionable bargain...it merely a synonym for something, which is extravagant and exorbitant”

This view has subsequently prevailed. It argues that the element of unconscionability does not contain any reference to the effect that the disparity between the positions of the two parties to a contract is to be considered to determine whether the sum stipulated is in the nature of penalty or liquidated damages. The relevant disproportion which should be taken into account should be measured by the comparison between the sum stipulated and the feasible actual loss sustained on breach without having any regard to the bargaining power of the parties. In *Bridge v. Campbell Discount Co*<sup>245</sup>, it had been confirmed that “Unconscionable must not be taken to be a Panacea for adjusting any contract between competent persons when it shows a rough edge to one side over the other and the courts

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<sup>242</sup> *Imperial Tobacco Ltd v. Parslay* [1936] 2 All ER 515. In this case it was held that “The only question to be considered was whether the sum claimed as liquidated damages was a fair pre-estimate of the damages likely to flow from the breach, and not unconscionable, neither the fact that the plaintiffs were a powerful and influential company and the trader a man in a very small way of business....”

<sup>243</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>244</sup> *Imperial Tobacco Co v. Parsley* [1936] 2 All ER 515, at 521 per Lord Wright.

<sup>245</sup> *Bridge v. Campbell Discount Co* [1962] AC 600.

of equity never undertook to serve as a general adjuster of men's bargain"<sup>246</sup>. However what is the effect of *Philips* case?

### 3:2:4:2 Effect of *Philips* Case

A new development in regard to the consideration of the inequality of the bargaining power was raised in *Philips Hong Kong LTD v. The Attorney General of Hong Kong*<sup>247</sup>. This case suggested for the first time that attention could be paid to the disparity of parties' powers. However it confirmed that this notion would not have any decisive effect on determining the nature of the sum stipulated. Though it might be proved that there had been a domination of one party over the other, the test should still remain as clearly laid down in *Dunlop*, namely whether the sum stipulated far exceeds anything that could be said to be a genuine pre-estimate the loss which might arise from the breach. In an important passage Lord Woolf stated<sup>248</sup>:

“Except possibly in the case of situations where one of the parties to the contract is able to dominate the other as to the choice of the terms of a contract, it will normally be insufficient to establish that a provision is objectionably penal to identify situations where the application of the provision could result in a larger sum being recovered by the injured party than his actual loss. Even in such situations so long as the sum payable in the event of non-compliance with the contract is not 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, it can still be a genuine pre-estimate of the loss that would be suffered and so a perfectly valid liquidated damage provision”

The development suggested in this case will now be examined as follows:

- 1- The bargaining strength is not of decisive effect
- 2- Is the application of unconscionability notion that the *Philips* case suggested?

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<sup>246</sup> Ibid, At 626 per Lord Radcliffe.

<sup>247</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>248</sup> Ibid. At 58-59 per Lord woolf

### 3:2:4:2:1 The bargaining strength is not of decisive effect

In light of *Philips Hong Kong v. The Attorney General of Hong Kong*<sup>249</sup>, it can be said that the way is now open to the first steps of giving “inequality of bargaining power” a role in determining the nature of the agreed sum. The new development runs as follows. In deciding whether the sum stipulated is a genuine pre-estimate of the likely anticipated loss, all terms of contract and other relevant surrounding circumstances are to be considered. Therefore, without any abandonment from the existing test it would be better to state that the situation in question (inequality of bargaining power) could be regarded as one of the important inherent circumstances, which has affected the contract at the time of contracting. The unconscionability of the injured party’s conduct in seeking to enforce the agreed damages should be examined as a significant factor for the purpose of deciding the nature of sum stipulated.

Therefore the activation of the current test after *Philips* case means that the court in deciding whether the agreed damages clause is of penal nature may look at two aspects.

Firstly the court should consider the relationship between the parties’ bargaining powers<sup>250</sup>, i.e. was there an element of domination by one party to impose the terms of contracts over the other? The effect of this approach depends on whether the contracts are freely negotiated or have clauses been imposed by virtue of a standard form or a superior bargaining position of one of the parties. In the former case, it would be assumed that the party subject to the penalty clause had had the opportunity to examine every single issue related to the contract<sup>251</sup> and must have been a good reason to agree on it. It follows from this that this party is aware of all the consequences that he might encounter if he had not performed his contractual obligations. He needs not have made the contract if he would not have been able to fulfill his promises. Therefore as there was no serious effect of the

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<sup>249</sup>*Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>250</sup> If claimed and proved by the party who seeks to establish that the clause is penalty.

<sup>251</sup> He might be experienced or make the contract with a full legal assistance of his advisor, who stands with him side by side in all contracting steps.

inequality of the parties' powers on a risk of disproportionate compensation, the court would not scrutinise the clause with great care to determine whether it is a penalty or not

However, in the event of pre-arranged contracts by an influence party it is presumed that the other side had not had any opportunity to discuss the terms of the deal. In other words, though the defaulting party had full foreknowledge at the time of making the contract of the consequences in the event of non performance, he had no option but to accept the pre-drafted deal. This situation might result in risk of awarding the injured party an extravagant compensation. The court would therefore be more zealous to scrutinise more closely the availability of the main element of the test<sup>252</sup>. To do so court should investigate all the terms of the contract and events surrounding the contracting process in order to ensure that there was no domination enabled one of the parties to control the other as to the terms of the contract. In the most recent case of *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited*<sup>253</sup> the Dunlop test was clearly reaffirmed however Jacob J has added that in accordance to what stated by Lord Woolf in *Philips* case<sup>254</sup> that "One should be careful before deciding whether or not a clause is a penalty when the parties are of equal bargaining power"<sup>255</sup>. However this does not mean, if it is proved that the contract was not negotiated at arm's length, granting the defaulting party a relief for mere the fact that there was inequality of bargaining power at the time of contracting. It just gives the court the motivation to move towards the second step of finding out the availability of the disproportion principle.

It should be noted that in investigating the matter of inequality of bargaining power the wealth of the parties is irrelevant. What is relevant is the relationship between the parties to a contract, which might explain the way by which they arrived to the sum stipulated

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<sup>252</sup> Which is: the sum should be extravagant and unconscionable.

<sup>253</sup> [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), *Weslaw* 116995. [2003] EWCA Civ 58.

<sup>254</sup> *Philips Hong Kong v. The Attorney General of Hong Kong*. (1993) 61 BLR 41.

<sup>255</sup> *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), *Weslaw* 116995. [2003] EWCA Civ 58. In the same case, Jacob also said in different place that: "A court should be careful not to strike down as a penalty a clause negotiated between willing parties who have similar bargaining strength"

and therefore inform the question of whether it was a genuine pre-estimate of damages. Lord Wright has clearly set out this fact when stated that he could not:

“See any reason for introducing into a question of this sort any consideration of the relevant wealth and poverty of the two parties. A millionaire may enter into a contract in which he is to pay liquidated damages, or a poor man may enter into a similar contract with a millionaire, but in each case the question is exactly the same, namely, whether the sum stipulated as damages for the breach was exorbitant or extravagant ”<sup>256</sup>.

Secondly, the court should apply the main element of the test, i.e. the disproportion principle. It should seriously look at the disparity between the sum stipulated and the possible actual loss which might be suffered as a result of breach of contract at the time of entry into the contract. Where there is no case of provision for an extravagant or excessive sum to be paid in the event of breach, the court shall not intervene and should declare the enforceability of the stipulated sum. The mere possibility that there is a disparity of bargaining powers is not adequate on its own to activate the penalty jurisdiction. But rather the sum stipulated should be disproportionately higher than the likely actual loss. However, does taking the inequality of bargaining power into account mean applying the unconscionability notion?

### **3:2:4:2:2 It is not the unconscionability notion**

The approach after *Philips* case by no means suggests paving the way for unconscionability to be the basis for the invalidity of penalty clauses. The unconscionability idea means that where the parties have freely negotiated the contract the agreed damages clause should be enforced despite the prima facie disproportion between the compensation provided and the loss suffered on breach. However, where the parties have not similar bargaining strength the clause should be set aside as a penalty. In this instance the prevention of unconscionable transactions rests on preventing the stronger party from imposing a remedy which is not in general permitted under the English case law. In contrast, this is not the case under the new development suggested in *Philips* case as the inequality of bargaining power will be just a step to applying the main

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<sup>256</sup>*Imperial Tobacco Co v. Parslay* [1936] 2 All ER 515, at 523 per Lord Wright.

test as so laid down in *Dunlop* case, namely whether the sum stipulated is a genuine pre-estimate damage.

It might be asked<sup>257</sup> why should not unconscionability be the basis for the intervention of the court to strike down penalty clauses<sup>258</sup> since this would not contain a complete relinquishment of *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*?<sup>259</sup> It is thought that this is so since the identification of an “extravagant” will be the introductory step, which will lead to inquiry into whether the contract had been freely negotiated. In response, with respect, a close look at its operation can conclude that adopting the unconscionability approach will involve a complete abandonment of *Dunlop* case rules, which represents the existing case law as to penalties. Adopting an approach based on an unconscionable conduct practised by one party over the other will divert attention from the current test as to what is a penalty provision- namely is it a genuine pre-estimate of what the loss is likely to be? to the different question, namely is there any unconscionable conduct? If there is no such conduct there will be no application of penalty jurisdiction even though the sum stipulated is much exceeds the possible actual loss. In other words, if the parties at the time of making the contract set an extravagant sum in comparison with the loss that could conceivably be proved as a result of breach, it would not be more than a sign leads into inquiry of whether there was unconscionability involved. This is completely contrary to the operation of the rule as so set out in *Dunlop* case. Furthermore, in adopting the suggested approach after *Philips* case it is the inequality of bargaining power which shall be a sign and motive for the court to look at the agreed damages clause more closely. In addition to the non-abandonment of the rule that the clause should be extravagant it achieves the notion of justice that the penalty jurisdiction is based upon. The approach is applicable to all cases where there is

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<sup>257</sup> Downs, T A “Rethinking Penalty Clauses” in “Wrongs and Remedies in the Twenty-First Century” edited by Peter Birks, Clarendon Press, Oxford, 1996. P 249, at 267.

<sup>258</sup> See for a suggestion to base the penalty rule upon the unconscionability notion: Poole, Jill. “Textbook on Contract Law”. 7<sup>th</sup> edition. Blackstone Press. 2004. P 451. Downs, T A “ Rethinking Penalty Clauses” in “ Wrongs and Remedies in the Twenty-First Century” edited by Peter Birks, Clarendon Press, Oxford, 1996. P 249 at 267. See also, Chen-Wishart, Mindy. “Controlling the Power to Agree Damages”. In “Wrong and Remedies in the Twenty-First Century” edited by Peter Birks, Clarendon Press, Oxford, 1996. P 271, at 283.

<sup>259</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

disproportionately large sum being recovered even though there is no domination by one side over the other in order to keep the aim of damages within the compensatory nature. In *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited*<sup>260</sup>, Keene LJ made clear that:

“It is quite clear from the authorities that the concept of penalty clause is not confined to situations where one party had a dominant bargaining power over the other, although it may, of course, often apply in such situation”<sup>261</sup>

### 3:3 What is the effect of hypothetical situations?

The party, who seeks to establish that the agreed-damages clause is a penalty, might identify hypothetical circumstances where the outcome of the application of the clause could result in making a sum payable to injured party wholly out of proportion to the loss, which the latter is likely to sustain on breach. In *Philips* case<sup>262</sup> the defendant (Philips) admitted that the sum claimed by the claimant (Government) by way of liquidated damages was not in fact extravagant in light of what had in fact occurred. Despite this fact the defendant argued that the clause was a penalty clause on the ground that there were a number of different hypothetical circumstances<sup>263</sup> in which the application of the clause would result in a disproportionate amount being recovered by the claimant<sup>264</sup>. However is the argument based on hypothetical situations lead to a satisfactory result?

This particular argument was firmly rejected for the validity of the clause should always rely on what is likely to be a normal operation of the clause rather than an unusual operation. Therefore the Privy Council stated that:

“arguments based on hypothetical situations where it is said that the loss might be less than the sum stipulated as payable as Liquidated Damages...should not be allowed to divert attention from the correct test as to what is a penalty provision- namely is it a genuine pre-estimate of what the loss is likely to be? to the different

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<sup>260</sup> *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), Weslaw 116995. [2003] EWCA Civ 58.

<sup>261</sup> *Ibid.*

<sup>262</sup> *Philips Hong Kong LTD v. The Attorney General of Hong Kong*. (1993) 61 BLR 41, at 56. See for this point also Stebbings, S. “Penalties- in more Sense than One”. *Construction Law Journal*. (2003) vol. 14 Part 5 20, at 21-22.

<sup>263</sup> None of which had even happened.

<sup>264</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, at 56.

question, namely are there possible circumstances where a lesser loss would be suffered?<sup>265</sup>”

Therefore, the use of unlikely situations should not be allowed to defeat the intended effect of parties to a contract being able to agree in advance upon damages recoverable as a result of breach. In other words, if the approach based on hypothetical circumstances is upheld the whole purpose of a provision as to agreed damages would be undervalued for this would mean that it would be extremely difficult to formulate any such clause which would not be open to attack as being penal<sup>266</sup>. Such an approach would not be in the interest of either of the parties since agreed damages provision may serve both parties. It may serve the perfectly proper goal of enabling a party to know beforehand what his liability will be and to convince the other party (the promisee)<sup>267</sup> of his reliability not least when he has no adequate reputation established. The Law Commission in its working paper<sup>268</sup> confirmed that:

“The fact that in certain circumstances a party to a contract might derive a benefit in excess of his loss does not...outweigh the very definite practical advantages of the present rule upholding a genuine estimate, formed at the time the contract was made of the probable loss.”<sup>269</sup>

It is hereby submitted that it is necessary for the courts when viewing every single case to examine the real and existing conditions and circumstances.

### **3:4 Time for the application of the current test**

#### **3:4:1 Time of contracting**

The existing principle is that the question of whether the sum stipulated is extravagant or unconscionable is judged by reference to all inherent circumstances and events as they

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<sup>265</sup> Ibid. At 64 per Lord Woolf.

<sup>266</sup> This is because: “As is the case with most commercial contracts, there is always going to be a variety of different situations in which damage can occur and even though long and detailed provisions are contained in a contract it will often be virtually impossible to anticipate accurately and provide for all the possible scenarios. Whatever the degree of care exercised by the draftsman it will still be almost inevitable that an ingenious argument can be developed for saying that in a particular hypothetical situation a substantially higher sum will be recovered than would be recoverable if the plaintiff was required to prove his actual loss in that situation”. *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, at 54.

<sup>267</sup> Who can be able to know with a reasonable degree of certainty his rights and can also avoid the difficulty, delay and expenses of judicial assessment.

<sup>268</sup> No 61. “Penalty Clauses and Forfeiture of Monies Paid”. London, Her Majesty’s Stationery Office. 1975.

exist at the time at which the clause of paying a sum of money on breach is agreed upon between the parties to a contract<sup>270</sup>. To do so, the court should compare the amount of compensation provided for in the contract with the greatest loss, which might have been reasonably contemplated by the parties at the time of contracting. If the quantum of damages stipulated was extravagant the sum stipulated will be classified as a penalty and not enforceable. However if the quantum was a genuine pre-estimate of likely loss at the time of contracting it is valid and enforceable as liquidated damages even though there is no loss suffered. This principle was confirmed in *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>271</sup> by Lord Dunedin, who stated there that:

“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 of as at the time of making the contract, not at the time of the breach<sup>272</sup>.”

However are all the events, which occur after concluding the contract without significance? The fact that the nature of the sum agreed upon in contract must be determined at the time when the contract is made, does not mean that the circumstances and events, which might occur after that time, must be disregarded. What has actually happened after the time of contracting can not be conclusive evidence of the status of the stipulated damages clause, as the court should consider the wider range of events which were in the contemplation of the parties at the time when contract was made<sup>273</sup>. In fact what actually happened might be considered as a productive element in determining the genuineness of agreed damages. It might provide valuable evidence of what could reasonably be contemplated by the parties to be the feasible loss at the time of contracting. Therefore the estimation of damages by the court without taking into consideration the actual loss, which has in reality happened, will be unrealistic and consequently not

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<sup>269</sup> Ibid. P 30.

<sup>270</sup> For example, in *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6, at 17 per Lord Davey. He confirmed the principle of the time of determining the nature of sum stipulated and this case itself Lord Davey indicated to affirm what have been decided by Lord Inglis in *Forrest and Barr v. Henderson*. (1869) 8 M 187 that: “Of course, the question whether it is exorbitant or unconscionable is to be considered with reference to the point of time at which the stipulation is made between the parties”. See also *Public Works Commissioner v. Hills*. [1906] AC 368, at 376 per Lord Dunedin. *The Victoria Laundry Ltd v. Newman Industries Ltd* [1949] 2 KB 528, at 539.

<sup>271</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>272</sup> Ibid. At 86-87 per Lord Dunedin.

<sup>273</sup> McKendrick, Ewan. “Contract Law”. 5<sup>th</sup> ed. Macmillan. 20003. P 444.

possible. This development was confirmed by Lord Woolf in *Philips Hong Kong LTD v. The Attorney General of Hong Kong*<sup>274</sup>, when he stated that:

“The fact that the issue has to be determined objectively, judged of the date the contract was made, does not mean what actually happens subsequently is irrelevant. On the contrary it can provide valuable evidence as to what could reasonably be expected to be the loss at the time the contract was made”<sup>275</sup>

Attention should be paid to the case of *Rowland Valentine Webster v. William David Bosanquet*<sup>276</sup>. One might argue that the court, in this case, has given its decision in accordance to the circumstances as they exist at the time of breach<sup>277</sup>. This means that there is a judicial trend towards judging the validity of agreed damages clause in relation to the loss suffered at the time of breach. This case concerned with a clause providing for liquidated damages of £500 to be paid in the event that the defendant failed to sell to the claimant “the whole or any part of the crop” of his tea estates. The defendant having sold five different parcels of the subject matter to a third party amounting to 53,315 Ibs, the claimant sued for the amount of damages agreed upon in the contract. The House of Lords upheld the clause as valid liquidated damages and granted the claimant the amount of £500.

It should be noted that the point on which the Privy Council relied upon to reach its conclusion in this case, was not judging the enforceability of agreed damages clause according to the facts and conditions as they existed at the time of breach. Rather it was the fact that the council when it gave its decision had, in order to determine the true construction of the agreed damages clause, regard to the range of losses the parties would anticipate the clause would cover when they made their contract. Taking this into consideration the Council decided that the parties, when they agreed on liquidated damages must have had in mind that the clause was only applicable to sales to a person other than the claimant in that kind of commercial quantity. Thus it should be confirmed that the parties did not intend the agreed damages clause to be applicable to all sales

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<sup>274</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>275</sup> *Ibid.* At 59 per Lord Woolf.

<sup>276</sup> [1912] AC 394.

<sup>277</sup> See for this The Law Commission, Working Paper No 61. “Penalty Clauses and Forfeiture of Monies Paid”. London, Her Majesty’s Stationary Office. 1975. P 27.

made by the defendant. It would not be possible that they had any intention of applying the clause to sale of some packets of the tea. Lord Mersey, confirming this interpretation, said:

“The parties to the agreement were merchants using language in the sense in which it is used in their trade. When they speak of a part of a crop they are not contemplating packets which might be sold over a grocer’s counter, but parcels such as were in fact sold in the present case”<sup>278</sup>

Therefore it can be concluded that the parties did not have any intention at the time of making the contract, to make a potential penalty clause applicable to every sale contrary to a right of pre-emption clause<sup>279</sup> (for breach of which liquidated damages were agreed to be payable)<sup>280</sup>. As a result it would become visible that this case lends little support to the view that the matter was decided at the circumstance as they exist at the time of breach. Consequently the position of the current law remains that the question whether the agreed damages clause is a valid liquidated damages clause or an invalid penalty clause is to be judged at the time of the making the contract. However is this attitude still acceptable particularly where there is no loss suffered and is it in line with the New Approach?

### **3:4:2 The no actual loss defence**

The existing principle of the law as to the time of application of test is still open to criticism. It should be noted that the requirement that the agreed damage clause is to be judged at the time of the contract is quite understandable in the historical perspective. This was the situation until *Kemble v. Farren* case<sup>281</sup> where the parties could determine the enforceability of the stipulated sum according to the word they used in their agreement<sup>282</sup>. The difficulties, which this principle presents, arises from the fact that the intention of the parties’ test no longer concludes the matter, and whether the sum

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<sup>278</sup> *Webster v. Bosanquet* [1912] AC 394, at p 398-399.

<sup>279</sup> The condition in this case was that the defendant would not sell the whole or any part of the crop of his estates to person other than the claimant.

<sup>280</sup> See for this interpretation *Cenargo Ltd v. Empresa Nacional Bazan de Construcciones Navaves Militares SA*, 2002] EWCA Civ 524. [2002] CLC. 1151. 2002 WL 347020

<sup>281</sup> *Kemble v. Farren* (1829) 6 Bing 141; 130 ER 1234.

stipulated is a penalty depends on rules of law. One consequence is that a sum may not represent a penalty at the time of contract whereas it will at the time of breach, and vice versa. The law commission<sup>283</sup> in its working paper remarked on such a consequence in that it does not have any justification to change the present case law in this area. It stated:

“...We realise that a possible objection to the present law is that circumstances may arise where the penalty clause is enforceable because it was a genuine pre-estimate, but as things turn out the loss suffered is negligible so that the stipulated sum exceeds the loss to a disproportionate extent...but our present view is that this objection does not justify a radical change in the present law”<sup>284</sup>

However, with all respect to the view expressed by the law commission, the current principle in which the court should measure the validity of the damages agreed upon in light of the circumstances existing when the contract is made irrespective of the actual loss is still objectionable. The sum stipulated might be a genuine pre-estimate of loss that might be sustained on breach at the time of the making the contract, however, might turn out to be much less than the stipulated sum or might be no loss at all at the time of breach. Put another way, sometimes the nature of the agreed damages clause should be determined in light of the actual loss suffered. In applying the existing principle the court may fall into absurdity when it decides to award the claimant the amount of agreed damages clause, though he suffered no loss. The practical impact of this rule has been clearly illustrated in *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda*<sup>285</sup>. In this case the Spanish government (the claimant) made a contract with the defendants to build four torpedo boats to be used in the Spanish-American War of 1898. It had been provided in the contract that the defendant should pay £500 per week for each vessel in the event of any delay to deliver them. Delivery was delayed by many months after the stipulated period and the price paid. Therefore the Spanish government successfully claimed from the defendant payment of £500 for each week that the vessels were late. The House of Lords decided that the sum should be

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<sup>282</sup> Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. *Sydney Law Review*. (1985) 10 503, at 514.

<sup>283</sup> The Law Commission in its working paper No. 61 “Penalty Clauses and Forfeiture of Monies Paid”. London, Her Majesty’s Stationery Office. 1975. At 22, suggested that “...to judge the validity of a penalty clause by reference to circumstances as they exist after the breach would mean the introduction of an unacceptable amount of uncertainty.

<sup>284</sup> *Ibid.*

<sup>285</sup> *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6.

treated as liquidated damages regardless of the fact that had all four vessels been delivered at the specified time, they would have been demolished together with the rest of the Spanish fleet. The judgment in this case was based upon what was expected to be a genuine pre-estimate of damages at the time of making the contract irrespective of any subsequent event which might prove that the claimant has suffered low loss.

The effect of this outcome means that the defendant was compelled to pay a large sum under circumstances where there was no actual loss suffered by the claimant. In other words, although the former had argued that the amount agreed upon was not a genuine pre-estimate of damages the court refused to accept the argument on the express grounds that this is the mere principle of the current law. This absurdity can be overcome by considering the actual loss where it is either nothing at all or much less than its amount. Therefore it would seem appropriate to suggest that the enforcement of agreed damages clause where there is no loss sustained sounds unreasonable. It is impossible to suggest that the parties would intend the agreed damages to be payable in the event that no loss was suffered from<sup>286</sup>. Therefore the defaulting party should be given the right to rely on the so called the 'no actual loss defence' as recognised by a number of American courts. The 'no actual defense' allows an ex post voiding of agreed damages clause that was genuine estimate of likely loss at the time of contracting<sup>287</sup>. In the American case of *Massman Const Co v. City Council of Greenville*<sup>288</sup> the court applied this approach. In this case there had been an agreement to build a bridge in which it was provided that the

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<sup>286</sup> The outcome of the case of *Schuler AG v. Wickman Machine Tool Sales Ltd* [1974] AC 235, could support this proposition. In this case it was decided that where the consequences of treating a term as a condition are unreasonable, having regard to the range of losses or consequences the parties would anticipate the clause would cover, it is less likely that the parties intended the use of condition to lend to the injured party the right to terminate the contract and claim damages.

<sup>287</sup> See for this DiMatteo, Larry A. "A Theory of Efficient Penalty: Elimination the Law of Liquidated Damages". *American Business Law Journal*. (2001) vol. 38. Part 4 633, at 663-664 where the author also stated that: "Alternately, the defense can be phrased simply as the failure of *anticipated* damages to materialize. In the language of common law excuse, the clause has been *frustrated* by a subsequent unexpected event. The unexpected event is the failure of a breach to produce any damages". It is well recognized under English law a contract is said to be 'frustrated' if it becomes impossible to perform due to unforeseeable circumstances, or if circumstances change to the extent that performance would be substantially different from what was anticipated by the parties.

<sup>288</sup> *Massman Const Co v. City Council of Greenville* 147 F. 2d 925 (C.C.A.5<sup>th</sup>, 1945). This case and this whole approach were referred to to criticize the outcome of *Clydebank* case in the English law Commission proposal 1993. See McGregor, Harvey. "Contract Code". Drawn up on behalf of the English Law Commission. 1993. P 133.

defendant would pay a certain sum of money in the event of late completion of the said bridge. When default was committed the claimant brought an action before the court claiming the amount agreed upon. The court refused to enforce the agreed damages clause on the express ground that the bridge would in any case have been unusable due to the lack of a road leading to it which was supposed to have been completed by state authorities.

The court justified its decision on the fact that the agreed damages clause, considering that there is no loss, was not designed for the purpose of enriching the injured party. Put another way, if there is no loss suffered the award of stipulated damages violates the compensatory principle of contract damages. One might raise the following question: Is risk allocation unjust enrichment?<sup>289</sup> In response, it should be emphasised that when the risk allocation in contract results in imposing an unfair and unconscionable damages the role of the court to remove the unfairness becomes significantly demanded. The court, in applying this approach, appears to have adopted the position that if the injured party suffers no loss the stipulated damages clause is a penalty. In the American case of *Wassenaar v. Panos*<sup>290</sup> the court fittingly stated this position:

“Although courts have frequently said that the reasonableness of the stipulated damages clause must be judged as of the time of contract formation...and that the amount or existence of actual loss at the time of breach or trial is irrelevant, except as evidence helpful in determining what was reasonable at the time of contracting..., the cases demonstrate that the facts available at trial significantly affect the courts' determination of the reasonableness of the stipulated damages clause. If the damages provided for in the contract are grossly disproportionate to the actual harm sustained, the courts usually conclude that the parties' original expectations were unreasonable”

This is also the very circumstance in which the court will have a discretionary power under the New Approach to reduce the amount of agreed damages. This is to say that the defaulting party will be allowed the defence that the clause is disproportionate or extravagant when compared to actual loss suffered. Under the New Approach the pre-

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<sup>289</sup> DiMatteo, Larry A. “A Theory of Efficient Penalty: Elimination the Law of Liquidated Damages”. *American Business Law Journal*. (2001) vol. 38. Part 4 633, at 664.

<sup>290</sup> *Wassenaar v Panos* 331 N.W. 2d 357 (Wis. 1983). 111 Wis.2d 518, 40 A.L.R.4th 266

estimate damages is assumed to be enforceable unless the defaulting party can prove that the agreed amount is out of all proportion when compared to the actual loss.

#### **4-Jordanian civil law**

##### **4:1 Basis for the validity: Article 364 of the Jordanian civil law**

Penalty clause is dealt with in civil law countries quite different compared to case law countries. As one of case law countries English law distinguishes between penalties and liquidated damages. The agreed damages clause is invalid as a penalty where it is disproportionately high in comparison with the likely actual loss that might be suffered as a result of breach at the time of making the contract. However, Jordanian law as one of the civil law nations establishes a strong presumption in favour of the enforceability of penalty clause.

Article 364 of the Jordanian civil law establishes the validity of penalty clauses. It states that "Contracting parties may, in advance, agree upon the amount of damages payable in the event that a breach occurs". Although penalty clause is ordinarily inserted in the principal contract concluded by the parties at the time of formation, it is equally valid and enforceable if it is agreed upon after making the contract by a separate agreement<sup>291</sup>. A penalty clause is therefore a contractual liquidation of compensation, which the injured party suffers through non-performance of principal obligation. Hence, the legislator deprived the penalty clause of its penal character by providing in the second paragraph of the article that "The courts may, upon the request of either party, increase or decrease, such damages to make the estimation equal to the actual damage. Any provision in the contract to the contrary shall be of no effect"<sup>292</sup>. In looking at the text of this article it can be clearly inferred that there should be actual damage suffered by the injured party (creditor) in order to have the right to receive the amount of penalty. It is noted that under

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<sup>291</sup> Article 364/1 Jordanian Civil Law. Also, Civil Cassation 221/91 Bar Association Journal [1993], p 186. It should be noted that if parties to a contract agreed upon the penalty clause in a separate act after making the contract, that separate agreement should have been made before the occurrence of breach. This is because if the agreement on penalty took place after the creditor had suffered the loss as a result of breach it would be considered a conciliation and not a penalty clause. See Morgos, Sulaiman. "Al-Wafi in Explaining the Civil Law". Vol.4 rules of obligations. 2<sup>nd</sup> ed. 1992. P 183. Sultan, Anwar. "Rules of Obligations". Anahdah Press. 1980. P 71-72.

<sup>292</sup> Article 364/2 Jordanian Civil Law.

Jordanian law the courts cannot remove the agreement of the parties, although they can amend it in some cases. As a result it can be said that the law is friendly to penal clauses, unlike English case law, which has for long been unfriendly to those clauses in contracts. Furthermore where the test for the intervention of the court to invalidate penalty clauses in English law is based upon the sum being extravagant and unconscionable, the mere possibility that the sum stipulated is just more than the actual loss is the basis for the intervention of the courts to reduce it in Jordanian law.

The Court of Cassation clearly affirmed numerous times<sup>293</sup> that should a clause be inserted in advance within a contract, upon which it was agreed that a sum of money to be paid as a result of breach, this clause will be both permissible and legal. In its decision No 2141/1999 in 2000, the Court of Cassation has clearly confirmed that:

“It seems sound and valid that one of the parties may provide and the other accepts that a sum of money to be paid on breach as damages. If such damages are not estimated in the law, the contract’s parties may, previously, agree upon it in the principal contract or in subsequent agreement. And in all cases the court can amend such agreement to make the damages equal to the loss sustained. Any agreement to the contrary is to be void in accordance with the article 364 of the civil law. Then, since the claimant did not perform its contractual obligations on the time stated, and did not evidence that there was no loss suffered by the defendant, the latter has the right to receive the amount of penalty”<sup>294</sup>

It can also be inferred from article 364/2 of Jordanian civil law that the rules governing the penalty clause are of the public order and therefore any agreement to the contrary of them shall be deemed not to have been made. The idea of public order has such a broad meaning that it is one of the most complicated legal issues. It has been said that: “it is fully difficult to imagine such a precise definition of public order because of its flexibility, wide boundaries and its changing from time to time and place to place”<sup>295</sup>. However, it can be asserted that it refers to the upper principles of society which every single member should comply with as they are intended to secure public rights. In other words, it is a

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<sup>293</sup> Civil Cassation No 2141/1999. Bar Association Journal. 2001. P 2206. Also Civil Cassation 3326/2000 Adaleh Centre Publications 2000, available at [Info@adaleh.com](mailto:Info@adaleh.com). Civil Cassation No 391/1987. Bar Association Journal. 1990. P 234.

<sup>294</sup> Civil Cassation No 2141/1999. Bar Association Journal. 2001. P 2206.

<sup>295</sup> Morgos, Sulaiman. “Al-Wafi in Explaining the Civil Law”. Vol.1. Assalam Press. 6<sup>th</sup> ed. 1987. P 138-139.

policy related to the political, economic, social and legal identity of the state. Thereby Jordanian law looks at the public order as upper rule that should not be violated<sup>296</sup>.

In the application of this notion on penalty clause rules, Jordanian civil law gives the parties greater latitude than the position in English case law at the time of making the contract to determine their future responsibilities. This enables them to make better decision on their transaction with no or less disorder to public order. As a result parties to a contract have confidence in their agreement on agreed damages clause in advance as their agreement will not at the end be wholly disregarded although it can be modified. In other words, contracting parties might agree on an excessive sum of money to be payable in the event of debtor's breach. Although the law makes such agreement void they trust in their agreed damages clause where the court can reduce it to be equal to the loss suffered. In contrast under the English case law the parties have less confidence in their agreed damages clause as they are always worried of being wholly disregarded by the court where it operates as a penalty.

#### **4:2 Penalty clause is not alternative**

A penalty clause is an accessory method to perform the obligations and does not therefore create an alternative undertaking. Therefore, it is not open to the defaulting party to discharge himself by paying the penalty instead of fulfilling his principal obligation under the contract<sup>297</sup>. The injured party also cannot demand penalty so long as the defaulting party can perform the principal undertaking. Hence, a penalty clause goes with the principal obligation in its validity and nullity. It should be noted that a penalty clause cannot be resorted to except in the following cases:

1-If specific performance has become impossible due to the defaulting party's breach. As mentioned above the principal method to fulfill the obligations under Jordanian civil law is to compel the debtor to carry out his contractual undertakings in accordance with the

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<sup>296</sup> Any provision in contradiction with the public order will be deemed illegitimate. See for that Civil Cassation No 2141/1999. Bar Association Journal. 2001. P 2206. See Al Sanhoori, Abdel Razag. "Commentary on Civil Law, Theory of Obligations". Arabic Torath Press. P 492.

<sup>297</sup> Abu Aso'od, Ramadan. "Rules of Obligations". Dar Almatbo'at. 1998. P 106.

terms set out in that contract<sup>298</sup>. Should specific performance become unfeasible as a result of his own fault the court can resort to penalty clause to compensate the injured party. Furthermore, the injured party can demand penalty if specific performance is not possible or adequate unless it is performed by his debtor in person. Therefore, where the former has contracted to obtain services of a personal quality from the latter, for example, to sing or take part in a film, he may obtain the amount payable under a penalty clause upon non-performance.

2-Specific performance will not be awarded where its effect may cause hardship to the defaulting party. Thus, he will be responsible to pay the amount of penalty<sup>299</sup> since this amount may compensate the injured party for the loss he has suffered. The main example for this case is that when the debtor undertakes not to exceed a certain space in the case of construction but then proceeds to do so. In this instance it is not appropriate for the injured party to claim a specific performance in which the defaulting party should remove the building, as this will cause a heavy burden to the latter. Two limitations are to be met to resort to the penalty clause in this case:

1- *There should be a real hardship that results in inflicting an enormous loss on the defaulting party.* In other words, the court decides the amount payable under penalty clause should be awarded instead of specific performance, as the latter would overburden the defaulting party. However, he can not resist the order of specific performance simply because he is experiencing some financial difficulties, as this is not sufficient to establish hardship. Whether or not specific performance will cause a hardship to the defaulting party is decided at the discretion of the court. It should be noted that the traditional general principles gave the injured party a right to compel the defaulting party on specific performance irrespective of whether specific performance may overburden the latter.

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<sup>298</sup> Article 355/1 of Jordanian Civil Law.

<sup>299</sup> Article 355/2 of Jordanian Civil Law. For example suppose that X rented the second floor of his building, which is still under construction, to some doctors and engineers. However he could perform his obligations as under the pressure of political and economic circumstances the prices of building materials have unreasonably increased. This made X totally unable to complete the second floor to be used by the lessees. Therefore forcing X to perform his contractual duties (delivering the second floor rooms to lessees) will highly overburden him. This gives X the right to demand paying the amount of penalty instead of specific performance.

However, by the application of equity and justice principles the legislator has given the court the authority to resort to penalty clause and damages in the event that specific performance became impossible. Therefore, the defaulting party will be compelled to stick to his bargain unless he can prove that this would result in injustice and hardship<sup>300</sup>.

2- *It will not inflict serious damage on the injured party*<sup>301</sup>. This means that the court should strike a balance between the two opposing interests of the debtor and creditor. If the court can avoid the hardship, which the defaulting party may encounter if it grants specific performance with a simple loss suffered by the injured party, an award of amount of penalty can be granted instead of specific performance. Specific performance may be refused against a defaulting party on grounds of existence of a hardship when the cost to him is wholly out of proportion to the benefit which performance will confer on the injured party. However, if that will lead to inflicting a serious damage on the injured party as the award of amount of penalty would defeat his reasonable aspirations and expectations, the court should award an order of specific performance. This is especially the case when the subject matter is in some way unique, which makes any substitute not satisfactory to the injured party. In such circumstances it is better to award specific performance as the court should prioritise the interest of the injured party over that of the defaulting party. For example a contract for the purchase of antiques, valuable paintings and other irreplaceable items as well as in contracts for the sale of land, specific performance is readily granted as the law takes the view that a purchaser is not readily compensated by damages<sup>302</sup>.

#### **4:3 Accessory nature of penalty clause**

It is asserted that the obligation inflicted on the defaulting party under a penalty clause is not an independent undertaking but one, which is accessory to the principal obligation. The main obligation in the contract is the one which the defaulting party obliges himself to perform, however penalty clause is a secondary undertaking to pay a certain sum of

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<sup>300</sup> The explanatory note of Jordanian Civil Law. Vol.1. 1975. P 392. Al-Sanhoori, Abdel Razag. "Al-Waseet in New Civil Law". Vol.2 Evidence and Rules of Obligations. Arabic Torath Press. 764.

<sup>301</sup> Article 355/2 of Jordanian Civil Law.

<sup>302</sup> Abu Aso'od, Ramadan. "Rules of Obligations". Dar Almatbo'at press. 1998. P56.

money in the event of non performance. Since penalty clause is a secondary obligation, nullity of the principal obligation results in nullity of this clause but not vice versa<sup>303</sup>.

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<sup>303</sup> Civil Cassation 117/1981 Bar Association Journal [1981], p 1473. In this case the court held that: "Since the rule is that if the object is void so is its accessories, the penalty clause included in a void sale contract is accordingly void".

## Chapter Three: Ambit of Application of Penalty Clause Jurisdiction

### 0-Introduction

The distinction in English case law between liquidated damages and penalties is only applicable where there has been a breach of contract committed by the contemplated payer. Although determined efforts have been made to persuade the court to widen the scope of operation of the doctrine of penalties, the arguments advanced in *Export Credits Guarantee Department v. Universal Oil Products Co*<sup>304</sup>, have been firmly rejected. The controversy is found over whether penalty jurisdiction is applicable in a case where the payment of an agreed sum is dependent on the occurrence of a specific event other than breach of contract. This rule is especially capable of causing difficulties in the context of minimum payment clauses in the event of termination of hire-purchase agreements. This unsatisfactory aspect of limiting the ambit of penalty jurisdiction will be critically examined. On the other hand, it seems that the policy of the law against penalties can be so easily circumvented by a trick of drafting. A skilled draftsman may change the form rather than the substance of a clause in a way that takes it outside the penalty jurisdiction. How can this be achieved and how does the law deal with such a situation? Is it regarded as satisfactory to manipulate the law regarding penalties by changing in forms of the clause?

Under English case law the injured party can not recover all losses. He is limited to losses which are recoverable under the so-called *Hadley v. Baxendale* rules. However, what is the position if parties to a contract have pre-estimated the damages that can be paid on breach without taking into consideration the remoteness rule? Therefore, the following issues will be now examined:

- 1- The limit upon ambit of the operation of penalty clause (necessity of breach)
- 2- Loss to be estimated
- 3- Evasion of penalty clause rules

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<sup>304</sup>*Export Credits Guarantee Department v. Universal Oil Products Co* [1983] WLR 399.

## 1- Limit upon the ambit of the operation of penalty jurisdiction

### 1:1 Necessity for breach

In *Philips Bernstein (Successors) Ltd v. Lydiate Textile Ltd*<sup>305</sup> Lord Diplock stated confirming that the penalty area is confined “to cases where there is a prior agreement by the parties to the contract as to an amount to be paid by the party in breach to the other party in respect of that breach”. Therefore, if an agreed sum is penal in nature but payable on some event other than breach, it will remain payable<sup>306</sup>. In other words, the penalty jurisdiction does not apply unless the sum specified as agreed damages is payable by the defaulting party upon his committing a breach of contract. This restriction in English law excludes some cases in which injustice is clear. It makes a distinction between the sum fixed in the contract by parties, and payable on breach of a primary obligation under a liquidated damages clause and a payment payable on the occurrence of some events not constituting a breach of contract by the payer. This distinction may have existed because whilst formulating the present rules a number of judges in the *Dunlop* case<sup>307</sup> “imprudently (but understandably) overlooked the possibility” that an agreed sum could be payable on the occurrence of events other than on breach<sup>308</sup>. However, the application of this principle, i.e. breach of contract as a precondition to invoke penalty jurisdiction, was justified as achieving the purpose of activation of the penalty rule. The goal is to prevent an injured party from recovering a sum of money by reason of a breach made by the defaulting party when that sum has little or no link to the loss sustained by the former as a result of latter’s breach. Courts have never undertaken to grant relief to the party because of what might be evident, in some events, to be a harsh or unreasonable

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<sup>305</sup> *Philip Bernstien (Successors) Ltd v. Lydiate Textiles Ltd* Unreported, June 26, 1962; Court of Appeal (Civil Division) No.238 of 1962.

<sup>306</sup> For general information about breach of contract as a precondition for the application of penalty rule see Halson, Roger. “Contract Law”. First published in Great Britain. Longman. 2001. P 509-512. Lal, Hamish. “The Doctrine of Penalties and the “absurd paradox”: Does it Really Matter in 2003?” [2003] *The International Construction Law Review*. 505, at 508-510. Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. (1985) 10. *Sydney Law Review*. 503, at 519-522.

<sup>307</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>308</sup> Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. (1985) 10 *Sydney Law Review*. 530, at 520.

commercial bargain<sup>309</sup>. This is because there is no “general principle of equity which justifies the court in relieving a party to any bargain if in the event it operates hardly against him”<sup>310</sup>. Moreover, it should be noted that the rule against penalties is an old equitable principle and has survived a long time despite involving a strong judicial power to override the express terms of a contract<sup>311</sup>. As a result an important decision of the House of Lords has affirmed the restriction of the operation of the penalty rule to the sum payable on breach<sup>312</sup>.

In its working paper the Law Commission recommended that the penalty jurisdiction should be applied whether or not there is a breach<sup>313</sup>. However the courts in this recommendation took no action and the House of Lords insisted in *Export Credits Guarantee Department v. Universal Oil Products Co*<sup>314</sup> that penalty jurisdiction is only applicable where the agreed sum becomes due as a result of breach by the payer. It was pointed out in this case that the breach, which makes the penalty rule applicable must be of a contractual promise made by the payer to the payee. Hence, not every breach is capable of activating penalty clause rules. It should be between the contracting parties and not with a third party who may have a link with the main contract.

In the case of *Export Credits Guarantee Department v. Universal Oil Products Co*<sup>315</sup> A had contracted to build a refinery for B. C had undertaken responsibilities as guarantor for the financing of project. A and C made an agreement under which A promised to reimburse C for any payments that C would have to pay to B under the guarantee. A defaulted under the finance agreement with B and so C’s guarantee was called upon. As a result of this C claimed reimbursement from A, who alleged that the clause concerned

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<sup>309</sup> *Export Credits Guarantee Department v. Universal Oil Products Co* [1983] 1 WLR 399, at 403 per Lord Rskill.

<sup>310</sup> *Bridge v. Campbell Discount Co* [1962] AC 600, at 614 per Lord Viscount Simonds.

<sup>311</sup> Atiyah. P. S. “An Introduction to the Law of Contract”. 5<sup>th</sup> ed. Clarendon Press. 1995. P 435.

<sup>312</sup> *Export Credits Guarantee Department v. Universal Oil Products Co* [1983] 1 WLR 399

<sup>313</sup> The Law Commission in its Working Paper No. 61. “Penalty Clause and Forfeiture of Monies Paid”. London. Her Majesty stationery Office, 1975. P 18-19.

<sup>314</sup> *Export Credits Guarantee Department v. Universal Oil Products Co* [1983] 1 WLR 399 [1983] 1 WLR 399, at 403

<sup>315</sup> *Ibid.* See for general analysis on this case Fox, D W. “Limiting the Ambit of Penalty Clauses”. Solicitors’ Journal. (1984). vol. 128. 179. See also the case of *Tool Metal M Co Ltd v. Tungsten Elec Co Ltd* [1955] 2 All ER 657, at 662.

was a penalty. The House of Lords rejected A's claim and decided that the stipulation was not a penalty as it provided for the payment of money on a specified event other than breach of contractual duty owed by the contemplated payer(C) to the contemplated payee (A). Rather the payment was due because of breach committed in another contract between A and B.

This means, the penalty rule was not applicable so long as the clause provided for the payment of money on the happening of a specified event rather than a breach of the type described. Lord Roskill explained the reasoning for this principle saying:

“My Lords, one purpose, perhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiffs as a result of the breach by the defendants. But it is not and never has been for the courts to relieve a party from the consequences of what may, in the event, prove to be an onerous or possibly even imprudent commercial bargain”<sup>316</sup>

One might argue that the event for which the sum became payable in this case was a breach of contract. However it should be noticed that the breach involved was not breach of contractual promise between the promisee and the promisor but rather the breach of another contract with a third party. This has been clearly confirmed by Lord Roskill when he explained the reason of the final judgment that: “the reason why the appellants' submissions failed in the courts below can be simply stated. The clause was not a penalty clause because it provided for payment of money upon the happening of a specified event other than a breach of a contractual duty owed by the contemplated payer to the contemplated payee”<sup>317</sup>. Consequently, in this case the House of Lords unanimously rejected the invitation to extend the penalty rule to include payments conditioned on the happening of events other than breach. This leads to examine the cases in which the penalty rule does not apply and the problems of this principle.

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<sup>316</sup> *Export Credits Guarantee Department v. Universal Oil Products Co* [1983] 1 WLR 399. At 403. See also *Tool Metal M Co Ltd v. Tungsten Elec Co Ltd.* [1955] 2 All ER 657, at 662.

<sup>317</sup> *Export Credits Guarantee Department v. Universal Oil Products Co* [1983] 1 WLR 399, at 402.

## **1:2 Cases in which the principle of necessity for breach is upheld**

It is natural to say that according to the foregoing discussion that rules regarding penalties and liquidated damages are inapplicable where there is no breach of contract. This is the situation even though the sum stipulated is unconscionable or extravagant. As a result the penalty jurisdiction has no application in the following situations:

### **1:2:1 Reimbursement Clause**

Where the parties stipulate that a sum of money which was paid under the contract is to be repaid to the original payer on the occurrence of certain event, no question of whether this sum is a penalty or liquidated damages arises. The clause concerned in this situation is the reimbursement clause<sup>318</sup>.

This situation is clearly illustrated in *Alder v. Moore*<sup>319</sup> where it was affirmed that there should be breach of contract to apply the rule against penalty. In this case an injured football player received a sum of money from his insurers which was paid in consideration of him having to give up professional football. It was provided that the same amount was to be repayable if the player started to play football again. The player signed a declaration that he would not play professional football again and in the event of infringement of this condition, he would be subjected to a penalty of the amount paid to him in settlement of his claim. The defendant began playing football four months after signing the declaration and the claimant sought a recovery of £500. The defendant argued that the clause was a penalty and that the insurers had sustained no loss by his resuming playing football again.

Confirming that rule against penalty does not apply where there is no breach, the argument of the player was rejected on the basis that there is no application of such rule since he committed no breach of contract when he did play again. This was justified on the basis that the contract concerned had reimbursement clause, which stands outside the scope of operation of penalty clause rules, as the payment was due on a certain event,

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<sup>318</sup> Chitty on Contract, 29<sup>th</sup> ed. Vol. 1 General Principles. Sweet & Maxwell. 2004. P 1499-1500.

which was not a breach of contract, and that the event having taken place the sum was repayable.

## **1:2:2 Termination clauses in hire purchase agreements**

Where the agreement provides that the owner can determine it on the occurrence of an event other than breach, the penalty jurisdiction will have no application. This principle has many examples of such events whereby events do not constitute a breach and so stand outside the scope of activation of penalty jurisdiction.

### **1:2:2:1 Death and liquidation of the Hirer**

It might be agreed between the parties that the minimum payment clause would be payable in the event of death or bankruptcy without any default by the hirer.<sup>320</sup> Therefore, the clause would be enforced on the occurrence of any of these circumstances. If due to the death of the hirer, the owner had determined the hiring agreement and claimed the agreed sum, there would be no question of whether the sum stipulated is a penalty or liquidated damages could arise in such situation<sup>321</sup>. This is because the sum specified “was a sum payable in respect of one event, namely, the determination and end of the hiring agreement...”<sup>322</sup>. An illustration of this can be found in *Re Apex Supply Co. Ltd*<sup>323</sup> where there was a hire purchase agreement between two companies. It was provided that if the hiring company terminated the contract, the owner company should repossess the goods and the former would pay a certain sum of money as compensation for depreciation of the subject matter. After the hiring company has gone into liquidation the owner company exercised its right given under the agreement and terminated it. Considering four unreported cases,<sup>324</sup> Simonds LJ held that the question of whether the sum agreed to be paid as compensation was a penalty or liquidated damages did not arise

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<sup>319</sup> *Alder v. Moore* [1961] 2 QB 57.

<sup>320</sup> See *Cooden Engineering Co. Ltd v. Stanford* [1953] 1 QB 86, at 98 per Somervell LJ.

<sup>321</sup> *Chester & Cole v Wright* 1930 noted in Jones & Proudfoot's notes on hir-Purchase Law. 2<sup>nd</sup> ed. P 124.

<sup>322</sup> *Ibid.* Per Creer LJ.

<sup>323</sup> *Re Apex Supply Co. Ltd* [1942] Ch 108.

<sup>324</sup> (*Elsey and Co Ltd v Hyde, Chester and Cole Ltd v Avon, Roadways Transport Development Ltd. v Browne & Gray and Chester and Cole v Wright*) These cases were mentioned in Jones & Proudfoot's notes on hire-purchase law. 2<sup>nd</sup> ed. At 107, 115, 118 and 124 respectively.

since “That this is a contract for the payment of certain sum in certain event and, that event having happened, that sum is payable”<sup>325</sup>.

### **1:2:2:2 Where the hirer himself terminates the hiring agreement**

The hirer may resort to his contractual right and terminate the hiring agreement. In such a case will he have a relief against penalties? English case law has settled that the penalty jurisdiction in this instance is irrelevant as the hirer exercising his option does not constitute a breach<sup>326</sup>. Hence, if the contract is determined by the hirer in conformity with the option given to him under the hiring agreement, the sum which must be paid accordingly is neither liquidated damages nor a penalty, but is a sum payable on the happening of a certain event<sup>327</sup>. In *Chester and Cole v Wright*<sup>328</sup> Greer LJ approved this principle on the basis that:

“There is no reason in law why, for a sufficient consideration, there should not be in the same document two contracts, one a contract to hire the motor-car on the terms of the agreement, and another, a contract that if that agreement comes to an end, then a certain sum will be payable by the hirer”<sup>329</sup>.

The question of whether the sum stipulated, which becomes payable as a result of hirer’s exercising his option to terminate the hiring agreement, is encompassed in the application of rule against penalties had come before the Court of Appeal in *Associated Distributors Ltd v Hall*<sup>330</sup>. In this case the hire purchase agreement was for hiring bicycle for which the price had to be paid in 52 weekly instalments. Clause 5 of the agreement gave the defendant (Hall) the right to terminate the hiring at any time and return the subject matter to the owner. Under clause 7<sup>331</sup> the hirer had to pay a sum of money as compensation for depreciation of the goods in addition to any other sum payable under the hiring contract. The amount paid before for rent had to make up a sum equivalent to not less than one-half of the total amount. The defendant having exercised his option and returned the subject matter after paying just one instalment, the claimant sued for the arrears of the

<sup>325</sup> In *Re Apex Supply Co. Ltd* [1942] Ch 108, at 119.

<sup>326</sup> *Bridge v. Campbell Discount Co.* [1962] AC 600

<sup>327</sup> See *Chester & Cole Ltd v Wright* 1930 noted in Jones & Proudfoot’s notes on hir-Purchase Law. 2<sup>nd</sup> ed. P 124. Per Lord Greer.

<sup>328</sup> *Ibid.*

<sup>329</sup> *Ibid.*

<sup>330</sup> *Associated Distributors Ltd v. Hall* [1938] 2 KB 83.

rent and any other amount due under clause 7. The claimant alleged that the clause was not a penalty as the contract was terminated by the exercise of an option by the hirer.

The Court of Appeal sustained the claim as it is only where there is a breach of contract the penalty rule is relevant. In delivering the judgment Slesser LJ<sup>332</sup> indicated the difficulty involved in this case where the owner as a result of default by the hirer could also have terminated the contract under clause 7 by the exercise of an option. However, "Here the hirer, not the owner, terminated the hiring. He has exercised an option and the terms on which he may exercise the option are those set out in cl. 7. The question therefore whether these payments constitute liquidated damages or a penalty in the instances mentioned does not arise in the present case"<sup>333</sup>.

This situation, where the hirer chooses to determine the hiring agreement, is puzzling and an object of controversy as it results in unjust consequences where it favours the less deserving hirer who acts in breach and refuses to pay the instalments. This leads to an unsatisfactory aspect of exacting a breach of contract by the payer to place the case within the ambit of penalty jurisdiction.

### **1:3 Unsatisfactory aspect in confining the penalty jurisdiction on breach**

Because the law on penalty clauses applies only when there is a breach of contract, it should be conceded that this principle produces some anomalous results by excluding from the scope of the penalty rule some clauses, which may be equally penal in effect. In other words, this approach excludes from the scope of the penalty jurisdiction a provision for the payment of what might be an extravagant and unconscionable sum of money upon some event other than breach<sup>334</sup>. If, for example, the agreed sum becomes payable on the purchaser turning out to be insolvent, being jailed, or leaving the country, then the sum is

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<sup>331</sup> Ibid. At 84.

<sup>332</sup> Ibid. 88 per Lord Slesser.

<sup>333</sup> Ibid. 88 per Lord Slesser.

<sup>334</sup> McKendrick, Ewan. "Contract Law". 5<sup>th</sup> Ed. Macmillan. 2003. P 446. Halson, Roger. "Contract Law". First published in Great Britain. Longman. 2001. p 510. Downs, T A. "Rethinking Penalty Clauses". In wrongs and remedies in the twenty-first century. Edited by Peter Birks. Clarendon presses, Oxford. 1996. P 255-256. Meagher, R. B. "Penalties in Chattel Leases". In Essay in Equity. Edited by P. D Finn. The Law Book Company Limited. 1985. P 46, at 55.

not payable on breach and does not constitute a penalty clause. Besides the penalty jurisdiction can often be readily avoided by a draughtsman in drafting a provision in a way that makes the specified sum payable on an event other than breach of contract<sup>335</sup>.

On top of that this principle also produces results which appear undesirable in practice whereby the hirer uses his option to terminate the hiring agreement. This issue necessitates critical scrutiny and will be tackled in light of *Bridge v. Campbell Discount Co* case<sup>336</sup>.

### 1:3:1 The problem of breach in hire purchase contract

The problem of breach in termination clauses originates from the following unsatisfactory paradox. If hirer gives a notice to owner to rescind the contract early, the contract may provide that the former to make the payment of a minimum sum as compensation for loss suffered by the latter. Since the agreement is terminated on a particular event, which does not constitute a breach of contract, the penalty rule will not apply and hirer will be denied relief. In contrast if hirer commits a breach<sup>337</sup> by not performing his contractual obligations under the contract, the penalty rule will apply to this case and render the agreed sum clause unenforceable<sup>338</sup>. This paradox had been

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<sup>335</sup> Halson, Roger. "Contract Law". First published in Great Britain. Longman. 2001. P 518-519 where he stated that: "This enables a penalty clause to be disguised, for instance, a car hire company concerned to ensure the prompt payment of its usual rate of hire of £100 per day might use the following techniques. First, by using the alternative considerations techniques, the rate of hire the car might be expressed to be £100 per day paid in advance or £200 per day if paid in arrears. Second, by using the discount techniques, the rate of hire might be expressed to be £200 with a 50 per cent discount for the payment in advance. The key to either technique is that the contract must be drafted to ensure that the hirer's failure to pay £100 in advance is not a breach of contract".

<sup>336</sup> *Bridge v. Campbell Discount Co* [1962] AC 600.

<sup>337</sup> In hire purchase agreement it has long been accepted that a clause providing for a sum of money payable on termination of agreement (in itself not an event of breach) is still within the ambit of rule against penalty clause if one of the grounds on which the agreement might be terminated is breach. otherwise it will not do so. This is what was initially decided in *Cooden Engineering Co. Ltd v. Stanford* [1953] 1 QB 86 before being affirmed by the House of Lords in *Bridge v. Campbell Discount Co* [1962] AC 600. and again by the Court of Appeal in *Financings Ltd v. Baldock*. (1963) 2 QB 104. See also for that Meagher, RP. "Penalties in Chattel Leases" in "Essays in Equity" edited by PD Finn, The law book company limited. 1985 46. Ziegel, Jacob S. "The Minimum Payment Clause Muddle". Cambridge Law Journal. [1964] 108, at 110-114. Hughes, AD. "Damages and Penalties in Hire-Purchase". Journal of business Law. [1962] 252.

<sup>338</sup> Poole, Jill. "Textbook on Contract Law". 7<sup>th</sup> ed. Blackstone Press. 2004. P 452. Beatson, J. "Anson's Law of Contract". 28<sup>th</sup> ed. Oxford University Press. 2002. P 629. Lal, Hamish. "The Doctrine of Penalties and the "absurd paradox": Does it Really Matter in 2003?". The International Construction Law Review. [2003] 505, at 510-511. Furmston, M P. "Contract Planning: Liquidated damages, Deposit and the

attacked by Lord Denning in *Bridge v. Campbell Discount Co.*<sup>339</sup>. His Lordship remarked unfavourably on this paradox saying “Let no one mistake the injustice of this, it means that equity commits itself to this absurd paradox: it will grant relief to a man who breaks his contract but will penalise the man who keeps it”<sup>340</sup>. In this case the hirer entered into a hire-purchase agreement with a finance company to buy a car. Clause 6 of the agreement gave the hirer the right to terminate the agreement at any time by giving notice to the owners. Clause 9 provided that if the agreement was for any reason terminated before the vehicle became the hirer’s property the hirer “shall forthwith...pay to the owners...by way of agreed compensation for depreciation of the vehicle such further sums...equal to two-third of the hire-purchase price”<sup>341</sup>. The hirer paid one monthly instalment on the total hire-purchase price and notified the company in writing afterwards to the effect that he couldn’t keep up paying the instalments. He said that: “Owing to unforeseen personal circumstances I am very sorry but I will not able to pay any more payments on the Bedford Darmobile... I am very sorry regarding this but I have no alternative”. Shortly after writing this letter the hirer returned the car to the company.

The Court of Appeal<sup>342</sup> decided that the sum stipulated was not a penalty since the action taken by the hirer did not amount to breach. The court justified this holding, referring to the decision in *Associated Distributors Ltd v. Hall*<sup>343</sup>, that the hirer’s notice amounted to an exercise of the option granted in clause 6 to determine the contract. That is, according to the orthodox approach that exacts the breach, the penalty is irrelevant in this case.

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Foreseeability Rule”. *Journal of Contract Law*. [1991] 1, at 8. Clarke, Mr Justice M J R. Commentary on “Contract Planning: Liquidated Damages, Deposit and the Foreseeability Rule”. *Journal of Contract Law*. [1991] 11, at 12-13. Waddams, S M. “Unconscionability in Contract”. *Modern Law Review*. (1976) Vol.39 (4) 369, at 375.

<sup>339</sup> [1962] AC 600.

<sup>340</sup> *Bridge v. Campbell Discount* [1962] AC 600, at 629 per Lord Denning.

<sup>341</sup> *Bridge v. Campbell Discount Co* [1962] AC 600.

<sup>342</sup> *Bridge v. Campbell Discount Co* [1961] 1 QB 445.

<sup>343</sup> *Associated Distributors Ltd v. Hall* [1938] 2 KB 83.

However, this decision was reversed by the House of Lords<sup>344</sup> which by the majority<sup>345</sup> held that there was a breach of contract by the hirer and there had to be relief against the penal sum stipulated. This was because the amount due under clause 9 was not a genuine pre-estimate of damages as the amount payable under the clause would decrease the longer the vehicle was still under the hirer's possession<sup>346</sup>. Therefore, the sum stipulated would become smaller with each instalment paid while the vehicle became older and its value decreases over the passage of time. Accordingly there was no evidence that the hirer had any intention of exercising the option granted to him by clause 6. Moreover, it was confirmed that the letter written by the hirer that he could not keep up the payment of instalments "...means that the writer feels reluctantly compelled to break his agreement"<sup>347</sup>. Why else should the hirer twice apologise humbly if he thought that he was merely exercising an option given to him by the agreement? Since the unjust consequences are clear in delimiting the application of penalty rule on breach, how can the problem of breach or paradoxical situation in the hiring agreement be solved?

### **1:3:2: How can the problem be solved?**

To reiterate under the current law the jurisdiction of penalty clauses applies only where there is a breach of contract and not where the one party, in particular the hirer in hire purchase contract, uses his contractual option to end the contract. In all cases this leads to unjust outcomes as the existing law gives the party in breach the right to seek judicial scrutiny of a penalty whilst the party who exercises its option may not. Therefore, which approach would be preferable, the existing one or the extension of penalty jurisdiction?

#### **1:3:2:1 Undesirable extension of the penalty jurisdiction**

In spite of the aforementioned paradox there is an approach, which prefers not to apply the penalty rule to cases where the agreed sum becomes payable on event other than breach. The argument for this view runs as follows: that the extension of the penalty

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<sup>344</sup> *Bridge v. Campbell Discount Co* [1962] AC 600. The same facts were repeated in *United Dominions Trust (Commercial) Ltd v. Ennis* [1968] 1 QB 54 and again the court was careful to decide that the hirer was not actually exercised his option and their lords did not give any decisive view about the applicability of rules against penalties on the event if the hirer had really exercised his option.

<sup>345</sup> Lords Morton, Radcliff, Devlin and in the alternative Lord Denning.

<sup>346</sup> *Bridge v. Campbell Discount* [1962] AC 600, at 623 per Lord Radcliff.

<sup>347</sup> *Ibid.* At 615 per Lord Morton.

jurisdiction would inevitably lead into new general equitable remedies and into new break with the old rules of freedom of contract with which the penalty rules have always been in conflict. This means that courts without proof of improper conduct by one party should not upset the freely made bargains<sup>348</sup>.

The undesirability of extending penalty jurisdiction had been reaffirmed in *Export Credits Guarantee Department v Universal Oil Products Co*<sup>349</sup> by Lord Roskill. He declared that the principle of the applicability of rule against penalties on breach had been settled and expressed his desire not to change what has been well established. He quoted, with entire agreement, the concluding observation asserted by Diplock LJ in *Philip Bernstien (Successors) Ltd v Lydiate Textiles Ltd*<sup>350</sup>: "I, for my part, am not prepared to extend the law by relieving against an obligation in a contract entered into between two parties which does not fall within the well defined limits in which the court has in the past shown itself willing to interfere"<sup>351</sup>. Therefore the concluding view of this approach is that relief against penalties should be confined to cases where the agreement is determined on breach. This view finds some support in *Bridge* case<sup>352</sup>. After deciding that clause 6 in the agreement is not in the nature of penalty, it had been pointed out that the hirer when he agreed to pay a price was given the option to exercise his right to determine the hiring agreement, as it seemed appropriate for him. "...He needs not exercise it if he does not want to"<sup>353</sup> or in other words he "is free to exercise it or to disregard it, as he thinks fit"<sup>354</sup>. Accordingly, it had been said that the holding in *Associated Distributors Ltd v Hall*<sup>355</sup> - where it was held the inapplicability of rule against penalties because the hiring agreement was determined by the hirer in exercising his option- was rightly decided. Consequently, unless the sum became payable on the

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<sup>348</sup> Wedderburn, K. W. "Hire Purchase-Penalties-Freedom of Contract". Cambridge Law Journal. [1961] 156, at 158. Also Fridman, G.H.L. "Hire-Purchase: Esstoppel-Penalties". Modern Law Review. [1961] 502, at 509.

<sup>349</sup> *Export Credits Guarantee Department v Universal Oil Products Co*. [1983] 1 WLR 399 at 404 per Lord Roskill

<sup>350</sup> *Philip Bernstien (Successors) Ltd v Lydiate Textiles Ltd* Unreported, June 26, 1962; Court of Appeal (Civil Division) No.238 of 1962. Cited in *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 at 404 per Lord Roskill.

<sup>351</sup> Ibid.

<sup>352</sup> *Bridge v. Campbell Discount Co* [1962] AC 600. Lord Viscount Simonds and Lord Morton of Henryton.

<sup>353</sup> Ibid. At 613 per Lord Viscount Simonds.

<sup>354</sup> Ibid. At 617 per Lord Morton of Henryton.

occurrence of breach, it could not be struck out as a penalty<sup>356</sup>. However, what is the justification of the approach, which seeks to extend the control of penalty clause to events other than breach?

### **1:3:2:2 Extension of application of the penalty jurisdiction**

Since the most frequent and oldest reason or rather the true basis of the penalty and liquidated damages distinction is unfairness<sup>357</sup> it is an odd rule to make such distinction only applicable on breach. This principle prompts the hirer under a hire purchase contract to default in payment in order to be in breach of contract rather than exercising his option to determine the contract. Furthermore, as it was pointed out by Lord Denning in *Bridge* case<sup>358</sup>, the hirer who wishes to return the goods will be better off if he commits a breach of contract than he would be if he exercises his option to terminate the agreement. In other words, the hirer who breaks the contract by failing to pay instalments may claim that the minimum payment clause is in penal nature. However, the hirer who decides to use a contractual right to determine the agreement in a lawful manner may not so claim, though the consequences of the clause are exactly in penal nature.

This position is, under the existing law, both “illogical and unjust”<sup>359</sup>. Such a distinction, namely, between termination on breach and in exercising the hirer his option, seems to be of little importance and unreasonable. In either case there is the same non-performance

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<sup>355</sup> *Associated Distributors Ltd v. Hall* [1938] 2 KB 83.

<sup>356</sup> Lord Viscount Simonds and Lord Morton of Henryton in *Bridge v. Campbell Discount Co* [1962] AC 600.

<sup>357</sup> Which indicates in this place the disproportion between the agreed sum and the actual loss suffered. In other words, it is asserted that it is unfair to allow the injured party to extract an excessively large sum from a defaulting party. This argument rests on two separate ideas: first: that invalidity of penalty clause often stems from abuses in the bargaining process, that is of procedural unfairness. See for this Goetz, Charles J. and Scott, Robert E. “Liquidated Damages, Penalties and the Just Compensation Principle: some Notes on an Enforcement Model and a Theory of Efficient Breach”. *Columbia Law Review*. (1977) 77, 554 at 591. Beale, Hugh. “Remedies for Breach of Contract”. Sweet and Maxwell. 1980. P 59. Burrows, Andrew. “Remedies for Torts and Breach of Contract”. 2<sup>nd</sup> ed. Butterworths. 1994. P 329. Second, that to allow the injured party to recover damages in excess of its actual loss is simply result in the deviation of the basic principles of justice. This rests on the natural justice argument, which adopts the compensatory principle as a moral standard and rejects penalty clauses because they are contrary to this principle, that is of the substantive unfairness. See for this Kaplan, Philips R. “A Critique of the Penalty Limitation on Liquidated Damages”. *Southern California Law Review*. (1977) 55, 1055 At 1070.

<sup>358</sup> *Bridge v. Campbell Discount* [1962] AC 600, at 629 per lord Denning.

<sup>359</sup> Goode, R.M. “Hire-Purchase Law and Practice”. 2<sup>nd</sup> ed. 1970. 392. Furmston, M P. “Contract Planning: Liquidated damages, Deposit and the Foreseeability Rule”. *Journal of Contract Law*. [1991] 1, at 8.

and the same stipulation for payment of compensation<sup>360</sup>. The only difference between the two situations is the action taken by every hirer. In the former there is an adept and clever hirer who rejects paying the instalment on time and goes through a long process by breaching the contract. Although he infringes the law, he will benefit from the advantage given to him from the penalty rule. On the other hand, there is an honest hirer who feels that he cannot carry on paying the due instalments and writes to the owner with great sorrow that he cannot do so and terminates the agreement immediately without any delay or deception. Therefore, it is submitted that this compromise is unsatisfactory as it puts a hirer who complies with law and acts conscientiously in a worse off position than one who breaks the law and avoids liability by invoking the penalty jurisdiction<sup>361</sup>.

The *Bridge v. Campbell Discount Co*<sup>362</sup> affirms that such a distinction will, as between two hirers, result in activating the penalty rule in favour of the less deserving one. Lord Denning indicated that applying the narrow approach of confining the rule against penalty clauses on breach of contract means that:

“If Mr. Bridge, after a few weeks, finds himself unable to keep up the instalments and, being a conscientious man, gives notice of determination and returns the car, without falling into arrear, he is liable to pay the penal sum without relief of any kind. But if he is an unconscientious man who falls into arrear without saying a word, so that the company retakes the car for this default, he will be relieved from payment of penalty”<sup>363</sup>

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<sup>360</sup> McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 476. Lord MacDermott in a Northern Ireland case of *Lombank Ltd v Kennedy and Lombank Ltd v. Grossan* [1961] NI 192 Court of Appeal in Northern Ireland. In this case the majority of the Court of Appeal held that the hirer exercised his option to rescind the contract and so there is no application of penalty rule. However, in his powerful dissent Lord MacDermott gave his view (at 207) of the applicability of penalty rule “when non-performance is not actionable in itself as when it is. In either case the essential question is surely the same-is the relevant stipulation calculated to secure the performance of the hiring”.

<sup>361</sup> Treitel, Sir Guenter. “The Law of Contract”. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1005. McGregor. “McGregor on Damages”. 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 476. Goode, R. M. “Hire-Purchase Law and Practice”. 2<sup>nd</sup> ed. Butterworths. 1970. P 392. McKendrick, Ewan. “Contract Law”. 5<sup>th</sup> ed. Macmillan. 2003. P 446. Furmston, M P. “Contract Planning: Liquidated damages, Deposit and the Foreseeability Rule”. *Journal of Contract Law*. [1991]1, at 8. This point of view has its support in *Bridge v Campbell Discount Co. Ltd* [1961] 1 QB 445 at 458.

<sup>362</sup> *Bridge v. Campbell Discount Co* [1962] AC 600.

<sup>363</sup> *Ibid.* At 629.

Consequently, due to the unfairness and undesirable outcomes that appear in practice as clarified above, it would be preferable to extend the operation of penalty jurisdiction to the case where hirer himself elects to terminate the hiring agreement.

It has been argued above<sup>364</sup> that the penalty rule should not be extended to an event other than breach as the equitable principle has now been well established. However, in deciding the application of penalty jurisdiction the distinction between the situation in which the termination of hire purchase agreement based on hirer's breach and that based on hirer's right to exercise his option is not historically justified and has led to extraordinary anomalies<sup>365</sup>. Therefore, this approach, including the situation in which the hirer terminates the hiring agreement within the spirit and purpose of the penalty jurisdiction, will not be considered as a break within the history and established precedent. This situation can be included within the established principles without creating any new equity. From the very earliest times equity has granted relief against penalties in the event of breach or against penalties where there is no breach, i.e. in the event of non-performance of a condition<sup>366</sup>. The reason for this approach was clearly pointed out by Lord MacDermott in Northern Ireland case of *Lombank Ltd v. Kennedy and Lombank Ltd v. Grossan*<sup>367</sup>. In his dissenting judgment he indicated that to apply the penalty jurisdiction to the situation where the hirer elects to exercise a contractual right to terminate the agreement, "the question is not one of extending the principles of the rule but of applying them to a modern form of contract dealing with a modern form of transaction"<sup>368</sup>.

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<sup>364</sup> See supra. P 95.

<sup>365</sup> The well-known example for that is the problem of breach in hire-purchase agreement. Supra. P 88.

<sup>366</sup> Take, for example, the common penalty bond where the promisor was usually relieved in the event of non performance of a condition. Though there was no breach of contract the court of equity relieved the promisor in pursuance of its general power to grant relief against penalties. See for explanation about some cases of penalties for non performance of a condition the case of *Bridge v Campbell Discount Co.* [1962] AC 600, at 629-631 per Lord Denning. See also Waddams, SM. "Unconscionability in Contracts". Modern Law Review. (1976) 39 (no.4) 369, at 375.

<sup>367</sup> *Lombank Ltd v. Kennedy and Lombank Ltd v. Grossan* [1961] NI 192 Court of Appeal in Northern Ireland. This case was referred to by Lord Denning *Bridge v. Campbell Discount Co* [1962] AC 600, at 631 where he said that: "I find myself in entire agreement with the judgement of Lord MacDermott in *Lombank Ltd v Kennedy and Lombank Ltd v. Grossan* from which I have profited much".

<sup>368</sup> *Ibid.* At 208 per Lord MacDermott.

Other reasons can also be put forward to support this view, which seeks the application of the penalty jurisdiction to a case where the hirer himself uses his contractual right and terminates the agreement:

1-When a hirer terminates the hiring agreement in exercising his contractual right, he does it deliberately without any force from an owner but under the pressure of the circumstances he encounters to avoid further losses. In doing so he makes his decision to terminate the agreement after taking into his account all the consequences especially his liability for owner's loss. Hence, granting relief against a penalty when the agreement has been terminated because of an event other than breach, will not affect the owner's entitlement to damages for the loss suffered as a result of the termination of the agreement<sup>369</sup>.

It is well established that where there is a breach of contract the courts would grant relief against penalty clauses. Although the courts would not enforce the penalty clauses at all, the loss actually suffered would be recoverable instead. Why does the same effect not apply where there has been no breach of contract? Lord MacDermott confirms in the Northern Ireland case of *Lombank Ltd v. Kennedy and Lombank Ltd v. Grossan*<sup>370</sup> that:

“In the case of the breach or non-performance which is actionable what equity says to the parties is, in effect, this- ‘You have agreed that a measured sum for compensation will be payable. That is really a penalty to secure performance and will not be enforced. But notwithstanding what you have agreed, the loss actually suffered will, as a matter of fairness, be recoverable instead.’ There seems to be no good reason why equity should not speak in the same terms where the non-performance is not actionable, and all the more so where the differences between what is actionable and what is not depends on a provision which does not really affect the equities of the situation.”<sup>371</sup>

2-In the *Bridge v Campbell Discount Co*<sup>372</sup> case , after the House of Lords held that the hirer was in breach of contract and so the clause was an unenforceable penalty, Lord

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<sup>369</sup> *Bridge v. Campbell Discount Co* [1962] AC 600, at 632.

<sup>370</sup> *Lombank Ltd v. Kennedy and Lombank Ltd v. Grossan* [1961] NI 192

<sup>371</sup> *Ibid.* At 208.

<sup>372</sup> *Bridge v. Campbell Discount Co* [1962] AC 600 [1962] AC 600.

Denning<sup>373</sup> indicated that the result would have been the same even if the hirer had not been in breach of contract. His Lordship remarked<sup>374</sup>, after considering *Associated Distributors Ltd v. Hall*<sup>375</sup> to be wrongly decided, that penalty jurisdiction is applicable to stipulations which requires the hirer to pay a minimum payment sum when the contract is determined as a result of using his contractual right. Consequently, the court should not apply the aforementioned distinction as “the minimum payment clause is a single and indivisible and no just distinction can be drawn between the cases where the hirer is in breach and where he is not”. Accordingly the courts should relieve against penalty provisions whatever the reason in which the hiring is being terminated. Burrows, in his book<sup>376</sup>, has commended this approach taken by Lord Denning on the grounds that the agreed sum payable upon termination or breach has the same purpose:

“Like agreed sums payable on breach, the purpose of agreed sum payable on an events closely allied to breach is either to pre-estimate the plaintiff’s loss caused by the “event” or to punish the defendant for, and hence deter him from, failure to perform. To distinguish them from agreed sums payable on breach does, therefore, produce unsatisfactory paradoxes”<sup>377</sup>

Lord Devlin approached the matter from a much narrower point of view. He argued that since the majority in *Bridge* case was to hold that the clause was sham and contained no genuine pre-estimate of the loss suffered by the injured party “it means that it was never made and does not exist; if it does not exist, it must be ignored altogether”. This is to say that if the clause is a sham when the contract is terminated on breach, it can not logically be regarded as a genuine when the hirer uses his contractual right and terminates it. Therefore, His lordship reached the conclusion that the clause should not be binding on the hirer in the *Bridge* case either and so relief should be granted<sup>378</sup>.

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<sup>373</sup> Ibid. At 631.

<sup>374</sup> Ibid. At 631 per Lord Denning.

<sup>375</sup> *Associated Distributors Ltd v. Hall* [1938] 2 KB 83. In this case it was held that where the hirer terminates the hiring agreement exercising the option given to him under the contract, the penalty rule will have no application as there has been no breach of contract committed.

<sup>376</sup> “Remedies for Torts and Breach of Contract”. 2<sup>nd</sup> edition. Butterworths. 1994. P 332.

<sup>377</sup> Ibid. P 332.

<sup>378</sup> *Bridge v Campbell Discount Co.* [1962] AC 600, at 634.

3-The proposal of the Law Commission in its working paper<sup>379</sup> supports this view of the abolition of the limit upon the ambit of the penalty jurisdiction. It confirmed that the penalty rule might be applied whether or not there is a breach of contract. The Commission recommended that the penalty jurisdiction “should be applied wherever the object of the disputed contractual obligation is to secure the act or result which is the true purpose of the contract”.

This approach is also strongly supported by some legislative provisions as will now be shown.

### **1:3:2:3 Legislative effect in solving the paradox**

Despite the unsatisfactory results in the non application of the penalty jurisdiction to the case where the hiring agreement is terminated by hirer himself, the position remains as stated in *Associated Distributors Ltd v. Hall* case<sup>380</sup>. Courts do not have the power to relieve against penalty clause where hirer chooses to terminate the hiring agreement in conformity with the option given by the agreement. Therefore the hirer who breaches the hiring agreement in unlawful manner is still better off than the one who terminates the agreement in a legitimate manner. It can be asked that, as long as this is the position of the law, why does a hirer resort to terminate the agreement voluntarily since he will not be relieved? It would be better for him to manipulate the deal until he is in breach. The dissatisfaction of this result and the aforementioned paradox prompted the legislator to intervene to order to ease the paradox within the area of the penalty rule.

### **1:3:2:3:1 Consumer Credit Act 1974**

The Hire Purchase Act was first enacted in 1965 before being replaced by the Consumer Credit Act 1974, which applied to all agreements where the hirer is an individual and the total purchase price does not exceed £25,000<sup>381</sup>. The Hire-Purchase Act 1965 required from a hirer to bring his payments up to one-half of the hire-purchase price after the

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<sup>379</sup> No. 61 “Penalty Clauses and Forfeiture of Monies Paid”. Her Majesty’s Stationery Office. 1975. P 17-18.

<sup>380</sup> *Associated Distributors Ltd v. Hall* [1938] 2 KB 83.

<sup>381</sup> S 8(3) and 9(3).

termination of the agreement in *any manner whatsoever*. Accordingly, it rendered any provision void in any agreement making a hirer responsible for paying an amount that exceeds one half of the hire purchase price. However, if the loss sustained by owner was less than the amount of one half, the court had the power to award a lesser amount equal to the loss suffered<sup>382</sup>.

The Consumer Credit Act 1974 encompassed the same provisions as in the Hire Purchase Act 1965. It confirmed the right of the hirer to terminate the hiring agreement at any time before the last instalment becomes due<sup>383</sup>. Under section 99 hirer should pay to owner, the amount (if any) by which one-half of the total price exceeds the aggregate of the sums paid and the sums due in respect of the total price immediately before the termination unless the agreement provides for any payment<sup>384</sup>. Thus, as the effect of termination may well leave the owner with depreciated goods and in order to make a measure of compensation, the Act requires hirer to pay such further sum (if any) to bring the total payments up to one-half of the total price. Furthermore, the court discretion is affirmed in this Act. If the court is satisfied that a smaller sum will adequately compensate the owner for his loss it may make an order for the payment of such a smaller sum to be paid in lieu of the one-half of the total price<sup>385</sup>. Accordingly, the 1974 Act rendered void any provision in any regulated agreement under it, if it is inconsistent with a provision for the protection of hirer given to him under section 100 (1)(3)<sup>386</sup>. Subsequently, under these provisions hirer who terminates the hiring agreement lawfully should be better off just as he would have committed a breach. This also gets the uncertainties of the case law and equity as to whether or not the law regarding penalties is applicable upon termination of contract, to some extent, removed<sup>387</sup>. In spite of this intervention, the unsatisfactory rules of Case law are still applicable where the agreement is not regulated as it was provided for in the legislation. This is to say if the amount of credit exceeds £25,000 or the hirer is not individual the penalty clause rules prevailing in case law are applied<sup>388</sup>.

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<sup>382</sup> S 29 (2)(c) read with S 28 (1)(a).

<sup>383</sup> S. 99 Consumer Credit Act 1974.

<sup>384</sup> S 100(1) Consumer Credit Act 1974.

<sup>385</sup> S 100(3) Consumer Credit Act 1974.

<sup>386</sup> S 173(1) Consumer Credit Act 1974.

<sup>387</sup> McGregor. "McGregor on Damages". 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 478.

<sup>388</sup> Treitel, S. G. The Law of Contract. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1005.

### **1:3:2:3:2 Unfair Terms in Consumer Contracts Regulations 1999**

It should be pointed out that the limit upon case law jurisdiction- rules against penalties and so granting relief to the consumer would not apply to an event other than breach- seems to have been repeated<sup>389</sup> in the Unfair Terms in Consumer Contracts Regulations 1999<sup>390</sup>. The regulations provide that in consumer contracts a term may be unfair if it requires any consumer “who fails to fulfill his obligation to pay a disproportionately high sum in comparison”<sup>391</sup>. Such a term is likely to be an unenforceable penalty via case law. Thus, the Unfair Terms in Consumer Contracts Regulations 1999 and the case law rules in regards to penalties shall result in the same outcome<sup>392</sup>. However, case law related to penalties is perfectly applied to all terms of any kind of contract, whilst the Unfair Terms in Consumer Contracts Regulations 1999 is only applicable to contracts between consumers and sellers or suppliers<sup>393</sup>. The most important matter is that the Regulations in some cases might apply to sums payable in an event other than on the occurrence of breach. It is possible that a consumer might be regarded as not having fulfilled his contractual obligations even though he is not in breach of contract. This might occur where the consumer has a legitimate justification for non-performance<sup>394</sup> in which case the regulations could be said to extend further than the case law rules.<sup>395</sup>

### **1:4 Does Jordanian law require breach as a prerequisite for the operation of penalty clause rules?**

The operation of the penalty jurisdiction in Jordanian law is not based on the mere fact that there has been a breach of contract. Having established this point the differences between English law and Jordanian law can be examined as follows:

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<sup>389</sup> Poole, Jill. “Textbook on Contract Law”. 7<sup>th</sup> ed. Blackstone Press. 2004. P 452.

<sup>390</sup> Schedules 2(1)(e).

<sup>391</sup> Ibid.

<sup>392</sup> Treitel, S. G. “The Law of Contract”. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1006.

<sup>393</sup> Macdonald, Elizabeth. “Exemption Clauses and Unfair terms”. Butterworths. 1999. P 212.

<sup>394</sup> At case law in this situation consumer would not be considered as in breach of contract.

#### **1:4:1 Fault as a prerequisite for the activation of penalty clause rules**

Jordanian civil law asserts that contractual liability is not raised merely because a defaulting party has not performed his obligations, but the liability for non-performance is based on fault<sup>396</sup>. Thus unlike English case law fault is a requirement for the activation of penalty clause rules under Jordanian civil law. In English case law the principle is that contractual liability is strict. In *Raineri v. Miles*<sup>397</sup> Lord Edmund-Davies stated that: "in relation to a claim for damages for breach of contract, it is, in general, immaterial why the defendant failed to fulfill his obligations and certainly no defence to plead that he had done his best"<sup>398</sup>.

Though fault, under Jordanian law, is a requirement for the availability of contractual liability, its scope depends on a distinction between so-called obligation to take care of a thing and obligation to achieve a promised result. In the former, the performance obligation is having to do no more than to exercise reasonable care and skill. Consequently, a debtor will be regarded as having performed his obligation if he exercised such care and skill despite the promised result not being achieved<sup>399</sup>. For instance although a patient (creditor) may not have been cured, a doctor (debtor) will normally be regarded as having fulfilled his contractual duty if he has done all he should have with reasonable care and skill. It is not sufficient for a creditor to claim damages for a breach of such an obligation to prove non-performance and presume a debtor's fault. Therefore, when a creditor decides to claim the amount of penalty it is necessary for him to prove a debtor's fault, i.e. that he has not used a reasonable care and skill required under the contract<sup>400</sup>. This is contrary to English Law whereby creditor's entitlement of agreed damages depends not only on proving the default but also on the damages being a genuine pre-estimate and not extravagant.

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<sup>395</sup> Halson, Roger. "Contract Law". First published in Great Britain. Longman. 2001. P 512. Treitel, S. G. "The Law of Contract". 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1007. Macdonald, Elizabeth. "Exemption Clauses and Unfair Terms". Butterworths. 1999. P 214.

<sup>396</sup> Article 358/2 of Jordanian Civil Law.

<sup>397</sup> *Raineri v. Miles* [1981] AC 1050.

<sup>398</sup> *Ibid.* At 1086.

<sup>399</sup> Article 358/1 Jordanian Civil Law.

<sup>400</sup> In Bailment, for instance, the Bailor should show that the Bailee was guilty of fault.

However, absence of fault in a general sense does not always mean that the debtor is not responsible. In regards to an obligation of achieving a promised result, it imposes upon debtor an obligation to bring about a promised result. Thus, for example, a vendor of goods is liable for non-delivery of the subject matter. It is sufficient for a creditor claiming damages of an obligation to show that the promise was made and not performed<sup>401</sup>. However, it would be grossly unfair if a debtor becomes liable for the non-performance of a contract if he was excused from its obligation to perform because he was prevented from fulfilling his duties by events beyond his control. In other words, the liability is strict but not necessarily absolute. A debtor's fault is presumed having it up to him to avoid himself from liability by providing proof that performance became impossible due to some event, subsequent to the formation of the contract and for which the party was not responsible<sup>402</sup>. Consequently, the debtor can show that the damage sustained was because of external causes, such as to an unforeseeable irresistible external cause (force majeure), the act of a third party or the act of injured party<sup>403</sup>. In such circumstances the law provides the debtor with the excuse that the contract has become impossible to be performed and he frees himself of blame.

It can be said that the position of Jordanian civil law resembles English law in regards to where the obligation is to achieve a promised result. In both English and Jordanian law the liability to achieve what was promised is described as strict, i.e. liability without fault. Thus there is no defence available that the non-performance was caused by a circumstance beyond the debtor's control unless the unforeseeable event caused a contract to be frustrated<sup>404</sup>, as it is known in English Law. Thus, for example, a builder is strictly liable to complete the work (building) on time; however a building contract may be frustrated if delays caused by external circumstances make performance "radically

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<sup>401</sup> In sale contract, for instance, it is enough for the purchaser to prove the non delivery of subject matter.

<sup>402</sup> Article 448 Jordanian Civil Law.

<sup>403</sup> Article 261 Jordanian Civil Law.

<sup>404</sup> Frustration is an expression indicating that the contract, subsequent to its conclusion has become illegal or impossible to perform due to some event for which the debtor is not responsible, i.e. unforeseeable circumstance that is beyond his control and discharges the contractual obligations of both parties automatically.

different from what was originally contemplated”<sup>405</sup>. Therefore, breach of contract is a precondition for the invalidity of penalty clauses in English law and for the activation of penalty clause rules in Jordanian law where the obligation is to bring about a particular result. The non-performance of a contractual obligation (such as not completing a building on time) without lawful excuse is a sufficient reason for the application of the rules related to penalties and liquidated damages under the English Law. As a result where the sum stipulated in a contract and payable on breach is characterised as a penalty, it will be totally disregarded by the court.

#### **1:4:2 Notice as a prerequisite to claim the amount of penalty clause**

In order to claim the amount payable under a penalty clause for non-performance of principal obligation, Jordanian law provides that the debtor’s liability to pay the amount may not arise until he has been given a warning by the creditor to perform.<sup>406</sup> This is in contrast to English case law<sup>407</sup>, which does not have any requirement of a notice for application of the penalty rule. The Jordanian Civil Cassation Court has clearly confirmed also this fact stating:

“The meaning of notice is to put the debtor into default by serving a notice of non performance, as it is not sufficient in an action for damages for delay in performance, merely to show that performance had become due and was not rendered on the due date. Yet the debtor should be given a notice of default”<sup>408</sup>

No particular form is required and it may be expressed through the notary public, registered post or in any other way would serve the purpose<sup>409</sup>. Furthermore parties to the contract may agree in advance that the debtor will have been regarded as warned after a certain time without any further act by the creditor<sup>410</sup>.

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<sup>405</sup> *Metropolitan Water Board v. Dick Kerr & Co* [1918] AC 119.

<sup>406</sup> Article 361 of Jordanian Civil Law.

<sup>407</sup> However it can be said that the notice requirement is satisfied by the very existence of the penalty jurisdiction. This means that parties to a contract know in advance the existence of the jurisdiction, which invalidate any provision of penal nature. This makes them on notice that courts will have a particularly shrewd look at agreed damages clause.

<sup>408</sup> Civil Cassation No.1036/987 Bar Association Journal 1989. P 3182. See also Civil Cassation No.881/88 Bar Association Journal 1990. P 1753. Civil Cassation No.455/1965 Bar Association Journal 1966. P 247.

<sup>409</sup> Civil Cassation No.881/88 Bar Association Journal 1990. P 1753.

<sup>410</sup> The explanatory note of Jordanian Civil Law. Vol.1. 1975. P 398.

The purpose of this provision is to warn and make it clear to debtor that he is requested to perform. It is also sometimes to inform him that he is in breach or creditor is not tolerant at the time the performance becomes due. It is not sufficient to claim a penal sum merely to show that performance has become due and was not accomplished on the due date. However, the general rule is that debtor should be informed that creditor still requires performance by a notice of default<sup>411</sup>. This is because performance might become due and creditor did not take any action demanding performance. Debtor might interpret this silence as a creditor's indulgence or satisfaction and acceptance to postpone performance or there was no damage suffered by the latter due to the delay. In other words, if a creditor wanted the performance without delay he should make it clear to his debtor in the formal way prescribed by the law.

Two consequences follow when performance has been delayed and a notice of default has been given. The most important result of the delay is that it gives rise to a claim of damages for delay. Once creditor provides a notice to his debtor the former will be entitled to receive the amount payable under a penalty against the damage suffered as a result of the latter's delay in performance. The debtor is subsequently liable to pay the penal sum from the time he receives a warning to perform. In other words the debtor is not responsible to compensate the creditor for the period before receiving a warning. This is because the action of creditor, who has a right due and does not give a notice to his debtor demanding performance, may be construed in a way that makes the debtor envisage that his creditor is satisfied of the delay or may have sustained no loss as a result of delay in performance. This fact can be inferred and supported by article 361 of Jordanian civil law, which imposes the requirement of a notice of default on all claims for damages. Secondly, once creditor warned debtor of his default, certain risks pass to the latter. The debtor would bear the liability of the deterioration of the subject matter, which was previously on the creditor's shoulder before giving a notice of default. For example, the lessee's obligation to return the subject matter after the end of lease. If he did not do so the deterioration liability would be passed to him after he had been given a notice from the lessor. However, it should be noted that there are cases in which the notice of non-

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<sup>411</sup> Abu Aso'od, Ramadan. "Rules of Obligations". Dar Almatbo'at press. 1998. P 87.

performance as a prerequisite for claiming the amount payable under the penalty clause, is not required<sup>412</sup>. The creditor may be entitled to the damages fixed in the penalty clause even though he did not give a notice to the debtor as illustrated in the following cases:

1-Uselessness of the notice: the general rule requiring creditor to give a notice of default does not apply where it will be pointless to remind the debtor to perform his contractual obligations. If the performance of the obligation became inconceivable and profitless due to the debtor's breach, such as he did not perform on the time stated in the contract, the notice will then be of no effective benefit<sup>413</sup>. Furthermore, the law has given parties to the contract the right to agree in advance that the debtor will be regarded as warned at the time the performance becomes due without any further action by the creditor<sup>414</sup>. When the parties agreed that the debtor would be regarded as already cautioned, there would be no need for the notice

Furthermore, the notice would be pointless if the debtor declares in writing<sup>415</sup> that he will not fulfill his undertakings. The law provides that the statement here should be in writing. Therefore if a debtor states orally that he will not perform in front of some witnesses such statement will not be sufficient for he may be forced under some circumstances to declare that he will not perform. However, it might be suggested that if the debtor confesses subsequently that he declared that orally, this confession could be enough and so the notice would be rendered.

2-Provision of law: Article 361 of Jordanian civil law provides that: "The damages shall not fall due unless the debtor is warned, except that the law ...provides otherwise". There are several stipulations in Jordanian civil law in which the general rule of requiring a notice of default does not apply<sup>416</sup>. There is no need to give the debtor a notice of default: "if his undertaking was to return something stolen or illegally handed over to him and he

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<sup>412</sup> Article 362 of Jordanian Civil Law.

<sup>413</sup> Civil Cassation 32/94 Bar Association Journal 1997. P 72.

<sup>414</sup> Article 361 of Jordanian Civil Law. It provides for that : "The damages shall not fall due unless the debtor is noticed except that the law or the contract provides otherwise"

<sup>415</sup> Article 362/4 of Jordanian Civil Law.

<sup>416</sup> See Article 362/3 and 4, Article 851/1, 858 and 859/1 of Jordanian Civil Law.

was well aware of that”<sup>417</sup>. The requirement of giving notice does not apply to such situation, as it would be contrary to the good faith for the debtor to insist on it. The sound reasoning of non-application of the precondition of providing a notice to the debtor to perform is that it is inconceivable to force the creditor to give debtor a notice of default to return something stolen, or illegitimately handed over to him particularly when he is completely aware of that. In both cases it is supposed that the debtor should return the subject matter without any notice, as he will be in bad faith if he insists on receiving a notice by the creditor.

## **2- Loss which to be estimated**

English law depends on the pre-estimated loss, which may be suffered as a result of breach, to determine the enforceability of agreed damages clause. Consequently, parties to a contract, when fixing the agreed damages, might agree on losses that cannot be obtained by unliquidated damages action. However, are parties to a contract limited to making a genuine pre-estimate of the damages, which the court would award in an action if there were no agreed damages clause? Or can they agree that losses, which might be sustained as a result of breach, might cover losses that are not recoverable at case law? The parties might include losses without taking into consideration the remoteness or mitigation limitation on damages. Are they allowed to do so? Therefore, losses which are recoverable at English case law will now be considered before exploring those are not recoverable.

### **2:1 Losses which are recoverable via English case law**

Not all losses sustained by the injured party as a result of breach of contract are recoverable at case law level. Some losses are too remote consequences of breach to be caught within the scope of contractual liability. This rule is called the remoteness rule. The formulation of the law related to this rule can be traced back to the case of *Hadley v. Baxendale*<sup>418</sup>. In this case, a shaft in the claimant’s mill had broken and had to be sent to the makers at Greenwich to serve as a pattern for the production of a new one. The

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<sup>417</sup> Article 362/3 of Jordanian Civil Law.

<sup>418</sup> *Hadley v. Baxendale* (1854) 9 Exch 341; 156 ER 145.

defendant agreed to carry the shaft to the makers. He delayed to do so and the work in the claimant's mill was prevented several days. The claimant claimed damages of £300 for loss of profits during the period and was awarded £50. In his judgment Alderson B produced what has since become known as the *Hadley v. Baxendale* rule in which he determined two kinds of losses that might be claimed by the claimant in an action of unliquidated damages<sup>419</sup>:

- 1- Natural Losses: These losses are flowing naturally from the breach of contract, i.e. according to the usual course of things. This kind of loss covers the inevitable consequences of the breach, which fall within the contemplation of both parties.
- 2- Exceptional losses: These losses are reasonably supposed to have been contemplated by both parties at the time they made the contract as the probable consequences of the breach. This kind of loss extends to the losses which do not arise naturally from breach but which are foreseeable in particular circumstances provided the defendant knows of those circumstances. In other words the greater loss suffered due to special circumstances is not generally recoverable unless both parties to the contract were aware of the special circumstances at the time that the contract was made<sup>420</sup>.

In applying these two limbs of remoteness rule the court held that the loss of profit could not be regarded as a natural loss since the stoppage was not the natural result of the delay. Thus, the defendant was not responsible under this limb and so under the second one since the latter requires an actual knowledge on the defendant side.

Furthermore, in deciding whether losses are recoverable by English case law, the court should consider the mitigation rule. This rule provides that damages due to a claimant and awarded by the court must be for losses, which the claimant could not have avoided by taking reasonable steps to minimise them. This is to say claimant should endeavour to

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<sup>419</sup> Ibid.

<sup>420</sup> However in *The Victoria Laundry Ltd v. Newman Industries Ltd* [1949] 2 KB 528 the Court of Appeal preferred the view that there was one rule of remoteness applicable in the law of contract that recovery be made in respect of "loss actually resulting as was at the time of the contract reasonably foreseeable as liable to result from the breach". See also *The Heron II* [1969] 1 AC 350.

lower the losses, which might be suffered from as far as can be expected from a prudent person<sup>421</sup>.

## 2:2 How the law stands for losses outside what court could award?

To reiterate parties to a contract might agree on damages exceeding what the court would award. They might estimate damages taking into consideration neither the remoteness rule nor the mitigation rule. As a result, is the clause, which pre-estimates damages at a figure commensurate with claimant's likely actual loss, but exceeds the damages that court would award on the ordinary way of compensation, valid?

It can be asserted that this point is still a controversial issue under the existing law. The Law Commission<sup>422</sup> provisionally thought that:

“The proper test by reference to which should be determined whether the stipulated sum is a genuine pre-estimate is the damages which a court would award. If a party wishes to ensure that he can recover compensation for a loss in excess of reasonable damage, he should do so by an express provision not by a penalty clause, and if he wishes to declare the existence of special circumstances to the other party, he should not simply depend on a stipulation for a high stipulated sum”<sup>423</sup>

Unlike what the Law Commission recommended it has been argued that such a clause may not be regarded as a penalty where it provides for the recovery of damages that wouldn't be awarded under the rule of remoteness. According to his comments in *Robophone Facilities Ltd v. Blank*<sup>424</sup> Diplock LJ was clearly of the view that a stipulated sum may provide for special loss sustained by the claimant. His lordship explained that the liability of the defendant in this situation might be implied or expressed. In delivering his speech he clarified that the basis of the defendant liability under the second limb of *Hadley v. Baxendale*<sup>425</sup> was that the defendant implied undertaking to bear the claimant's actual loss. The implication of this liability resulted from the defendant knowing the

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<sup>421</sup> The doctrine of mitigation was established in the House of Lords in *British Westinghouse Elec. Mfg Co. v. Underground Elec. Ry. Of London* [1912] AC 673 at 689 per lord Haldane.

<sup>422</sup> The Law Commission in its Working Paper No. 61. “Penalty Clause and Forfeiture of Monies Paid”. London. Her Majesty stationery Office, 1975.

<sup>423</sup> *Ibid.* At 32-33. The Commission recommended that the liability of the defendant should be extended by a clear notice of the loss or a clearer clause.

<sup>424</sup> *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128.

special circumstances, which might enhance the loss of the claimant, and that he had made the contract without a disclaimer of the liability to bear the claimant's actual loss<sup>426</sup>. His Lordship confirmed subsequently in his well-known statement that this implied liability that:

“The onus of showing that such a stipulation is a penalty clause lies on the party who is sued on it...it may seem at first sight that the stipulated sum is extravagantly greater than any loss which is liable to result from the breach in the ordinary course of the things, i.e. the damages recoverable under the so called “first rule” in *Hadley v. Baxendale*. This would give rise to the prima facie inference that the stipulated sum was a penalty; but the plaintiff may be able to show that, owing to special circumstances outside “the ordinary course of things”, a breach in those special circumstances would be liable to cause him a greater loss of which the stipulated sum does represent a genuine estimate...the basis of the defendant's liability for the enhanced loss under the “second rule” in *Hadley v. Baxendale* is his implied undertaking to the plaintiff to bear it. His actual knowledge of the special circumstances is relevant as *one* of the factors from which his undertaking can be implied...<sup>427</sup>”

However the liability of the defendant to bear the claimant's actual loss can be expressed by the words of the parties in the contract. In other words, the defendant may express that he will be liable for the entire claimant's actual loss whatever that may be, irrespective of whether he knew the special circumstances which are likely to enhance the claimant's actual loss<sup>428</sup>. Diplock LJ went on to say “Such undertaking needs not to be left to implication; it can be express”<sup>429</sup> before explaining the frank liability saying that:

“If at the time of the contract the plaintiff informs the defendant that his loss in the event of a particular breach is likely to be £x by describing this sum as liquidated damages in terms of his offer to contract, and the defendant expressly undertakes to pay £x to the plaintiff in the event of such breach, the clause which contains the stipulation is not a penalty clause unless £x is not a genuine and reasonable estimate by the plaintiff of the loss which he will in fact be likely to sustain. such a clause is, in my view, enforceable whether or not the defendant knows what are the special circumstances which make the loss likely to be £x rather than some lesser sum which it would be likely to be in the ordinary course of the things<sup>430</sup>”.

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<sup>425</sup> *Hadley v. Baxendale* (1854) 9 Exch 341; 156 ER 145.

<sup>426</sup> *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128, at 143 per Diplock LJ

<sup>427</sup> *Ibid.* At 142-143 per Diplock LJ

<sup>428</sup> *Ibid.* At 143 per Diplock LJ

<sup>429</sup> *Ibid.*

<sup>430</sup> *Ibid.*

It is hereby agreed upon that this suggestion sounds sensible in permitting the agreement of the recovery of losses, which are not recoverable at case law because they are too remote. This is because the clause in contract, which makes the defendant responsible for the whole loss flowing from breach as opposed to the loss which could be recovered under the so called *Hadley v. Baxendale* rule, would in any case amount to notice of special losses irrespective of the defendant knew the special circumstances which caused these losses or not<sup>431</sup>. If at the time the contract is made, the claimant notifies the defendant that his probable actual loss is likely to be £X and the defendant expressly agrees to contract on this term. By this agreement the defendant knew of the special circumstances which made the loss likely to be £X. However, the sum fixed should form a genuine pre-estimate of losses, which might ensue as a result of breach by the defendant. Otherwise it would be an unenforceable penalty as the test of determining the validity of agreed sum is always that the sum stipulated shouldn't be extravagant or unconscionable in any case. This is to say that the sum stipulated should be in line with the loss sustained because of the breach, as the justice principles rejects the agreed damages of being manifestly higher than the loss suffered (New Approach).

On the other hand there are losses that in the ordinary way the claimant will not be compensated for, but which he could have avoided by taking proper steps. This is the rule of mitigation. However, would the agreed sum be valid liquidated damages or invalid penalty if this rule was ignored? This question, as yet, has not been clearly addressed by the courts. It is argued that the agreed damages clause may provide that the claimant can recover his actual loss with or without stating frankly this in the contract. However, on the other side it might well be unsatisfactory to uphold an agreed sum assessed on the assumption that the claimant would fail to mitigate for it. In other words, parties to a contract could not agree on damages for losses that the claimant could have avoided by

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<sup>431</sup> Downes, T Antony. "A Textbook on Contract". 7<sup>th</sup> ed. 1999. P 360. Waddams, SM. "The Law on Damages". 4<sup>th</sup> ed. Canada Law Book Ltd. 2004. P 446. Matheou, Michael. "Minimum Liquidated Damages-Should the Decision of the High Court in Hong Kong be Torpedoed". *Construction Law Journal*. (1992) 8(1) 25, at 30. Beale, H G, Bishop WD and Furmston, MP. "Contract, Cases and Materials". 4<sup>th</sup> ed. Butterworths. 2001. P 581.

taking reasonable steps as far as it is expected from a reasonable man<sup>432</sup>. The justification for preventing such losses from being compensated by agreement is that permitting the recovery of these losses “would either encourage wasteful failures to mitigate, or would over-compensate the wily party who both claimed the liquidated damages and mitigated<sup>433</sup>”.

It can be concluded that the invalidity of penalty clauses does not prevent the level of agreed damages clause from being set above an ordinary award of damages. It should be enforced so long as the sum is a genuine pre-estimate of losses, which might be suffered by injured party. The agreed sum can be recovered even though it includes losses which are too remote. However, it cannot be obtained if it involves losses which could have been avoided.

### **2.3 Jordanian law and English law distinguished**

In a comparative sense: unlike English case law, Jordanian civil law provides that the validity of a penalty clause is posed in relation to the actual loss suffered by the injured party. This means that the right to claim the penalty amount is determined by an actual loss<sup>434</sup> sustained by the injured party<sup>435</sup>.

The established rule in Jordanian law is that damages can be awarded in relation to the actual loss provided that the injured party should furnish proof of that loss, i.e., to activate the contractual liability in general. However, contrary to this rule the injured party needs not prove either his loss or its amount to claim the agreed penalty, as there is always an assumption of the existence of such loss<sup>436</sup>. In a dispute concerning a sale contract of which the ministry of supply was the purchaser the Court of Cassation confirmed this fact. In the contract the ministry had agreed with a supplier to provide it

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<sup>432</sup> Burrows, Andrew. “Remedies for Torts and Breach of Contract”. 2<sup>nd</sup> ed. Butterworths. 1994. P 327. Downes, T Antony. “A Textbook on Contract”. Blackstone Press. 5<sup>th</sup> ed. 1995. Reprinted 1999. P 360.

<sup>433</sup> Beale, Hugh. “Remedies for Breach of Contract”. Sweet & Maxwell. 1980. P 57.

<sup>434</sup> However it should be noted that the recoverable loss, at Jordanian law, means the loss that the injured party has suffered from but not the anticipated profits that he naturally missed as a result of non performance.

<sup>435</sup> Article 363 Jordanian Civil Law. Civil Cassation 523/82 Bar Association Journal 1982, P 1565.

<sup>436</sup> This can clearly inferred from the article 364/2 of Jordanian civil law which provides that: “The courts may, upon the request of either party, increase or decrease such damages to make the estimation equal to the actual loss”. Civil Cassation 582/91 Bar Association Journal 1993. P 737.

with some goods at a certain time. The vendor having failed to deliver the subject matter on time, led to the ministry terminating the contract and claiming the penalty. The vendor counterclaimed that the ministry had sustained no loss, as it had made another contract and received the goods from another supplier. The Court of Appeal held that the damages agreed upon in the contracts should be paid to the ministry. However, the vendor brought this dispute to the Jordanian Court of Cassation, which upheld the judgment of the Court of Appeal stating that:

“If the damages, which is to be payable in the event of breach, has (previously) been agreed upon in the contract, the loss, inflicted on the creditor, will be assumed. The creditor will not be asked to provide proof of the loss he has suffered, however it is the debtor, in order to get rid of the responsibility, who will be asked to show that the creditor has suffered no loss”<sup>437</sup>

In deciding that the Ministry of Supply had the right to receive the amount which was payable under the penalty clause, the Court of Cassation held that:

“Since the claimant (debtor) has not presented any evidence that the ministry has sustained no loss and the court of appeal found that the amount of penalty was corresponding to the exact loss sustained by the ministry, binding the claimant to pay the amount of penalty conforms to articles 363 and 364 of the Civil Law”<sup>438</sup>.

Therefore, if either party claims that the damages payable under the penalty clause is not equal to the loss suffered, he should provide proof of that<sup>439</sup>. If injured party claims that the assessment of the damages is not equal to the actual loss, he should show that the amount of penalty clause is less than such loss sustained. Defaulting party should provide proof that the amount of penalty is excessive in comparison with the actual loss sustained by the injured party. However, even where law does not force injured party to prove his loss it would be often advisable for him to demonstrate that he has sustained loss and the amount of it. This is because the court, under Jordanian civil law, has the power to reduce the amount payable under the penalty clause and it shall absolutely take into consideration the amount of loss actually suffered by him as a result of non performance. There is also always a chance that the court may exercise its discretion to reduce the sum of money of the penalty clause. In giving evidence of the actual loss, the injured party is

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<sup>437</sup> Civil Cassation 3326/2000 Adaleh Centre Publications 2000, available at [Info@adaleh.com](mailto:Info@adaleh.com).

<sup>438</sup> Ibid.

<sup>439</sup> Civil Cassation 582/91 Bar Association Journal 1993. P 737.

always in a good position against the court's power to reduce the amount agreed upon in the contract as compensation. Proving the actual loss sustained as a result of breach may also have some importance in the English case law. After the decision in *Philips Hong Kong v. The Attorney General of Hong Kong*<sup>440</sup> it became clear that what happened after the formation of the contract (including the actual loss) is of some weight as evidence to what was within the contemplation of the parties at the time the contract was made. In other words, proving the extent of loss actually suffered will have no decisive evidence of decreeing the validity of agreed sum. However, it may be relevant in an English case law distinction between liquidated damages and penalties regarding the question of whether the sum stipulated was in fact a genuine pre-estimate or extravagant and unconscionable to the loss suffered.

### **3-Evasion of penalty jurisdiction**

A skilful draftsman can easily side step the penalty jurisdiction<sup>441</sup>. As has been shown above the penalty jurisdiction has no application where there has been no breach. Therefore, making the agreed sum payable on event other than breach will lead the sum being taken outside the ambit of operation of penalty rule. Moreover, the penalty rule can be avoided in the following two cases which will now be considered: Promoting a term into condition and providing for acceleration clause in contract.

#### **3:1 Promoting a term into condition**

##### **3:1:1 Generally**

This instance is well illustrated by Mustill LJ speech in *Lombard North Central v. Butterworth*<sup>442</sup> whereby: "A clause expressly assigning a particular obligation to the category of condition is not a clause which purports to fix the damages for breach of the obligation, and is not subject to the law governing penalty clauses"<sup>443</sup>.

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<sup>440</sup>*Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>441</sup>*Lombard North Central v. Butterworth* [1987] 1 All ER 267, at 280.

<sup>442</sup>*Lombard North Central v. Butterworth* [1987] 1 All ER 267.

<sup>443</sup>*Ibid.* At 273 per Mustill LJ

To examine this situation there will be a focus on firstly, the damages recoverable via case law in the event of breach of term in hire purchase agreement and secondly an exploration of how the law stands for avoiding the penalty jurisdiction by promoting a term into condition. The decisions in *Lombard North Central v. Butterworth*<sup>444</sup> and in *Financings Ltd v. Baldock*<sup>445</sup> cases will be fully considered. In the *Lombard* case breaching a term resulted in not to applying the penalty jurisdiction, whilst breaching the same term in the *Financing* case gave the defaulting party relief against penalty clause. The question why will be the object of this discussion.

### **3:1:2 Damages recoverable in case of breaching a term (non repudiatory breach)**

English law has already determined the measure of damages available to an owner who has terminated a contract for breach either he has the right to terminate under the law (repudiatory breach) or by virtue of power contained in a contract (non-repudiatory breach). In the former situation, if a hirer has repudiated a contract by refusing any responsibility of paying rentals owner has the right to treat such repudiation as a breach of contract. Accordingly, owner is entitled to recover his actual loss, i.e. loss of bargain damages. In the latter situation, where owner has terminated the hiring agreement by virtue to the express term of the contract recoverable damages are restricted up to the date of termination, i.e. the instalments in arrears with interest and nothing more<sup>446</sup>. Such a restriction on damages available to owner in the latter case is simply because there are no breaches thereafter. Having established the above two rules on damages available to owner it is submitted that a contractual term stipulating for loss of bargains damages to be recoverable where there is no repudiatory breach is to be treated as unenforceable penalty. In translating this principle to breach of a term (paying the instalments on time for example) in an agreement of hiring owner is entitled to damages up to the date of termination. This is because there is no repudiatory breach but it is only non-payment which does not amount to repudiatory breach.

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<sup>444</sup> *Lombard North Central v. Butterworth* [1987] 1 All ER 267.

<sup>445</sup> [1963] 2 QB 104.

<sup>446</sup> *Financings Ltd v. Baldock* [1963] 2 QB 104, at 110-113. Per lord Denning M R. For details see Opeskin, Brian. "Damages For Breach of Contract Terminated Under Express Terms". *Law Quarterly Review*. (1990) 106 293. Hughes, A D. "Breach, Repudiation and Termination of the Hire-Purchase Agreements". *Journal of Business Law*. [1964] 28.

Therefore if it was provided in an agreement of hiring that owner could recover his loss of bargain damages in the event of breach of a term, such provision would be dealt with as an invalid penalty clause for the legal damages available in this case are up to the date of determination. This result is well illustrated in *Financings Ltd v. Baldock* case<sup>447</sup> where there was a Hire-Purchase Agreement provided that Baldock had to pay the price by instalments. Clause 8 stipulated that if Baldock (the hirer) failed to pay any instalment within 10 days after becoming due, the Financings (the owner) had the right to terminate the agreement. Clause 11 gave the owners a right to recover two thirds of total amount to be paid on any termination by them under clause 8. Having the hirer failed to pay the first two instalments on time, the owner determined the agreement and repossessed the truck. This clause was held to be an unenforceable penalty clause on the basis that the owner was entitled to recover damages up to the date of termination, as the breach committed by the hirer was a non-repudiatory breach according to case law rules

However, what will the position be if parties to a hire-purchase agreement promoted such a term into the classification of condition? And how does the law deal with this situation?

### **3:1:3 How the law stands for classification a term as a condition in contract?**

The decision of the Court of Appeal in *Lombard North Central v. Butterworth*<sup>448</sup> unveiled a method for the owner in a hire purchase agreement to avoid the result in *Financings Ltd v. Baldock*<sup>449</sup>. *Lombard* case demonstrates that it is possible for the contracting parties to provide expressly in their contract that specified breaches, which would not of themselves go to the root of the contract, i.e. they are not repudiatory breaches, are nevertheless to be treated as if they do so. Take for instance the parties' agreement to reclassify cases in which a particular term, e.g. that payment should be made on time, is elevated to a condition. As a result the smallest breach of such a term would have an effect as if the party in breach has repudiated the contract. Therefore, classifying a term into condition becomes of the essence of the contract breach of which

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<sup>447</sup>*Financings Ltd v. Baldock* [1963] 2 QB 104.

<sup>448</sup>*Lombard North Central v. Butterworth* [1987] 1 All ER 267.

<sup>449</sup>*Financings Ltd v. Baldock* [1963] 2 QB 104.

entitles the injured party (owner) to claim the recovery of loss of bargain damages. This outcome leads to say that penalty jurisdiction might be easily eluded by skilful draftsman in categorising a term as a condition. This situation differs from what took place in *Financings* case<sup>450</sup> for in this instance the parties stipulated that punctual payment of each rental was to be of the essence of the agreement. Therefore making term condition by virtue of the time factor enabled the owner to recover the loss of bargain damages, although on the authority of *Financing* the result would have been otherwise, if such a clause was absent<sup>451</sup>. In *Lombard North Central v. Butterworth*<sup>452</sup> by Mustill LJ stated that:

“...I acknowledge of course, that by promoting a term into the category, where all breaches are ranked as breach of a condition, the parties indirectly bring about a situation where, for breaches which are relatively small, the injured party is enabled to recover damages as on the loss of bargain, whereas without the stipulation his measure of recovery would be different. But I am unable to accept that this permits the court to strike down as a penalty the clause which brings about this promotion”<sup>453</sup>

*Lombard* case provides an interesting example of a time stipulation made a condition by virtue of an express term in contract. In this case the claimant, a finance company, leased a computer to the defendant for a period of 5 years on payment of an initial sum of £584 and 19 subsequent quarterly instalments of the same amount. Clause 2(a) of the agreement made punctual payment of each instalment of the essence and clause 5 stated that failure to make due and punctual payment entitled the claimant to terminate the contract. Clause 6 provided that, on termination, the claimant was entitled to all arrears and to all future instalments, which would have fallen due, had the contract not been determined. The first two payments of rent were punctually made, the next three were only paid after some delay and when further delay occurred in making the sixth payment, the claimant terminated the contract under clause 2(a) by giving notice to the defendant. Accordingly, the court had to deal with clause 6 whether it is a penalty or not<sup>454</sup>.

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<sup>450</sup> Ibid.

<sup>451</sup> This is what was held in *Lombard North Central v. Butterworth* [1987] 1 All ER 267. See Chitty on Contract, 29<sup>th</sup> ed. Vol.1. General Principles. Sweet & Maxwell. 2004. P 1497. Koffman, Laurence and Macdonalds, Elizabeth. “The Law of Contract”, 4<sup>th</sup> ed. Tolley. 2001. P 491.

<sup>452</sup> *Lombard North Central v. Butterworth* [1987] 1 All ER 267.

<sup>453</sup> Ibid. At 273 per Mustill LJ.

<sup>454</sup> Ibid. At 267.

It should be noted that clause 6 in this case was, in reality, a penalty clause and could not be enforced. However, the court when viewed clause 2(a) (which had made punctual payment of the essence of contract) in conjunction with clause 6 (which entitled the owner to all arrears and to all undue payments) led to the compelling conclusion that a default in paying on time was to be regarded as a repudiatory breach going to the heart of the contract<sup>455</sup>. Nicholls LJ observed that: “This conclusion emasculates the decision in *Financing Ltd v. Baldock*, for it means that a skilled draftsman can easily side step the effect of that decision. Indeed that is what occurred here”<sup>456</sup>

### **3:1:4 Unsatisfactory aspect: difference in form not in substance**

What made the claimant’s position in the *Lombard* case capable of evading the effect of *Financing* case was something in form and not in substance. It was the skill of draftsman who drew the provision in a way that makes the requirement as to time of the essence of contract. In such an adept policy a term was classified into the category of condition and then prevented the penalty jurisdiction from being invoked.

The result of the *Lombard* case (the supremacy of form over substance) was not a satisfactory outcome even in the views of the Lords Justice in *Lombard North Central v. Butterworth*<sup>457</sup>. Mustill LJ considered it “without much satisfaction”<sup>458</sup>. The claimant obtained by changing in words a consequence which the law of penalties could have precluded if there had been no provision making an express right of termination in the event of non-payment a condition. Nicholls LJ was also critical of the result, as there was “no practical difference”<sup>459</sup> between the contract including a power to terminate it by the owner on non-payment of instalments<sup>460</sup> and the contract including a provision to the effect that the payment of each instalment on time must be strictly complied with<sup>461</sup>. “The

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<sup>455</sup> Ibid. At 268.

<sup>456</sup> Ibid. At 280 per Nicholls LJ.

<sup>457</sup> *Lombard North Central v. Butterworth* [1987] 1 All ER 267.

<sup>458</sup> Ibid. At 275 per Mustill LJ.

<sup>459</sup> Ibid. At 280 per Nicholls LJ.

<sup>460</sup> In this situation the owner would have the right to recover damages for any breaches up to the date of termination. This would be caught by penalty clause rules.

<sup>461</sup> In this situation the owner would have the right to recover the loss of bargain damages, as the breach goes to the root of the contract. this would not be caught by penalty clause rule.

difference between these two agreements is one of drafting form and wholly without substance”<sup>462</sup>. This is to say that the difference in form produced such different remedial consequences and that was something his Lordship viewed with “considerable dissatisfaction”.<sup>463</sup>

The intention test<sup>464</sup> as a basis for loss of bargain damages might be introduced in favour of the conclusion in the *Lombard* case. This test is based on the fact that one of the consequences of termination after breach is the recovery of damages and its assessment, like other consequences of termination, depends on the intention of the parties. When the parties expressly provide for the loss of bargain damages to be recoverable, effect should be given to parties’ agreement as it represents the injured party’s loss as the parties have envisaged. When the parties do not make an express provision the injured party’s entitlement of loss of bargain damages may be inferred from the contract<sup>465</sup>.

Problems may arise when the parties classify a term as a condition because termination as a contractual right is activated by a breach which would not give rise to a right to terminate at common law<sup>466</sup>. In other words, in doing so the parties elevate a term into the category where all breaches are classified as a breach of condition. In principle where there is a breach of condition in a contract the injured party is entitled to accept the breach as repudiation and thus terminate and get his loss of bargain damages. However the presence of a provision by which a term is promoted into the category of a condition confers a right to terminate upon the injured party, but says nothing about the assessment

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<sup>462</sup> *Lombard North Central v. Butterworth* [1987] 1 All ER 267, at 280 per Nicholls LJ.

<sup>463</sup> *Ibid.*

<sup>464</sup> This test asserts that the remedial consequences flowing from termination of the contract by virtue of termination clause “depends upon the true construction of the relevant provision”. However if the contract “purport[s] to confer on one of the parties a right to recover a sum of money from the other, a question may arise whether this right is unenforceable as constituting a penalty”. *Financings Ltd v. Baldock* [1963] 2 QB 104, at 121. For details see Opeskin, Brian. “Damages for Breach of Contract Terminated Under Express Terms”. *Law Quarterly Review*. (1999) 106 293, at 304-308.

<sup>465</sup> See Carter, J W. “The Effect of Discharge of a Contract on the Assessment of Damages for Breach of Contract”. *Journal of Contract Law*. [1989] 249, at 252. Opeskin, Brian. “Damages for Breach of Contract Terminated Under Express Terms”. *Law Quarterly Review*. (1999) 106 293, at 304-305. See also the renowned dicta of Diplock LJ in *Robophone Facilities v Blank* [1966] 3 All ER 128, at 142-143 where he nicely explained that the liability of the defendant to bear the claimant’s actual loss might be implied or expressed. For Diplock LJ’s view explained see *supra*. P 106.

<sup>466</sup> Treitel, S. G. “The Law of Contract”. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. PP 802-805.

of damages<sup>467</sup>. It has been argued<sup>468</sup> that the assessment should be linked to the presumed intention of the parties. "It is simply more likely for the parties to have intended loss of bargain damages to be recoverable where termination is based on a [repudiatory] breach, so that an express statement of what breaches are to be so regarded is merely an indirect way of describing when, by the terms of their agreement, the parties have envisaged loss of bargain damages to be recoverable"<sup>469</sup>. This proposition is supported by *Lombard North Central v. Butterworth* case<sup>470</sup> where it was held that a provision of elevating a term into condition is a sufficient basis for the injured party to recover damages for the whole transaction in the event of breach. To sum up, this argument states that where parties to a contract have promoted a term into condition it is sufficient to confer upon the injured party the right to terminate and receive loss of bargain damages. However, this conclusion is open to the following criticism.

1-As the parties' intention to make a term condition may be implied, this gives the injured party the opportunity to argue<sup>471</sup> that it is simply sufficient to stipulate in contract that instalments should be paid on time in order to classify a term as a condition. Thus, the effect of this agreement provides that failure by promisor to make punctual payment shall be regarded as repudiation on his part. As a result a promisee may rely on the presumed intention to claim loss of bargain damages based on the termination for breach of a condition. This is to say that the conclusion in the two cases<sup>472</sup> concerned should have been the same by allowing the injured party (owner) to terminate and receive the loss of bargain damages. This outcome is not preferable as will be pointed out below.

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<sup>467</sup> *Financings Ltd v. Baldock* [1963] 2 QB 104, at 108.

<sup>468</sup> For details of this argument see Carter, J W. "The Effect of Discharge of a Contract on the Assessment of Damages for Breach of Contract". *Journal of Contract Law*. [1989] 249, at 253-254.

<sup>469</sup> *Ibid.* At 261.

<sup>470</sup> *Lombard North Central v. Butterworth* [1987] 1 All ER 267.

<sup>471</sup> This is what has been argued in *Financings Ltd v. Baldock* [1963] 2 QB 104, at 108. However such an argument was rejected by Diplock LJ who stated (at 120) that: "he [the hirer] was clearly in breach of his contractual obligation to pay two instalments on the due dates but, in the absence of any express provision to the contrary in the contract, these breaches of a contract of hire...would not of themselves go to the root of the contract or evince an intention on the part of the hirer no longer to be bound by the contract". also in *Charterhouse Credit Ltd v. Tolly* [1963] 2 QB 683 where Upjohn LJ indicated that in *Financings Ltd v. Baldock* [1963] 2 QB 104 there was a right to terminate, but not a right to "treat the contract as repudiated".

2-Such an approach (granting loss of bargain damages) would involve an element of injustice against promisor, such as the consumer in *Lombard* case itself, for it will sometimes result in the imposition of a liability which he will find financially intolerable. This is particularly the case where the termination of the contract is motivated by the fact that the contract turned out to be a bad bargain for the injured party. Put another way, the injured party would seek to put an end to the contract not least when he knows that such an action would substantially benefit him by gaining damages for the whole transaction<sup>473</sup>. Therefore the classification of a term into condition in this way would encourage termination of contracts rather than their performance. This contradicts the rule that contracts are entered into to be fulfilled and not to be escaped from. As Roskill LJ stated in *The Hansa Nord* case<sup>474</sup>:

“In principle, contracts are made to be performed and not to be avoided according to the whim of market fluctuation and where there is a free choice between two possible constructions I think the court should tend to prefer that construction which will ensure performance, and not encourage avoidance of contractual obligations”

3-Moreover, *Financings Ltd v. Baldock*<sup>475</sup> was distinguished on the ground that the contract merely contained an option to terminate on non-payment rather than a clause which made punctual payment of the essence. The position in the *Lombard* case was, in substance, the same in giving the owner the right to terminate under the contract with the only difference being that the contract in the latter case affirmed this right twice<sup>476</sup> rather than once in the former case<sup>477</sup>. It was acknowledged that the result of the *Lombard* case (avoiding the penalty rule by elevating a term into condition) has given a chance for any party who wishes to extract penal damages to do so by drafting the contract in such a way

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<sup>472</sup> *Financings Ltd v. Baldock* [1963] 2 QB 104 and *Lombard North Central v. Butterworth* [1987] 1 All ER 267.

<sup>473</sup> The injured party can benefit twice: evading penalty clause rule and getting the loss of bargain damages. See McKendrick, Ewan. “Contract Law”. 5<sup>th</sup> ed. Macmillan 2003. P 225-226. Treitel, S. G. The Law of Contract. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P807. Carter, J W. “The Effect of Discharge of a Contract on the Assessment of Damages for Breach of Contract”. Journal of Contract Law. [1989] 249, at 261.

<sup>474</sup> [1976] QB 44.

<sup>475</sup> *Financings Ltd v. Baldock* [1963] 2 QB 104.

<sup>476</sup> The twice in *Lombard* case to confirm the right to rescind were in clause 2(a) the hiring agreement made punctual payment of each instalment of the essence of the agreement and Clause 5 provided for that failure to make due and punctual payment entitled the claimants to terminate.

<sup>477</sup> In *Financings* case the right to terminate was given under clause 8 which stated that if the hirer should fail to pay any instalment within 10 days after it had become due the owner may terminate the agreement.

that all terms are deemed to be conditions breach of which is regarded as repudiatory. This result allows the injured party to recover damages for the whole transaction, namely loss of bargain damages, even where the breach which has occurred was a non-repudiatory breach at common law<sup>478</sup>. Whether the term which obligates a hirer to pay instalments on time is of the essence or not determines the damages recoverable in such situations. By reason of the provision making the time of payment of the essence the owner would recover damages (loss of bargain damages) which are disproportionately higher than which could be recovered if the provision was drawn otherwise. This confirms that a skilled draftsman could easily avoid the penalty rule.

Consequently, it could be concluded that the result which was achieved in the *Lombard North Central v. Butterworth*<sup>479</sup> case - avoiding penalty jurisdiction by providing that the time was of the essence and thereby making a term condition, breach of which gave the owner the right to receive damages for the whole transaction, which would not be achieved otherwise<sup>480</sup> - should not be preferred<sup>481</sup>. Therefore the penalty jurisdiction should not be evaded merely because the parties stipulate that paying instalments on time is of the essence. The owner should not be allowed to collect damages for the whole transaction rather than damages up to the date of determination if the hirer breaks a term in the contract. Therefore, the outcome in the aforementioned two cases (*Lombard case and Financings case*) should have had the same result of giving the owners the right to get damages up to the date of termination making the provision of giving loss of bargain damages an unenforceable penalty clause. In other words, the express agreement of the parties' classification of a certain term as a condition would be preferable to only confer upon the injured party the power to terminate the contract, but not an entitlement to receive loss of bargain damages.

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<sup>478</sup> See the view expressed by Nicholls LJ in *Lombard North Central plc v. Butterworth* [1987] 1 All ER 267, at 280. See for details Bojczuk, William. "When is a Condition not a Condition". *Journal of Business Law*. [1987] 353, at 359- 362.

<sup>479</sup> *Lombard North Central v. Butterworth* [1987] 1 All ER 267.

<sup>480</sup> *Financing Ltd v. Baldock* (1987) 1 All ER 267.

<sup>481</sup> Treitel, G. "Damages on Rescission for Breach of Contract". *Lloyd's Maritime and Commercial Law Quarterly*. [1987] 143 at 146. Bojczuk, William. "When is a Condition not a Condition". *Journal of Business Law*. [1987] 353, at 361. Chitty on Contract. 29<sup>th</sup> ed. Vol.1. General Principles. Sweet & Maxwell. 2004. P 1497-1498.

### 3:2 Acceleration clause

Acceleration clause states that the remaining balance becomes due immediately should the debtor fail to pay any of the instalments. The effect of this clause does not place any extra liability upon the debtor but presupposes the continuation of the contract as planned apart from that it compels the debtor to pay the whole balance<sup>482</sup>. However what is the possibility of the application of penalty jurisdiction to this clause especially in that it might contain an interest payable with the principal? The application of penalty jurisdiction to a clause, which accelerates the existing liability, depends on the following situations.

#### 3:2:1 Where acceleration clause is for the principal only

The penalty jurisdiction is not applicable to a clause in a loan agreement which merely accelerates liability for payment of principal. The total sum in this instance is construed as a debt presently owing to creditor at the time of making the agreement but only payable on default. It is a kind of indulgence to defer payment of debt and may be withdrawn at the discretion of creditor<sup>483</sup>. In other words, the creditor has at the outset the right to postpone payment of due sum by making regular quarterly instalments equivalent to the principal. On the other hand, he has the right to withdraw this indulgence and accelerate the whole amount to be payable at once in the event of debtor's default. Accordingly, there is no question of penalty may arise if the indulgence is withdrawn. This is because the debtor is not being made to pay any amount more than he contracted to pay; it is only an acceleration of the amount which was already postponed. This fact was well illustrated in *John Wallingford v. Mutual Society*<sup>484</sup> by Lord Selborne LC where stated that:

“I cannot think that such an acceleration of payments has anything common with a penalty. It was a contract for certain payments which were *debita in presenti*

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<sup>482</sup> However, where the debtor fails to pay an instalment when due, the creditor, in the absence of an acceleration clause, may only sue for the unpaid instalment because breach as to future instalments has not yet occurred.

<sup>483</sup> *Protector Endowment Loan and Annuity Company v. Grice* (1880) 5 QB 592. *John Wallingford v. Mutual Society* [1880] 5 AC 685 at 710 per lord Watson. See Chitty on Contract. 29<sup>th</sup> ed. Vol.1 General Principles. Sweet & Maxwell. 2004. P 1496-1497. McKendrick, Ewan. “Contract Law”. 5<sup>th</sup> ed. Macmillan. 2003. P 445. Koffman, Laurence and Macdonald. “The Law of Contract”. 4<sup>th</sup> ed. Tolley. 2001. P 493. Treitel, Sir Guenter. “The Law of Contract”. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1001. Goode, RM. “Acceleration Clauses”. *Journal of Business Law*. [1982] 148, at 150.

<sup>484</sup> *John Wallingford v. Mutual Society* [1880] 5 AC 685.

although *solvenda in futuro*; and, being such, it is consistent both with principle and with authority to hold, that if the party who ought to have paid them, or any of them, at the proper time failed to do so, the default was his own, and the time might lawfully be accelerated for the other payments which were originally deferred.”<sup>485</sup>

The case of *Protector Endowment Loan and Annuity Company v. Grice*<sup>486</sup> is usually cited as the authority for this proposition. It is a clear example of creating an existing debt and of the inapplicability of penalty clause rules to this situation. In this case the claimants lent money to the defendant with interest and the latter gave the creditor a bond for the total amount repayable, i.e. £70. (This sum was covering the principal of the loan, interest thereon, the expenses of negotiating it, and a margin representing a premium for the insurance of the debtor’s life). The contract provided that failure to pay any single instalment makes the balance of instalments payable promptly. Default having been made in payment of one instalment, the claimants brought an action and claimed the outstanding balance. The Court of Appeal held (reversing the judgment of Bowen, J.) that the claim by claimants to recover the whole amount was lawful and there was no question of treating the stipulation to pay immediately as a penalty<sup>487</sup>.

### **3:2:2 Where acceleration clause is for the principal and interest**

A clause which merely makes debtor liable to pay the balance outstanding and interest accrued on the due instalments is not subject to the penalty jurisdiction. This situation is envisaged where the interest is to be paid upon each instalment. In *Oresundsvarvet Aktiebolag v. Marcos Diamatis Lemos (The Angelic Star)*<sup>488</sup> the claimant agreed to build a bulk carrier named *Angelic star* and to sell and deliver her to the purchasers. 20 per cent of the price had to be paid in advance and the balance on delivery by means of delivery credit. The delivery credit had to be repaid over 8 years by 16 instalments with interest of 8.5 per cent payable on the outstanding balance of the loan. Article 7(13) of the contract provided that in the event of default the whole amount of the loan and all other moneys

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<sup>485</sup> Ibid. At 696. Per Lord Selborne LC.

<sup>486</sup> *Protector Endowment Loan and Annuity Company v. Grice* (1880) 5 QB 592.

<sup>487</sup> See also *Oresundsvarvet Aktiebolag v. Marcos Diamatis Lemos (The Angelic Star)* [1988] 1 Lloyd’s LR 122. This case will be fully considered in the next situation where acceleration clause is for principal and interest.

owed to the lenders should be paid at once. The purchasers defaulted and the claimant applied for a summary judgment against the defendants. The Court of Appeal decided that clause 13 was not a penalty clause as there was an acceleration of paying a sum due, i.e. the capital and the outstanding interest due (interest for the accrued instalments). The court construed the words "All other moneys due to the Lenders by the Owners", as meaning "all other moneys due at the time of happening an event of default" and could not be construed as "all other money which would otherwise become due by the owners in the future"<sup>489</sup>.

The parties could pre-compute the interest and integrate it with the instalments of principal. In this situation the position would be different if it is stipulated for the whole amount to be payable. A provision in a contract is supposed to provide for the whole principal and its whole interest to be paid forthwith without giving any discount for unaccrued interest<sup>490</sup>. In such a case the penalty jurisdiction is applicable for the debtor is being made to pay immediately a future interest, i.e. payment not yet due and so the court has the power to award a fairly lower figure commensurate with the creditor's loss<sup>491</sup>. However, if an acceleration clause does allow a discount for unaccrued interest it will not be subject to the rules relating to penalties and liquidated damages.

This is also the situation where the transaction is concerned with conditional sale agreements (instalments sale). When concluding a sale contract the parties might agree in advance that the price would be payable by instalments. Just as in the interest in a loan agreement, such agreement contains a finance charge component that it is simply a "time price differential" representing the cost to a prospective purchaser of the privilege of paying by instalments<sup>492</sup>. Consequently, an acceleration clause in conditional sale

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<sup>488</sup> *Oresundsvaret Aktiebolag v. Marcos Diamatis Lemos (The Angelic Star)* [1988] 1 Lloyd's LR 122 [1988] 1 Lloyd's Law Report 122.

<sup>489</sup> *Ibid.* At 125 per Lord John Donaldson, M.R., at 126 Lord Justice Neill and at 127 per Lord Justice Ralph Gibson.

<sup>490</sup> *Oresundsvaret Aktiebolag v Marcos Diamatis Lemos (The Angelic Star.* [1988] 1 Lloyd's Law Report 122.

<sup>491</sup> *Ibid.*

<sup>492</sup> Goode RM. "Hire-Purchase Law and Practice". 2<sup>nd</sup> ed Butterworths 1970. P 275.

agreements will be subject to penalty jurisdiction if it has not provided a discount of the finance charge component for the unexpired period<sup>493</sup>.

It might be argued that *Protector Endowment Loan and Annuity Company v. Grice*<sup>494</sup>, an authority against the proposition, that the whole principal with its integrated interest is subject to the rules relating to penalties and liquidated damages. This is because the parties had not made any rebate for the unaccrued interest and provided for to be payable at the acceleration clause. This was based on the grounds that the amount claimed (£70) was covering in addition to the principal of the loan, the interest thereon, the expenses of negotiating it and a margin representing a premium for the insurance of the debtor's life. However when the court held that the rule against penalties was not applicable to this case it justified its decision on the basis that the provision to be held as a penalty clause, it should stipulate for a larger sum to be paid in the event of default. In this case it was an agreement of paying a precise sum of £70, i.e. a debt, and there was no additional sum mentioned to be paid on the occurrence of the default. The defendant did not take the point that the amount claimed included unaccrued interest; and the judgment was based on the notion that the claimant did not claim more than the amount which he had bargained. They agreed that the whole amount of £70 was the global sum that did not refer to interest or any expenses<sup>495</sup>. Thus, it was an "agreement for the discharge by quarterly instalments of the whole debt", but the event of failure to comply with the agreement the whole sum of £70 had to become payable at once<sup>496</sup>. This leads to the suggestion that this case does not seem to be an authority to support the proposal that the full amount of pre-computed interest can be recovered and out side the penalty clause rule.

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<sup>493</sup> *Wadham Stringer Finance Ltd v. Meaney* [1980] 3 All ER 789.

<sup>494</sup> *Protector Endowment Loan and Annuity Company v. Grice* (1880) 5 QB 592.

<sup>495</sup> Goode, R. M. "Acceleration Clauses". *Journal of Business Law*. [1982] 148, at 151.

<sup>496</sup> *Protector Endowment Loan and Annuity Company v. Grice* (1880) 5 QB 592, at 594 per Cockburn, C.J. and see also at 596 per Brett, L.J.

### 3:2:3 How is the penalty jurisdiction applicable to acceleration clause?

Lord Dunedin stated in the leading case<sup>497</sup> the test for the invalidity of penalty clauses in English law<sup>498</sup>. The sum stipulated might be liquidated damages if it is a genuine pre-estimate of the loss that is likely to be suffered as a result of breach at the time of making the contract. However, it will be held as a penalty if it has no relation to the loss likely to be suffered. The effect of the above critical analysis in which two cases were examined (where the acceleration for the principal alone; and the other where it is for the principal and its interest) leads to the assertion that acceleration clauses are subject to rules relating to penalties and liquidated damages. In other words, the conclusion is that acceleration clauses are subject to the penalty jurisdiction but will be held to constitute valid liquidated damages clauses, would seem to be a straightforward application of Lord Dunedin's test. Thus, the validity of acceleration clause should be determined by the general disproportion principle.

An example of this would be, if £5000 was due to creditor under a contract in which it was provided the sum was to be paid in £500 monthly instalments. If debtor defaulted in punctual payment of any of those instalments, he would be responsible to pay the whole amount immediately. That is, if debtor did not pay the monthly £500 he would, under the acceleration clause, be requested to pay the whole outstanding balance of £5000 instantly. This clause confers upon creditor the right, while keeping the agreement alive, to recover from defaulting debtor the full unpaid balance payable under the contract. Therefore under acceleration clause the liability of the debtor is still the same by paying the entire amount of £5000, but, earlier than otherwise. In such a situation it is argued that an acceleration of liability is not caught by the penalty rules though it makes the payment more expensive for debtor by paying it at once instead of instalments<sup>499</sup>. This is the only situation where the amount is liquidated damages.

One might criticise this position as follows. The crucial ingredient in such clauses is that there should be a present debt, which by the indulgence can be paid by instalments,

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<sup>497</sup> *Dunlop Pneumatic Tyre Co v. New Garage & Motor Co* [1915] AC 79.

<sup>498</sup> *Ibid.* At 87.

<sup>499</sup> Treitel, S. G. "The Law Of Contract". 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1001.

provided that each instalment must be paid on time. This means a further drafting exploitation of the difference between substance and form results in evading penalty clause rules<sup>500</sup>. In response, an argument of form and substance in this instance can not be strengthened or make any unjust consequence as seen in the event of promoting a term into condition. This is because acceleration clauses do not compel the debtor to pay a penny more than he contracted to pay at the outset; he is merely being required to pay it sooner. In other words, his right to postpone payment is withdrawn.

However, suppose that the parties, in the instance given above, agreed that an interest of £2000 to be payable with the principal. They integrated the £2000 with £5000 by adding £200 to each instalment. Having the debtor or purchaser defaulted in paying one instalment, the creditor or vendor, under acceleration clause, claimed the whole amount of £7000 to be paid immediately. In this instance the debtor is being asked to pay an extravagant sum in the event of not paying a one instalment. This may be said to constitute an invalid penalty. Therefore it is suggested that the acceleration clause in this situation should be subject to the penalty rule for it has some compulsion and hardness towards the debtor. In *Oresundsvarvet Aktiebolag v. Marcos Diamatis Lemos (The Angelic Star)*<sup>501</sup> Lord John Donaldson, M.R. stated.:

“Clearly a clause which provided that in the event of any breach of a contract a long term loan would immediately become repayable and that interest thereon for the full term would not only be still payable but would be payable at once would constitute a penalty as being “a payment of money stipulated as *in terrorem* of the offending party”<sup>502</sup>.

In summing, if the debtor agreed to pay an interest or a financial charge component that was because he was given the right to pay the principal or the price by instalments. If this right was withdrawn without giving a proper rebate for the unaccrued interest the acceleration clause would be regarded as a penalty.

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<sup>500</sup> Jacobs, Sydney. “Damages in a Commercial Context”. LBC Information Services. 2000. P 270.

<sup>501</sup> *Oresundsvarvet Aktiebolag v. Marcos Diamatis Lemos (The Angelic Star)* [1988] 1 Lloyd’s LR 122.

<sup>502</sup> *Ibid.* At 125.

As far as Jordanian law is concerned there is no provision in the code on the question of whether the penalty clause rules are capable of being applicable to an acceleration clause in all kind of transactions. The law, for example, gives parties to a contract the right to agree in advance that the price in conditional sale agreement should be payable in instalments<sup>503</sup>. However it does not tackle the situation in which the parties may provide in their agreement that in the event of default, namely non payment of any instalment on time, the whole unpaid instalments will be accelerated. In other words, the law regards this agreement as valid and leaves no power for the courts to apply the rules relating to penalty clauses. Article 483 of the law compels the purchaser to pay the price immediately however it legitimatises the parties' agreement to make the price payable in instalments. As a result it upholds any agreement between the parties to pay the price in any way at their will unless such agreement is invalid by law<sup>504</sup>. This also means it upholds their agreement on acceleration clause for this clause does not conflict with the law<sup>505</sup>. However, the existing position of the Jordanian law regarding acceleration clause lays itself open to criticism as it sometimes encourages parties to evade penalty clause rules. It is suggested that the position in English case law is preferable and capable of being followed to improve the way of tackling such clauses in Jordanian law. This is to say making the penalty jurisdiction applicable to acceleration clauses particularly where there is no rebate for the unaccrued interest or financial charge component.

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<sup>503</sup> Article 483 of Jordanian Civil Law.

<sup>504</sup> See article 164/2 Jordanian Civil Law.

<sup>505</sup> See for this meaning Civil Cassation 64/960 Bar Association Journal 1960. P 62.

## **Chapter Four: Courts Power over Penalty Clauses**

### **0-Introduction**

The rule in English case law is simple, and the technical application of current rules of the law leads to a clear outcome. Where the agreed sum, whatever it is called in the contract, is held by the courts to constitute a penalty it “cannot be enforced so as to enable a party to recover...more than his actual loss”<sup>506</sup>. In other words, the penalty clause is of no legal effect and should be considered, as though it had not existed in the contract at all. As a result the injured party is relegated to having his damages for the losses he has suffered to the ordinary way of unliquidated damages action. The court will declare the agreed damages clause unenforceable according to the disproportion principle in three cases: where there is a possibility to calculate likely anticipated loss at the time of contracting, where a single lump sum is payable on one of several events (presumption) and where a graduated sum slides to the wrong direction. However, is agreed damages clause a “dead letter” in all cases or are there cases in which the court can uphold this clause? The courts have over the time identified some cases in which the stipulated sum might be regarded as valid liquidated damages.

It is also important to emphasise that the New Approach’s impact appears mostly in this chapter. The approach operates from the presumption that penalty clauses should be given effect, as reflecting the will of the parties to a contract. This does not mean denying any power of control over such clauses. Rather the court will have the power, which however should be seen as exceptional, to modify their amounts. The effectiveness of the New Approach will be demonstrated by examining the following two possibilities: enforcement of all agreed damages clauses and non-enforcement as opposed to the existing bifurcation of these provisions.

Therefore this chapter seeks to deal with the courts’ power over penalty clauses in English law as to penalties in comparison to Jordanian law. To do so the following issues will now be considered:

- 1- Courts intervention to declare the invalidity of penalty clauses: examining the cases where courts should declare the unenforceability of penalty clauses in order to distinguish them from liquidated damages clauses
- 2- The position of Jordanian civil law compared to English law
- 3- Effect of New Approach on courts power over penalty clauses

## 1-Courts intervention to declare the invalidity of penalty clauses

In *Robophone Facilities Ltd v. Blank*<sup>507</sup> Diplock LJ said that: “The court has no general jurisdiction to re-form terms of a contract because it thinks them unduly onerous on one of the parties...“penalty clauses” are simply void”. Therefore the court should not allow the injured party to recover under a penalty provision in contract a sum of money manifestly in excess of his likely actual damages. It should declare the unenforceability of the penalty clause leaving the injured party to sue for damages regarding the loss he suffered as a result of breach as he can prove in the ordinary way<sup>508</sup>. Consequently “In practice a penalty clause in a contract...is effectively a dead letter”<sup>509</sup> or “from another point of view a “brutum fulmen””<sup>510</sup>. Therefore although they maintain a supervisory jurisdiction on contracts made by the parties, the courts have no power to rewrite such contracts, but they can relieve the injured party against the provisions, which are of penal nature.

In essence agreed damages clause might be penalty or liquidated damages according to the degree of disproportion between its amount and the likely actual loss suffered at the time of making the contract. The mere fact that agreed damages clause is in excess of the probable loss does not excite the court to hold such clause as a penalty. Rather it should be extravagant and unconscionable to the loss likely to be sustained on breach. The

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<sup>506</sup> *Jobson v. Johnson* [1989] 1 WLR 1026, at 1038.

<sup>507</sup> *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128, at 142 per Diplock LJ.

<sup>508</sup> *Jobson v. Johnson* [1989] 1 WLR 1026, at 1032. *Commissioner of Public Works v. Hills*. [1906] AC 368. This case was said in *Jobson v. Johnson* at 1038 to be “further illustration...” that penalty clauses are unenforceable. See also McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> edition. Sweet & Maxwell. 2003. P 429-430. Halson, Roger. “Contract Law”. First published in Great Britain. 2001. P 516. McKendrick, Ewan. “Contract Law “. 5<sup>th</sup> ed. 2003. P 442.

<sup>509</sup> *Jobson v. Johnson* [1989] WLR 1026, at 1040. See also *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, where Lord Woolf said that: “the courts have always avoided claiming that they have any general jurisdiction to rewrite the contracts that the parties have made”.

distinction between liquidated damages and penalty clauses has not always been an easy task for the courts to decide. It is occasionally a matter of some difficulty to ascertain whether agreed damages are, in the individual facts of the case, penalties or liquidated damages, but the principles applied by the courts are well established. The courts have developed specific rules to make such jobs easier by determining the cases in which the court may intervene to knock a penalty clause down. Lord Dunedin effectively set out cases relying upon the previous decisions of the courts. He stated that in the leading case of *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>511</sup>: "...I shall content myself with stating succinctly the various propositions which I think are deducible from the decisions which rank as authoritative". Then he set out these rules which would be the guidelines in establishing circumstances that justify the court's intervention to invalidate penalty clauses and making the distinction with liquidated damages clauses. It should be noted that all these cases are activated in conformity with the chief test<sup>512</sup> in determining the invalidity of penalty clauses in English case law. Accordingly the following rules for distinguishing and determining the unenforceability of penalty clause will be now considered:

### **1.1 Cases where courts should declare the invalidity of penalty clauses**

Three cases may be mentioned to constitute the circumstances in which the court would declare the unenforceability of penalty clause if its amount was an extravagant and unconscionable:

- 1- Where there is a possibility to calculate likely loss at the time of contracting
- 2- Where a single lump sum is payable on one of several events (presumption)
- 3- Where a graduated sum slides to the wrong direction

#### **1.1.1 Where there is a possibility to calculate the anticipated actual loss**

Where there is, at the time when the contract is made, no difficulty in calculating the loss, which might be sustained as a result of breach, namely in an instance where the loss inflicted on an injured party from breach could be reasonably or accurately calculated in

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<sup>510</sup> *Wall v. Rederiaktiebolaget Luggude* [1915] 3 KB 66, at 73 per Bailhache J.

<sup>511</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 86.

money, the task of the court would be straightforward to determine the enforceability of agreed damages clause. If the injured party seeks to enforce the sum stipulated as liquidated damages, he should provide proof that the sum is equal, or not represent extravagant or exorbitant sum, to the sum which might have been produced from calculating the likely anticipated loss. This principle is justified on the grounds that the loss can be readily calculated in money at the time of contracting. Therefore it can be argued that the standard in this case may be regarded as an objective one. This is because the task of establishing the test of the sum being an extravagant and unconscionable is made in an easy and simple way. It does not depend on what the parties have stipulated in the contract, but on the comparison between the sum stipulated with the genuine estimation that should have been given, where there had been a genuine attempt of the parties to provide for the anticipated loss. In other words, where there is no difficulty in pre-estimating the likely anticipated loss suffered, the concept of loss is easy to understand and the calculations can be based on figures which can be verifiable and reliable. This case is particularly relevant where the obligation accrued on defaulting party is paying a sum of money, or this obligation is one of different undertakings. However where there is a difficulty in calculating the anticipated loss the clause is more likely to constitute valid liquidated damages. The three cases will now be examined.

#### **1.1.1.1 Where paying a sum of money is a single obligation**

The most obvious instance for this case is where the defaulting party fails to pay a sum of money, whereby a larger sum will be payable. This sum will be treated as a penalty since it does not represent a genuine pre-estimate of loss. It will not constitute liquidated damages<sup>513</sup> on the grounds that this rule is based on the principle that the exact amount of loss is known, and fixing a greater one payable can not be regarded as a genuine pre-estimate of damage<sup>514</sup>. Nevertheless, it should be noted that not paying the sum stipulated on time might become serious or rather harmful to the injured party because of consequential losses. In other words, the injured party might be ruined because of non-

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<sup>512</sup> The main test is the sum being extravagant and unconscionable in comparison with the greatest loss which might be suffered as a result of breach at the time of making the contract. *Supra*. P 52.

<sup>513</sup> *Dunlop Pneumatic Tyre Company LTD v. New Garage and Motor Company LTD*. [1915] AC 79, at 87.

<sup>514</sup> Furst, Stephen and Ramsey, Vivian. "Keating on Building Contracts". 7<sup>th</sup> ed. Sweet and Maxwell. 2001. P 284.

paying the sum agreed upon in the contract on time, and so the damages might be enormous. In spite of that, Lord Dunedin has stated in the leading case<sup>515</sup> that “ it will be held to be a penalty if the breach consist 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 <sup>516</sup>”. Therefore, according to this rule, if the debtor promises to pay the creditor £1000 at a certain time and the contract provides that on default in punctual payment the debtor should be liable to pay £3000. The creditor can not recover the £3000 for non-timeous payment as it is a penalty in accordance with the above rule.

However, this rule can be considered rather harsh in some cases<sup>517</sup>. Paying a sum of money on time might be of great significance to the injured party. For instance it might be needed to pay a deposit in a deal containing an enormous value and the defaulting party knows this fact<sup>518</sup>. Thus, it might be said that the parties might stipulate for the likely actual loss even though the sum stipulated is more than the sum which represents the original obligation, on the condition that it is not too extravagant or exorbitant. To this result it would be appropriate<sup>519</sup> to say that the rule contained in Lord Dunedin

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<sup>515</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>516</sup> *Ibid.* At 87 per Lord Dunedin. It has been found many, *obiter dicta*, supporting this rule. In *Law v. Local Board of Redditch* [1892] 1 QB 127 per Lord Esher M.R at 130 he stated : “ On rule which appears to be recognised ...where the parties to a contract have agreed that , in case of one of the parties doing or omitting to do some one thing he shall pay a specific sum to the other as damages, as a general rule such a sum is to be regarded by the court as liquidated damages and not a penalty. One recognised exception to such rule is where a sum of money is to be payable upon the non payment of smaller specified sum, in which case the courts have treated the larger sum as a penalty”. *Astley v. Weldon* (1801) 2 B& P 346; 126 ER 1318,at 1323 per Lord Chambre J.

<sup>517</sup> McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> edition Sweet & Maxwell. 2003. P 434. Treitel, S. G. “The Law of Contract”. 11<sup>th</sup> ed. Sweet and Maxwell. 2003. P 1000. Ogus, A I. “The Law of Damages”. Butterworths. 1973. P 45. Muir, Garry A. “Stipulations for the Payment of Agreed Sums”. *Sydney Law Review*. (1985) 10 503, at 515.

<sup>518</sup> *Wallis v. Smith* (1882) 21 Ch.D 243, 257 where Lord Jessel delivered the strongest attack upon that rule when said that: “ Now it may well be that the court thought that it was absurd to make a man pay a larger sum by reason of non payment of a smaller. It has always appeared to me that the doctrine of the English Law as to non-payment of money, the general rule being that can not recover damages because it is not paid by a certain day, is not quite consistent with reason. A man may be utterly ruined by the non-payment of sum of money on a given day, the damages may be enormous, and the other party may be wealthy. However that is our law. If however, it were not our law the absurdity would be apparent... it is not unreasonable as it appears to me in these cases to say if you don't pay the £500, or it may be £50, on that date you shall pay £5000 for damage I shall sustain”

<sup>519</sup> For details to this end see Ogus , A I. “The Law of Damage”. Butterworths. 1973. P 45. Treitel, S. G. “The Law of Contract”. 11<sup>th</sup> ed. Sweet and Maxwell. 2003. P 1000.

statement would be preferable not to be applied to all cases<sup>520</sup> on the grounds that the injured party's obligations may mean that the loss sustained exceeds the sum due and the sum stipulated. Then the latter should be recoverable as liquidated damages if it is a genuine pre-estimate of likely loss, which might be sustained by non-payment even though it is in excess of original sum. This has been supported by recent judicial trends<sup>521</sup> where the courts have allowed the injured party to be entitled to a "Special damages"<sup>522</sup> (other than interest)<sup>523</sup> against the loss suffered by him on the ground that the non-payment on time might negatively affect him in any way. This is particularly the case when the defaulting party knows that the injured party will be badly affected. Reasons to know should be concluded from the conditions and circumstances surrounding the contract. In *Wadsworth v. Lydall*<sup>524</sup> the Court of Appeal upheld this proposition by granting special damages, despite the fact that they were in excess of the sum stipulated. In this case Brightman L.J confirmed the right of the claimant to be entitled to such damages as liquidated damages:

"If a plaintiff pleads and can prove that he has suffered a special damages as a result of the defendant's failure to perform his obligation under a contract and such damage is not too remote on the principle of *Hadley v. Baxendale*, I can see no logical reason why such special damage should be irrecoverable merely because the obligation on which the defendant defaulted was an obligation to pay money and not some other type of obligation<sup>525</sup>,"

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<sup>520</sup> The rule is "it will be held to be a penalty if the breach consist 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". *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 87.

<sup>521</sup> *Trans Trust v. Danubian Trading Co* [1952] 1 All ER 970, at 975. *Wadsworth v. Lydall* [1981] 1 WLR 598. *The President of India v. Lips Maritime Corporation* [1988] 1 AC 395.

<sup>522</sup> This term indicates the loss which does not result directly from the breach but which is still not unlikely consequence of the breach, i.e. consequential losses.

<sup>523</sup> *The President of India v. Lips Maritime Corporation* [1988] 1 AC 395, at 429 where Lord Mackay of Clashfern stated there that: "the reasoning of this house in *President of India v. La Pintada Cia Navigacion SA* ([1985] AC 104) make it clear that the damages other than interest may be recovered for breach by late payment". It should be noted that in *President of India v. La Pintada Cia Navigacion SA* [1985] AC 104. the House of Lords affirmed the common law rule that interest is not payable by way of general damages for delay in payment of debt, unless there is an express provision to do so in the contract. See also for details Yoshida, Ikko. "Comparison of Awarding Interest on Damages in Scotland, England, Japan and Russia". *Journal of International Arbitration*. 17(2) 41, at 53-58.

<sup>524</sup> (1981) 1 WLR 598. The House of Lords had approved this approach by allowing the recovery of special damages in its decision in *President of India v. Lips Maritime Corporation*. [1988] 1 AC 395. See also Downes, Antony. "A Textbook on Contract". 5<sup>th</sup> ed. Blackstone Press. 1997. Reprinted 1999. P 347. Chitty on Contract. 29<sup>th</sup> ed. Vol.1 general principles. Sweet & Maxwell. 2004. P 1509-1502.

<sup>525</sup> *Wadsworth v. Lydall*. [1981]1 WLR 598, at 603 per Brightman.

Based upon this the Court of Appeal held that:

“... Since the defendant knew or ought to have known that the plaintiff would need to acquire another farm or smallhold, using the £10,000 payable under the contract for the purpose. and that if the £10,000 was not paid, the plaintiff would be compelled to incur expense in arranging alternative finance and paying interest, the claim for £335 and £1620 were not too remote and were payable by the defendant”<sup>526</sup>

### 1.1.1.2 Where paying a sum of money is one of several obligations

Where one of several obligations can, at the time when contract is entered into, reasonably or accurately be computed in money, fixing a larger sum as an agreed damages will prima facie be treated as a penalty. This penal nature will also apply to all other probable breaches, irrespective of maybe having a larger loss, calculable or not<sup>527</sup>. In *Kemble v. Farren*<sup>528</sup> an actor contracted with a manager of a theatre and under the contract the manager agreed *-inter alia* – to pay to the actor £3 per night that the theatre was open. They laid down in the contract £1000 to be payable by either if it failed to perform the agreement, or any part of it, or any stipulation contained in it. This sum was held to constitute a penalty clause for from the tenor of the agreement the provision meant that the £1000 would have to be paid by the manager if he had failed to pay the actor £3 for one night. In holding the penal nature of the sum Tindal CJ stated that when: “a very large sum should become immediately payable in consequence of the non-payment of a very small sum, and that the former should not be considered as a penalty appears to be a contradiction in terms”<sup>529</sup>. In this case since one of the different undertakings could be exactly calculated in money, there was no difficulty in the calculation thereby fixing a larger sum payable in the event of any breach of which the sum become payable, would be treated as a penalty.

Therefore, the rule concerned - paying a larger sum in the event of non-payment of a smaller sum either in the situation in question or where the paying a sum of money is a

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<sup>526</sup> Ibid. At 298-299. And see also *Muhammad Issa Sheikh Ahmad v. Ali* [1947] AC 414. And *Trans Trust v. Danubian Trading Co* [1952] 1 All ER 970. *Herbert v. Salisbury and Yeovil*, (1866) LR 2 EQ 221.

<sup>527</sup> This has been clearly affirmed in general terms by Heath J in *Astley v. Weldon* (1801) 2 B&P 346; 126 ER 1318: “where articles contain covenants for the performance of several things, and then one large sum is stated at the end to be paid on breach of performance that must be considered as a penalty”.

<sup>528</sup> *Kemble v. Farren* (1829) 6 Bing 141; 130 ER 1234.

single obligation - should be applied if a sum stipulated was excessively high in comparison with the loss, which might be suffered as a result of breach at the time of contracting. Otherwise it is liquidated damages but only if it represents a genuine attempt to pre-estimate the probable actual loss which might ensue upon breach. As has been seen before, the mere fact that the sum stipulated is merely in excess of the probable actual loss should not motivate the court to strike down the sum as a penalty. As a penalty jurisdiction is a blatant interference in the doctrine of freedom of contract, the court's intervention should be available where there is a clear injustice involved. This is because the court, in general, should not be allowed to interfere in a freely made agreement unless there is a clear disproportion between the agreed sum and the loss likely to flow from breach.

### **1.1.1.3 Where there is a difficulty to calculate the anticipated actual loss**

The principle is that the greater the difficulty of estimating or proving damages, the more likely the stipulated damages will appear genuine estimation of the loss that might be suffered. The very uncertainty of the likely loss sustained at the time of formation the contract is the main reason, which motivates the parties to agree beforehand on compensation of damages sustained on breach<sup>530</sup>. Basically, any sum agreed upon by parties in these circumstances is supposed to be considered as liquidated damages, when from the nature of the case and tenor of the agreement, it is clear that the damages have been the subject of actual and fair calculation and adjustment between the parties. This fact was embodied in *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>531</sup>. In this case Lord Dunedin stated that:

“It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimate 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.”<sup>532</sup>

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<sup>529</sup> Ibid. See also in *Astley v. Weldon* (1801) 2 B&P 346; 126 ER 1318.

<sup>530</sup> *Clydebank Engineering Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6, at 11 per Lord Halsbury.

<sup>531</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>532</sup> Ibid. At 87 per Lord Dunedin.

The mere fact that the damages for breach of contract would be very difficult and complex to be assessed does not mean that the stipulated sum could not be liquidated damages. For example, in contracts with public organizations such as for construction of roadworks or defence supplies or the like, where it is often impossible to quantify the loss suffered by delay or non-performance, liquidated damages clauses are almost universally used<sup>533</sup>. In *Philips Hong Kong Ltd v. The Attorney General of Hong Kong*<sup>534</sup>, Lord Woolf stated:

“It would be obvious that substantial loss would be suffered in the event of delay but what that would be would be virtually impossible to calculate precisely in advance. In the case of a government body the nature of the loss it will suffer, as a result of the delay in implementing its new road programme is especially difficult to evaluate”<sup>535</sup>

It might be argued that liquidated damages may not be applied for following late completion of a project because the employer (injured party) suffers no loss. This is however doubtful because in law the difficulty of precise calculation has long been recognised in the courts and provided that a genuine attempt is made at pre-estimating loss, such loss would be accepted as liquidated damages. Furthermore the argument is wrong in fact as the injured party will usually have suffered a loss, if only in extra supervision costs or financing charges<sup>536</sup>. In *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda*<sup>537</sup>, the contracts contained liquidated damages clause for late delivery specifying the damages payable per week for each vessel that was delivered late. The House of Lords refused the argument of the contractors that the amount paid for late delivery could not be a genuine pre-estimate of loss since there was no loss as “a warship does not earn money”<sup>538</sup>. Therefore the sum was liquidated damages and not a penalty in spite of the fact that it was not possible to put a commercial value of the loss of use of such a vessel. However under the New Approach the stipulated sum can be reduced where it is disproportionately greater than the actual loss. It is the

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<sup>533</sup> Atiyah, P. S. “An Introduction to the Law of Contract”. 5<sup>th</sup> ed. Clarendon Press. Oxford, 1995. P 435. *Philips Hong Kong Ltd v. The Attorney General of Hong Kong*. (1993) 61 BLR 41.

<sup>534</sup> (1993) 61 BLR 41.

<sup>535</sup> Ibid. At 60.

<sup>536</sup> Eggleston, Brian, “Liquidated Damages and Extension of Time in Construction Contracts”. 2<sup>nd</sup> ed. 1997. P 65.

<sup>537</sup> *Clydebank Engineering and Shipbuilding Co. v. Don Jose Romos Yzquierdo Y Castaneda* [1915] AC 6.

defaulting party who should prove the extravagance of stipulated sum for the loss suffered by the government should always be presumed.

The conclusion is that if there is any difficulty, at the time of contracting, to estimate the loss likely to be suffered on breach, due to some special circumstances, it is a sign that the sum stipulated is valid liquidated damages, provided that there was a fair calculation between the parties.

### **1.1.2 Where a single lump sum payable on one of several events (presumption)**

Parties to a contract might agree on a single lump sum to be payable in the event of breach of any one of the undertakings in the contract. The enforceability of such a sum depends on whether or not it is extravagant and unconscionable in comparison with the probable actual loss sustained on breach. Previously, the courts have tended to regard as a rule of law that the single lump sum is strictly a penalty. Whenever the contract contained more than one undertaking, and a single lump sum was provided to be payable for a breach of any one of them, the sum was treated as a penalty without any exceptions. This is to say that the sum could not form valid liquidated damages under any shape or circumstance. In *Astley v. Weldon*<sup>539</sup> this trend was clearly pointed out when Lord Eldon C.J stated that:

“Where a doubt is stated whether the sum inserted is a penalty or not, if a certain damage less than that sum is made payable on the face of the same instrument, in case the act intended to be prohibited be done, shall be construed to be a penalty”.

This approach was open to doubt. It is not reasonable to hold that the parties intended the whole amount to be payable in the event of any breach of several stipulations<sup>540</sup>. The single lump sum might be regarded as a true and honest attempt to pre-estimate the likely actual loss as will be shortly illustrated. Therefore, there had to be a more reasonable approach in order to temper such rigorous rule, which was capable of making the

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<sup>538</sup> Ibid. At 12 Lord Halsbury.

<sup>539</sup> *Astley v. Weldon* (1801) 2 B& P 346; 126 ER 1318. This principle was framed in a slightly different form in *Law v. Local Board of Redditch* [1892] 1 QB 127 by Kay L.J when he stated in this case that the courts would refuse to give effect to a provision” where the damages were made payable not on a single event but on number of events, some of which might result in inconsiderable damage”.

<sup>540</sup> *Galsworthy v. Sstrutt* (1848) 1 Ex 559, 666; 154 ER 280.

stipulated sum irrecoverable in almost all cases of different contractual undertakings<sup>541</sup>. Then the courts have tended to embrace a fairer approach by considering the single lump sum as a penalty a presumption and not a rule of law. Therefore, there is an inference that the single lump sum is to be treated as a penalty in the event of breach of any one of several undertakings if it is excessively higher than the lowest loss, which might be suffered from different breaches. This presumption was first pointed out by Lord Waston in *Elphinstone v. Monkland Iron & Coal Co*<sup>542</sup> and then incorporated by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>543</sup>, by saying that:

“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 several events, some of which may occasion serious and others but trifling damage<sup>544</sup>”.

This presumption supposes that the test to determine whether the single lump sum stipulated in contract is a penalty or liquidated damages, should be measured and compared with the lowest loss which might be sustained by the injured party from various breaches<sup>545</sup>. Therefore, where a contract contains several obligations and damage likely to result from the breach of any one of them is capable of being measured by a precise sum, then, if the sum stipulated is disproportionately higher than that sum, it would be inevitably treated as a penalty. It is no more than an inference in favour of penalty, which might be rebutted in several ways, as will now be tackled. Therefore, where the court looks at a case involving a single lump sum it will be a sign that the sum stipulated is a penalty unless the injured party provides proof of the sum being valid liquidated damages.

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<sup>541</sup> McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 436. Ocus. AI. “The Law of Damages”. Butterworths. 1973. 43.

<sup>542</sup> *Elphinstone v. Monkland Iron & Coal Co* [1886] 11 AC 332, at 334 per Lord Waston. This sum then was followed and approved by Lord Davey in *Clydebank Engineering and Shipbuilding Co. v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6.

<sup>543</sup> [1915] AC 79

<sup>544</sup> *Ibid.* At 87 per Lord Dunedin.

<sup>545</sup> *Ibid.* At 89 per Lord Dunedin where he stated that “If there are various breaches to which one indiscriminate sum to be payable in breach is applied, then the strength of the chain must be taken at its weakest link.”. See also *Astley v. Weldon* (1801) 2 B& P 346; 126 ER 1318.

### 1.1.2.1 Where courts declare the validity of a single sum

Lord Dunedin in *Dunlop* case stated that a “presumption is raised in favour of a penalty where a single lump sum is to be paid by way of compensation in respect of many different events, some occasioning serious, some trifling damage”<sup>546</sup>. However such a single lump sum might turn out to be valid liquidated damages and enforceable in some circumstances where the presumption is rebutted in favour of the injured party. This might be achieved in several ways, which will now be considered:

- 1- Where the losses are difficult to assess
- 2- Where the stipulated sum is taken as an average of the likely loss
- 3- Parties’ agreement to confining the field of the stipulated sum

#### 1.1.2.1.1 Where losses are difficult to be assessed

This way supposes that losses, which might arise from breach of various undertakings, are unfeasible to be assessed owing to certain circumstances. Therefore, it cannot be known, at the time of contracting, that losses from one breach would be greater or less than those losses which might flow from another breach. In this situation the sum stipulated should be treated as valid liquidated damages, as “[I]t is well known that damages...though very real may be difficult of proof and that proof may entail considerable expenses<sup>547</sup>”. The very uncertainty of the amount of probable recovery and the difficulty of precise pre-estimate of the loss likely to arise as a result of breach, have always been treated as factors lending weight to arguments for enforcement of the agreed damages clause<sup>548</sup>.

Where the losses are difficult to assess making the amount of damages uncertain the court should not be ready to discover the penal nature of the clause for this is the base at which

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<sup>546</sup> *Dunlop Pneumatic Tyre Company LTD v. New Garage and Motor Company LTD* [1915] AC 79, at 96 per Lord Atkinson

<sup>547</sup> *Rowland valentine Webster v. William David Bosanquet*. [1912] AC 394, at 398. Per Lord Mersey.

<sup>548</sup> *Clydebank Engineering and Shipbuilding Co. v Don Jose Ramos Yzequiedo Y Castaneda*. [1905] AC 6, at 11. See also *Rowland valentine Webster v. William David Bosanquet*. [1912] AC 394, at 398. Per Lord

the parties always justify their agreement on damages beforehand. However, the sum stipulated as a result of the agreement should be a genuine pre-estimation of the likely loss. The consequence of the stipulation should not be to award the injured party a disproportionately larger sum whereby it would be regarded as a penalty. In *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>549</sup> Lord Atkinson indicated frankly this situation, where the presumption in favour of penalty operates with some latitude, saying:

“Although it may be true...that a presumption is raised in favour of a penalty... it seems to me that that presumption is rebutted by the very fact that the damage caused by each and every one of those events however varying in importance, may be of such an uncertain nature that it cannot be accurately ascertained<sup>550</sup>”.

In *Dunlop* case itself<sup>551</sup> the presumption was rebutted as it was difficult “to estimate precisely in money, the exact amount of damages which might be caused”<sup>552</sup>. In this case Dunlop agreed not to tamper with the markings on Ps tyres, nor to sell the tyres below the listed price, nor to sell to persons whose supplies Ps had decided to suspend, nor to exhibit or export them without Ps consent. A provision was included in the contract to the effect that £5 was to be payable for every tyre sold or offered in breach of the agreement. There were many ways in which tyres could be sold or offered in breach of the contract, but loss probably to result from any such breach was difficult to assess and therefore £5 was regarded as a reasonable speculation and thus valid liquidated damages.

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Mersey. *Dunlop Pneumatic Tyre Company LTD v. New Garage and Motor Company LTD* [1915] AC 79, at 87 per Lord Dunedin.

<sup>549</sup> [1915] AC 79.

<sup>550</sup> *Ibid.* At 96 per Lord Atkinson. See also *Galsworthy v. Strutt* . (1848) 1 EX 659; 154 ER. 280 where this instance was first put. Lord Parke stated there that “Now it is perfectly competent to parties to make a stipulation to pay a fixed sum for the breach of a covenant, the damage arising from which it is extremely difficult to ascertain, and I think that it is not an unreasonable stipulation which the defendant has made that he should pay £1000 upon the event of either of matters mentioned in this agreement.” As well as Lord Atkinson B at 282 stated there that “The amount of damage which a person might sustain by another’s practising within 7 miles for the period of 7 years would not be the same in amount as if he was to practise within 40 miles, or next door, nor the same if he had set up in business in the first, second or sixth year. In one case the fixed damage might be small and in the other large but the parties have agreed to a certain fixed sum in order to prevent the necessity of being at the expense of procuring the attendance of witnesses for the purpose of giving evidence upon these matters”.

<sup>551</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>552</sup> *Ibid.* At 96.

### 1.1.2.1.2 Where the stipulated sum is taken as an average of likely losses

This case supposes that, though the sum is construed to apply to the breach of different undertakings, it can still be valid liquidated damages if it is an attempt to average out the loss probably sustained from breach of all obligations<sup>553</sup>. In *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>554</sup> Lord Parker of Waddington, clearly affirmed the case of rebutting the presumption in favour of penalty when a single sum is provided for. His Lordship raised an instance in the case itself confirming that averaging the feasible losses, which might be suffered on breach, can displace this presumption.

“Supposing it was recited in the agreement that the parties had estimated the probable damage from breach of one stipulation at from £5 to £15, and the probable damage from a breach of another stipulation at from £2 to £12, and had agreed on a sum of £8 as a reasonable sum to be paid on the breach of either stipulation, I cannot think that the court would refuse to give effect to the bargain between the parties<sup>555</sup>.”

However, it should be noted that to put this situation in action, namely making the sum stipulated valid and thus avoiding the activation of penalty jurisdiction, two factors should be met<sup>556</sup>. Firstly, it must not be a great difference between the largest possible loss and the lowest possible loss. Secondly, there should have been a difficulty in assessing the loss, which might be sustained as a result of breach. This is because if one of the losses is capable of exact evaluation, at the time of contracting, the agreed damages should represent a genuine pre-estimate of that loss. In delivering the judgment in *Ariston SLR v. Charly Records*<sup>557</sup> Beldam LJ held the sum stipulated as a penalty, as, *inter alia*, it has not been any difficulty to make an accurate or reasonable estimation. He stated that: “It would not have been difficult to have made the daily sum proportionate to what was

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<sup>553</sup> Halson. Roger. “Contract Law”. First published in Great Britain. Longman 2001. P 515. McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 442-443. Ogus. AI. “The Law of Damages”. Butterworths. 1973. P 44.

<sup>554</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>555</sup> *Ibid.* At 99 per Lord Waddington. But it should be just noted that His Lordship, when made the calculation process, has not reached to the exact average, which should have been 8.5, as  $(10+7)/2=8.5$ .

<sup>556</sup> See for these factors, see *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128 where Diplock LJ where stated that “... such estimate depend upon number of factors incapable of precise prediction and can never be more than approximate within fairly wide limits”. And see also *English Hop Growers v. Dering* [1928] 2 KB 174, 182 per Lord Scutton LJ. When stated that “Damages of the same kind, but difficult to value exactly may be averaged to avoid the difficulty it seems...also reasonable”.

<sup>557</sup> *Ariston SLR v. Charly Records* [1990] The Independent Law Reports .13 April.

detained by providing for a sum to be paid per item per day, or for each title which couldn't as result of such detention be manufactured elsewhere."<sup>558</sup>

In *Robphone Facilities v. Blank*<sup>559</sup> these two factors were applied. In this case the contract was for the hiring of a telephone-recording machine for 7 years. It was provided that if the agreement was terminated for any reason, the hirer should pay to the owner company all rentals which had fallen due and also by way of liquidated damages a sum equal to 50 per cent of all rentals for the unexpired period. The defendant (hirer) failed to take delivery of the machine or to pay any of the hire rentals. The claimants successfully claimed damages of £245, 14s as a 50 per cent of the rental machine. Lord Diplock LJ worked out an average of the approximation of claimants' actual loss. He asserted that the likely loss ranged between 47 per cent of the aggregate rents for the unexpired period of the contract if it is terminated at the beginning of the contract period, and 57 per cent if it is terminated in the last year of the 7 years. Based upon this he stated, regarding his choice of 50 per cent that:

“The parties have selected a readily ascertainable figure which reasonably close to the actual loss likely to be occasioned to the plaintiffs so far as it is capable of prediction, and if this figure will tend to operate slightly to the advantage of the plaintiffs if the contract is terminated early in its life, it will tend to operate rather more heavily to the advantage of the defendant if it is terminated late in its life<sup>560</sup>”.

Consequently, it can be said that the sum stipulated will be held as liquidated damages and so avoid the penalty rule, if the aforementioned two factors are met. Otherwise the sum will be treated as an invalid penalty. Therefore the sum stipulated should be a proper reflection to all losses, which may be suffered on breach, whether that be a serious or a mere trifle. However, if the amount specified can be regarded as a genuine pre-estimate of the loss which may be caused by serious breach, the sum can still be considered as penalty since it is extravagant and unconscionable for the other losses though they may

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<sup>558</sup> Ibid.

<sup>559</sup> *Robophone Facilities Ltd v. Blank* [1966] 3 All ER 128.

<sup>560</sup> Ibid. At 1449 per Lord Diplock.

not have occurred in reality<sup>561</sup>. This unsatisfactory result needs to be considered more closely.

#### **1.1.2.1.2.1 Unsatisfactory aspect (danger) where the range of losses is broad**

The presumption in favour of penalty where a single lump sum is provided to be payable on breaches of different stipulations of different kind of damage may be displaced in using an average of the possible losses. However the difference in likely losses should not be large. Lord Woolf stated that “A difficulty can arise when the range of possible loss is broad”<sup>562</sup>. Therefore if, for instance, the largest probable loss, which might be suffered from a certain breach is of £30,000 and the lowest one is of £100, it is not reasonable to agree that a sum of £15,050 should apply to both of them. Therefore there is still a possibility that the single sum can be a penalty where the range of losses is broad. In this case the consequences of the overthrown, old approach (which strictly considers a single sum as a penalty where the loss probably to be sustained on breach of various stipulations are different in kind) would turn up again. The danger<sup>563</sup> is that if an agreed damages clause could be held to apply to breaches which might occasion a trifling loss, the entire provision could be regarded as a penalty. This is so despite the clause potentially being a proper reflection and therefore a genuine pre-estimate of loss if the breach which actually occurred was in its most serious form. In other words, where the range of possible loss is broad there is always a possibility that the agreed damages will be entirely out of all proportion in relation to some of the losses, which might be suffered from, and thus a penalty for all cases. In *Ariston SLR v. Charly Records*<sup>564</sup> though the claimant had argued that the agreed sum was an average of the loss which might be suffered and thus valid liquidated damages, it was held that the single lump sum was a penalty. This is because it was not a true averaging of all losses so long as it would have been regarded as out of proportion to some of them. As a result this case is vital in demonstrating the danger pointed out above. The agreed damages clause was a genuine

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<sup>561</sup> This is what happened in *Ariston SLR v. Charly Records* (1990) The independent Law reports .13 April.

<sup>562</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, at 59.

<sup>563</sup> Halson. Roger. “Contract Law”. First published in Great Britain. Longman 2001. P 516. Treitel, S. G. “The Law of Contract”. 11<sup>th</sup> ed. Sweet and Maxwell. 2003. P 1002.

pre-estimate of the loss that had *actually* occurred as a result of the breach. In spite of this fact the whole sum was struck down as a penalty for it was a disproportionately large sum to certain losses which have not in fact occurred. Beldam LJ rebutted the claimant's argument saying:

“Though it was not an unreasonable to take such an overall figure as a suitable basis for genuine pre-estimate of damage should Ariston [claimant] fail to return all or many of parts, that sum would clearly have been out of proportion to any loss suffered if Ariston failed to return only a few of comparatively unimportant items, and as such was a penalty.”<sup>565</sup>

#### **1.1.2.1.2.2 How to avoid such danger**

If a danger arises where the different possible losses are broad the important issue, which should be examined is whether the unsatisfactory consequences resulting from that may be avoided. Could presumption raised in favour of penalty, where a single sum is stipulated to be paid on breach of different undertakings of different importance, be avoided where there is a great difference between the largest possible loss and the lowest one? There seems to be two different solutions to evade the difficulty in question according to the existing law<sup>566</sup>: ascertaining the true construction of agreed damages clause, and stipulating different sums for different breaches.

##### **1.1.2.1.2.2.1 Ascertaining the true construction of agreed damages provision**

Where the losses are of greatly different significances, the court would interpret the construction of the agreed damages clause in a way to keep a perfectly fair bargain alive<sup>567</sup>. To do so the court should consider the range of losses that could have been anticipated the agreed damages clause would cover at the time of making of the contract. As a result the court will have to make every possible attempt to construe that the agreed

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<sup>564</sup> (1990) The independent Law reports .13 April. This case was referred to, in *Philips Hong Kong LTD v. Attorney General of Hong Kong*. (1993) 61 BLR 41, to confirm the situation of displacing the presumption in favour of penalty where a single lump sum is provided for to be paid.

<sup>565</sup> Ibid.

<sup>566</sup> This does not also conflict with the consequences of the New Approach.

<sup>567</sup> Treitel, S. G. “The Law of Contract”. 11<sup>th</sup> ed. Sweet and Maxwell. 2003. P 1002.

sum is not intended to be payable on the occurrence of trifling breaches but on those causing the most injurious damage<sup>568</sup>.

If parties to a contract stipulated that the amount of £10,000 was to be payable on breach of different undertakings, some of which may cause serious and others less injurious loss and of which the lowest loss was of £500 and the largest was of nearly £10,000. If there has been a breach and the latter loss (£10,000) which has actually resulted from the breach, the application of the presumption concerned will leave the whole agreed damages clause vulnerable to be knocked down as a penalty. This is because the stipulated sum was extravagant and unconscionable to the less serious loss, which has not actually occurred. In avoiding this danger<sup>569</sup> the court should do its best to construe that the whole £10,000 was payable only on the occurrence of the most serious loss. To do so the court should have regards to all possible losses that were within the contemplation of the parties at the time of contracting. As a result it can be inferred that the parties, when agreeing in advance on damages, could not have had in their mind that the £10,000 would be held to apply to small breaches of contract which result in trifling losses of £500. In other words, the court should conclude that the sum stipulated had only been intended to be payable on breach which result in major losses. If this construction was not followed by the courts, the consequences would simply be that the whole clause would fall as a penalty for the sum stipulated was grossly extravagant to a minor loss (£500). This is despite the fact that what has *actually* occurred (New Approach) was adequate to make the sum stipulated (£10,000) a genuine pre-estimate of loss sustained and so a perfectly valid liquidated damages provision.

This approach has been, more recently, upheld in *Cenargo Limited v. Empresa Nacional Bazan de Construcciones Navales Militares SA*<sup>570</sup>. In this case it was contended that the agreed damages clause in the contract would only be regarded as a genuine pre-estimate of the loss suffered if it was interpreted as applying solely to permanent deficiencies in

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<sup>568</sup> See *Philips Hong Kong LTD v. Attorney General of Hong Kong*. (1993) 61 BLR 41, at 59 per Lord Woolf.

<sup>569</sup> The danger is the following: upsetting freely made bargain and court's time being wasted.

<sup>570</sup> [2002] EWCA Civ 524. [2002] CLC 1151. 2002 WL 347020.

the capacity of the trailers of the vessel. Based upon this it was submitted that if the clause was to be interpreted as covering temporary and minor deficiencies it would be a penalty and so unenforceable. Lord Longmore, in delivering the judgment, stated that:

“It is important to have in mind the range of losses the parties would anticipate the clause would cover when they made their contract. I do not consider that the parties in this case, when agreeing liquidated damages in relation to trailer carrying capacity, could have had in mind defects in design or workmanship which could be rectified without incurring major expense, even if it could be said that until such defects were rectified the vessel’s spaces were, in breach of contract, not fully available”<sup>571</sup>

In applying this principle the Court of Appeal concluded that the deficiencies concerned in this case were minor and could have been remedied in a matter of hours for a minimum cost. Therefore where a substantial sum was payable in respect of deficiencies a court should lean naturally to the conclusion that the agreed damages clause had not been intended to apply to minor breaches resulting in trivial losses but only to major breaches. Namely the true construction of the agreement on damages beforehand was that the agreed damages were only intended to be payable in the event of major breaches which result in major deficiencies.

#### **1.1.2.1.2.2 Agreement on different sums**

As parties to a contract might at the time of contracting know that the losses, which might be suffered from, are of great and different importance, they should take into consideration the presumption raised in favour of penalty in this situation. Therefore the parties to a contract may provide for different sums to be payable on different breaches. In *Imperial Tobacco Co v. Parsley*<sup>572</sup> there was an agreement of “price maintenance” in which the defendant promised not to sell the goods of the claimants lower than what they

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<sup>571</sup> Ibid.

<sup>572</sup> *Imperial Tobacco Co v. Parsley* [1936] 2 All ER 515. See also *Philips Hong Kong Ltd v. The Attorney General of Hong Kong*. (1993) 61 BLR 41. In this case there were two liquidated damages. One was \$74, 104 per day payable for not completing the whole of the works within the specified time and the other was varied between \$60, 655- \$77, 818 per day for the delay in meeting Key Dates. Lord Woolf stated there that: “Philips argues...it can and most probably will result in the Government receiving at least double compensation. It is suggested that this can happen because the Government will receive liquidated damages both for the delay which causes a Key Date to be missed and again when the same delay result in the date for the completion not being met. It is suggested it can also happen as a result of the same delay causing two or more Key Dates to be missed. (Liquidated Damages will continue to be paid in respect of the earlier

decided. It was provided in the agreement that for every breach by the defendant he would pay to the claimants the sum of £15 as liquidated damages in respect of each sale. Breaches having been made by the defendant, the claimants brought action to recover £165 as liquidated damages for 11 of such breaches. In this case the court paid attention to the particular breach that occurred and the sum provided for to be payable in the event of the occurrence of that breach. Therefore the only point in this case was to determine whether the sum stipulated £15 was obviously larger than any loss that might be suffered by the claimant as a result of any breach of the contract. The court's view was that the £15 was liquidated damages for each breach committed by the defendant. Accordingly, the court held the sum to be liquidated damages because it was a genuine pre-estimate of the loss suffered and not a penalty. As Lord Wright stated: "I see nothing at all in this case to justify the court in saying that this sum of £15 is unconscionable or extravagant when as applied to each particular instance in which the breach has been committed"<sup>573</sup>.

This result can be translated to the situation in question where the range of losses is broad. Should the parties not have a regard to such a great range this may lead, as they understand the penalty jurisdiction, to upset their agreement on damages in knocking the sum stipulated down as a penalty not least where the range of likely losses is broad. One solution to avoid the penalty jurisdiction in such a situation is by stipulating for different sums. The size of each sum determined according to the size of the possible loss. In other words, there should be a stipulated sum payable on the occurrence of a trifling breach which results in trifling losses, as, in the words of Lord Woolf:

"The failure to make special provision for those losses may result in the liquidated damages not being recoverable"<sup>574</sup>.

Where different sums are stipulated to be payable on different breaches is provided for, the court concentrates upon the breach that has occurred and the particular sum stipulated in relation to it (New Approach). If that sum is a genuine pre-estimate of loss suffered (either the largest or the lowest) it will constitute valid liquidated damages irrespective of

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Key date after the later date is missed)". See for the analysis of this point Hock-lai Ho. The Privy Council on Liquidated Damages. *Journal of Contract Law*. (1995) Vol.8, No.3 280.

<sup>573</sup> *Imperial Tobacco Co v. Parslay* [1936] 2 All ER 515, at 521 per Lord Wright.

<sup>574</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, at 59.

any other breaches that may have occurred since each one has its own stipulated sum. However, if the sum is extravagant and unconscionable in comparison to the loss suffered as a result of the breach to which the sum is provided for, it will still be held as a penalty.

#### 1.1.2.1.3 Parties' agreement to confining the field of stipulated sum

In looking at the true construction of the agreement it may appear that the sum was made payable for the breach of a single obligation or a number of similar obligations<sup>575</sup>. In this case the sum stipulated is to be considered valid and enforceable, despite it being provided for as payable for different breaches, if parties to a contract determine the cases in which that sum becomes payable. This might be done by confining the sum to be paid in only certain breaches or even only in certain aspects of a single breach. However, the stipulated sum should still not be extravagant and unconscionable. The main examples of this situation are illustrated in the two famous cases of *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>576</sup> and *Ford Motor Co v. Armstrong*<sup>577</sup>. In these two cases the courts reached different judgments regarding the sum stipulated, in spite of both having the similar facts.

In the *Dunlop* case<sup>578</sup>, the parties agreed to delimit the agreed damages to be payable in certain breaches rather than the other. In this case the purchaser adhered not to tamper with marks on the goods, not to sell or offer the goods to a certain prohibited customers and not to resell them for less than a certain price and not to exhibit or export without the consent of the claimant. Otherwise the defendant should pay £5 for every tyre, tube or cover which was sold or offered in breach of the contract. The defendant sold a tyre cover to a co-operative society below the listed price. The House of Lords held the £5 to be liquidated damages on the basis that the parties agreed on the sum to be payable in the event of a certain breach which is not to resell the goods below the listed price<sup>579</sup>. In the

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<sup>575</sup> Ogus, AI. "The Law of Damages". Butterworths 1973. P 44. McGregor, Harvey. "McGregor on Damages". 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 436.

<sup>576</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>577</sup> *Ford Motor Co v. Armstrong* (1915) 31 TLR 267.

<sup>578</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>579</sup> In spite of the fact that there was another obligation, which was not to exhibit them without consent.

*Ford Motor* case<sup>580</sup>, though the facts in this case are the same of those in *Dunlop* case, the Court of Appeal reached another result by holding that the sum was a penalty, because the sum had to be payable for any breaches without any delimiting.

It should be observed that the parties in *Dunlop*<sup>581</sup> case had, in reality, agreed the sum to be payable in breach of a single undertaking<sup>582</sup>. They delimited the stipulated sum to apply only if there was a breach in selling the goods below the listed price, and not by exhibiting them without consent. In contrast, if the parties had agreed that the sum to be payable in any event, the sum would have been considered a penalty. This is what actually occurred in *Ford Motor* case<sup>583</sup>, in which the sum stipulated was to be payable in the event of several breaches of variant importance, without any limit to the sum to be payable on one, or some of them.

Furthermore, the courts always refuse to accept any attempt by defendants to narrow the meaning of what constitutes a single obligation<sup>584</sup>. It might be argued that, relying on the third of the rules raised by Lord Dunedin in the *Dunlop* case under which a clause is presumed to be a penalty when a single sum is made payable on the occurrence of one or all of several events, the sum stipulated is a penalty where there is one obligation in contract breach of which might be caused by several events. It should be noted that in this case it is supposed that there are several undertakings inflicted on the injured party, however, the breach of which is a breach of single obligation, but “capable of being broken than once, or more ways than one...<sup>585</sup>”. This situation has always been dealt with in the event of the delay in completion<sup>586</sup> in which the only event gives rise to the liability to pay liquidated damages is delay, which may be caused by any number of different

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<sup>580</sup> *Ford Motor Co v. Armstrong* (1915) 31 TLR 267.

<sup>581</sup> *Dunlop Pneumatic Tyre Company LTD v. New Garage and Motor Company LTD*. [1915] AC 79.

<sup>582</sup> The only obligation, which was intended, was, keeping the price of the goods to the same level.

<sup>583</sup> *Ford Motor Co v. Armstrong* (1915) 31 TLR 267.

<sup>584</sup> McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 438.

<sup>585</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, At 98 per Lord Waddington.

<sup>586</sup> *Law v. Local Board of Redditch* [1892] 1 QB 127. See also *Philips Hong Kong v. The Attorney General of Hong Kong*. (1993) 61 BLR 41.

circumstances<sup>587</sup>. In these circumstances the defendant always argues that the sum is provided for to be payable on breach of several obligations and is consequently a penalty. Lord Woolf in *Philips Hong Kong v The Attorney General of Hong Kong*<sup>588</sup> rejecting the argument relied on by Philips to establish the provision in the case as penal on the grounds that there was a single sum payable on several events, held, consistently with authorities<sup>589</sup> that:

“In this case the only event giving rise to the liability to pay liquidated damages is delay. Although that delay may be caused by any number of different circumstances, this is not a case of different causes of loss being compensated by the same figure of liquidated damages”<sup>590</sup>

The foundation stone to this instance was well illustrated in *Law v. Local Board of Redditch*<sup>591</sup>. In this case, the court rejected the attempt and argument of the defendant that the sum stipulated was payable on several obligations, referring to the provision in the contract that: “The works shall be completed in all respects and cleaned of all impediment, tackle implements and rubbish”. The court decided that the sum was to be regarded as liquidated damages. It justified its decision on the basis that, the sum agreed to be paid as liquidated damages was payable on a single event, namely non-completion of the works.

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<sup>587</sup> For more details see McGregor, Harvey. “McGregor on damages”. 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 438-440.

<sup>588</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993)61 BLR 41.

<sup>589</sup> *Law v. Local Board of Redditch* [1892] 1 QB 127 was cited. See also *Elphinstone v. Monkland Iron & Coal Co* [1886] 11 AC 332, at 342 where lord Herschell expressed himself in strong language saying: “I know of no authority for holding that a payment agreed to be made under such conditions...is to be regarded as a penalty only; and I see no sound reason or principle or even convenience for so holding”. *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda* [1905] AC 6, at 16 where Lord Davey said that: “I confess I know of no other ground...upon which a clause fixed under conditions...for breach of a particular stipulation in an agreement can be held to be a penalty and not liquidated damages”.

<sup>590</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993)61 BLR 41, at 62. See also The foundation stone to this case was well illustrated in *Law v. Local Board of Redditch* [1892] 1 QB 127). In delivering the judgment Kay LJ had clearly stated confirming the principle that: “I can not agree with the ingenious argument that, because there may be many matters, some very small, which would constitute non-completion, these sums may be regarded as payable on several breaches. According to that argument, there must be considered to be several different non-completions of the works. There may be different causes of non-completion, but non-completion is only single event”

<sup>591</sup> *Law v. Local Board of Redditch* [1892] 1 QB 127.

### 1.1.3 Where a graduated sum slides to the wrong direction

Parties to a contract might provide for a graduated sum to be paid in accordance to significance of breaches. The clearest example for such a case is where the breach is a delay in performance (which is common in building contracts), whereby the sum will continue to increase over time, so far as, there is a breach. In other words, "Liquidated Damages will continue to be paid in respect of the earlier Key Date after the later date is missed"<sup>592</sup>. The leading case which illustrates this situation is *Clydebank Engineering and Shipbuilding Co v. Don Jose Ramos Yzquierdo Y Castaneda*<sup>593</sup>. In this case the sum stipulated was \$500 per week for each vessel that was late in being delivered. This meant that that sum, as in any such case in the event of breach by delay to complete, would be increased much more, so far as, the vessels had not been delivered yet. The House of Lords in this case confirmed this fact by upholding the sum as valid liquidated damages. For instance should the delay be for two weeks the sum will increase £1000 and if the breach, i.e. the delay, goes on for more weeks then the sum will increase still further. The longer the delay continues the more the sum will increase, which demonstrates that the sum is for legitimate damages due to the losses suffered on the continuing breach.

As a principle the graduated sum must be increased in proportion to the size of breach to be upheld as valid liquidated damages. Therefore, if that sum slides conversely, namely, it was decreasing in proportion to the size of breach, it will be treated as a penalty and irrecoverable<sup>594</sup>. The depreciation apparently increases over time, which makes the sum said to be compensation for depreciation, not a genuine pre-estimate of loss if it decreases over time<sup>595</sup>. On this basis, an attempt to use the principle of graduated damages to support the minimum payment clause was rejected in *Bridge v. Campbell Discount Co*<sup>596</sup>.

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<sup>592</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>593</sup> *Clydebank Engineering and Shipbuilding Co. v. Don Jose Romos Yzquierdo Y Castaneda* [1915] AC 6. See also *Law v. Local Board of Redditch* [1892] 1 QB 127. *Cellulose Acetate Silk Co. Ltd v. Widnes Foundry (1925) Ltd* [1933] AC 20. *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>594</sup> Burrows, Andrew. "Remedies for Torts and Breach of Contract". 2ed. Butterworths. 1994. P 325. Treitel, S. G. "The Law of Contract". 11<sup>th</sup> ed. Sweet and Maxwell. 2003. P 1006. Ogus, A I. "The Law of Damages". Butterworths. 1973. P 48-49.

<sup>595</sup> Chitty on contract. 29<sup>th</sup> edition. Vol. 1 General Principles. Sweet & Maxwell. 2004. P1494.

<sup>596</sup> *Bridge v. Campbell Discount Co* [1962] AC 600.

In this case a minimum payment clause was included in a hire-purchase agreement. It provided that if the hirer for any reason terminated the contract, the car should be returned and also the rentals already paid should be made up to two-thirds of the hire purchase price by way of an agreed compensation for depreciation. In its decision the House of Lords held the sum to be a penalty and so unenforceable. In particular, the House opposed the argument that the stipulated amount was compensation for depreciation. This was because the longer the subject matter remained in the possession of the hirer, the more its value would depreciate. Yet the clause operated in such a way the estimated amount payable would decrease progressively as the period of the hire continued and more instalment payments were paid. Thus:

“It is a sliding scale of compensation, but a scale that slides in the wrong direction...the fact this anomalous result is deliberately produced by the formula employed, I think, that the real purpose of this clause is not to provide compensation for depreciation at all but to afford the owners a substantial guarantee against the loss of their hiring contract<sup>597</sup>”

Furthermore, the graduated sum might be regarded as liquidated damages on the basis of a consideration other than the time. Namely, it might be vindicated as valid according to the number of items in question, whereby it will be so much according to the items, which they were not delivered on time<sup>598</sup>. In the case of *Elphinstone v. Monkland Iron and Coal Co*<sup>599</sup> lessees, granted the privilege of placing stay from blast-furnaces on land let to them, covenanted to pay £100 for every acre of the land that was not restored at a particular date. The House of Lords in its decision held that the sum was liquidated damages and so recoverable. This judgment was also based on the fact that the stipulated sum increases so far as the amount of loss resulting from breach is subject to increase. The sliding scale in this place runs in the right direction, which is increasing in sum and loss sustained simultaneously. If it is supposed, in this case, that 3 acres of the land were not restored, then the sum would be increased accordingly to £300 and so on. If there was no such graduation the sum fixed is more likely to be upheld as a penalty.

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<sup>597</sup> Ibid. At 623 per Lord Radditch.

<sup>598</sup> Chitty on Contract. 29<sup>th</sup> edition. Vol. 1 General Principles. Sweet & Maxwell. 2004. P 1494.

<sup>599</sup> *Elphinstone v. Monkland Iron & Coal Co* [1886] 11 AC 332.

## **2-Jordanian civil law**

### **2.1 General principle: literal enforcement subject to adjustment of agreed penalty**

The general rule in Jordanian civil law is that when the terms of the operation of penalty clause are met, the court should enforce the amount agreed upon in favour of the injured party. In other words, the law in article 364/1 adopts the literal enforcement where the injured party may not be awarded a larger or smaller amount than the penal sum. However in order to prevent the possibility of abuse, the same article in paragraph 2, gives the court the power to adjust the amount of penalty. It states that “the courts may, upon the request of either party, increase or decrease, such damages to make the estimation equal to the actual damage”<sup>600</sup>. Therefore it empowers the court to award more or less than the stipulated sum to be equal to the recoverable loss suffered. By giving it a power to modify the penalty, the court uses this discretionary authority guided only by the amount of damage actually suffered by the injured party and independent of the intention of the parties. The same paragraph makes it clear that the parties may under no circumstances exclude such a possibility of reduction. It declares that any provision in the contract to rule out the power of the court to modify will be considered null and void.

The validity of penalty and the possibility of amending its amount, were confirmed by the Court of Cassation through several decisions<sup>601</sup>, but perhaps most clearly asserted when it stated that:

“When the parties to a contract agree on a certain sum of money to be payable in the event of non performance, the court should, in principle, enforce agreement and award the sum no more no less. However, if the promisor claims that the agreed penalty is manifestly excessive or in excess of the actual damage sustained by the promisee, the court has the power to make penalty equal to the damage sustained in accordance to article 363 and 364 of Civil Law”<sup>602</sup>

It should be noted that article 364/2 specifies the considerations, which should be taken into account by the court when exercising its power of modification. The court may not

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<sup>600</sup> According to Jordanian law the actual damage means the loss the injured party has suffered exclusive the profits he has missed on breach. It seems that it is better to call it the recoverable damage instead, as it does not include some losses which actually suffered.

<sup>601</sup> Civil Cassation No. 391/87 Bar Association Journal 1990. P 234 -235. Civil Cassation No. 560/983 Bar Association Journal [1984]. P 1097. Also Civil Cassation No. 702/982 Bar Association Journal [1983]. P 127.

exercise the authority of adjustment by its own motion but there should be a demand from the party who claims a reduction or increasing. Furthermore, court's power to reduce the damages estimated in penalty clause at the request of the defaulting party, or increase it at the request of injured party, is not unconditional. The party claiming modification should provide legal evidence to prove his claim; otherwise the court will not modify the stipulated sum at his request<sup>603</sup>. Consequently if the party, who claims reduction or increasing of damages, does not furnish proof of his demand he will be bound to the damages agreed upon in penalty clause.

Attention should be paid to the power given to courts under Article 364/2, in reducing or increasing the stipulated sum. Two situations need to be explored: firstly it gives courts the power to reduce agreed penalty in all cases and secondly a debate was raised with regard to the power given to courts to make damages payable under a penalty clause equal to the recoverable loss, which is actually sustained by injured party. This power, under article 364, will be dealt with in detail after approaching the following question: is there any difference between civil contract and administrative one in exercising the power of reduction?

### **2.1.1 Does the courts' power of reduction apply to both civil contract and administrative contract?**

Firstly it should be noted that all rules regarding penalty clause were first organized in article 178 of the Jordanian law of civil procedures 1952. Article 178 was stating that:

“Courts do not have a power to wholly disregard, but to reduce an agreed penalty clause upon the request of debtor except in the case that the clause was inserted in favour of governmental establishment”.

This was the case until the enactment of article 364 of Jordanian civil law 1976, which re-regulated penalty clause rules. After the 1976 Code the court's power to reduce the amount of penalty became firm, either penalty clause was stipulated in favour of ordinary person, or of the government.

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<sup>602</sup> Civil Cassation No. 560/983 Bar Association Journal [1984]. P 1097.

Despite this fact it was argued that article 178 of Jordanian law of civil procedures of 1952, which involved regulating penalty clause rules, was not amended by article 364 of civil code. Accordingly it was asserted<sup>604</sup> that the courts' authority of reducing an agreed penalty does not apply to those cases where the government is one of the contracting parties, namely to administrative contracts. Put another way, it means that courts cannot reduce the amount of penalty clause, though it is excessively high, when it was in the interest of the government by virtue of article 178 of law of procedures. To consolidate this claim it was said that this law is still in effect and is a private law compared with civil law. Given article 1448 of the latter law includes an imperative rule to prioritize the private codes; it was thus asserted that the judgment of article 178 of law of procedures should be considered an exception from article 364 of civil code.

This is imprecise primarily because when Jordanian legislator enacted article 178 of the law of procedures of 1952, which organised the rules with regards to the damage and compensation, it followed the same style of the legislator of the Ottman Government, which dominated Jordan at that time. Therefore the legislator included these rules in civil procedures law and not in Medgella Al-Adlieah, which was then the civil law, following in the footsteps of Ottman counterpart. This confusion was noticed by the Jordanian legislator when the civil law of 1976 was established and so it re-regulated the rules of compensation including those related to penalty clauses in article 364 of civil law. By doing so the legislator rescinded article 178 of law of procedures<sup>605</sup>. In its decision No. 391/87 the Court of Cassation<sup>606</sup> held that:

“The rules pertaining to penalty clauses which were contained in the Civil Procedures Law were canceled by the enactment of Civil Law...and it was agreed upon that it is the civil law which is a private law and not the law of procedures”.

As a result the situation became that the power to reduce the amount of penalty given to the court under civil code applies to both contracts civil and administrative.

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<sup>603</sup> Civil Cassation No. 391/87 Bar Association Journal [1990]. P 234.

<sup>604</sup> See for that Civil Cassation No. 391/87 Bar Association Journal [1990] P 234, at 236.

<sup>605</sup> This fact was clearly confirmed when the new Law of Civil Procedures of 1988 was enacted without any indication to the provisions related to the penalty clause rules.

<sup>606</sup> Civil Cassation No. 582/91 Bar Association Journal [1993] P 737. See also Civil Cassation No. 391/87 Bar Association Journal [1990] P 234.

However in rather a recent judgment concerning a sale contract in which the Ministry of Supply was the purchaser, the Court of Cassation held that the agreed penalty may not be reduced if it is provided for the interest of one of the governmental departments<sup>607</sup>. In this case the Ministry of Supply made a contract with a supplier company to import 200,000 boxes of powdered milk from New Zealand. It was provided that if the supplier company did not meet the established delivery deadline it should pay JD1, 500 for every day of delay in the delivery of the goods. Due to a problem in the engine of the vessel that carried the goods, the supplier (claimant) had to return the vessel again to Auckland port in New Zealand after a day running. Subsequently the goods had to be transferred to another ship. This resulted in the supplies being 10 days late in delivery. Having the supplier made this breach of the contract, the Ministry of Supply sued for, and got a judgment of, JD1, 500, which was the agreed penalty provided in the contract. On appeal the supplier claimed that the agreed penalty was disproportionately high, as there was no damage suffered by the ministry as a result of the delay. The Court of Cassation reached the conclusion over this claim saying that:

“The amount of damages set out in advance, in a contract that the government was one of its parties, could not be reduced upon the request of the supplier due to the nature of such contract, its relation to public interest and its effect on the proper running of public utilities”<sup>608</sup>

This is to say that the Court of Cassation decided that the judicial authority of reduction is only applicable to civil contracts. In holding to this the court returned back to the position obtained during the application of article 178 of law of civil procedures. However it should be noted that the court did not justify its judgment on applying this article because it became of no effect. It justified itself on the fact that it had the right to construe the law when it interpreted article 364 of civil law and which as a result does not apply to this case. This is because the damage suffered by the government is presumed and so it is not allowed to provide proof that there was no damage suffered or that it was less than the agreed penalty<sup>609</sup>. However does this interpretation sound correct and legal?

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<sup>607</sup> Civil Cassation 825/96, Bar Association Journal 1998, p 1428.

<sup>608</sup> Ibid.

<sup>609</sup> Ibid.

### 2.1.1.1 Unsound interpretation

This interpretation of the extent of the power of reduction appears unsound. In other words, there is nothing frank in article 364 of civil law to support the court's conclusion. This article does not give courts the right to abstain from reducing the agreed penalty even when it is in excess of the loss suffered where the government is one of the contract's parties. As was seen above the law of procedures 1952 gave the court such power if the clause was inserted in civil contracts, but not into contracts where the government was one of its parties. If the legislator wanted to reaffirm this position it would have done so when it re-regulated penalty clause rules in the civil code 1976. It is not believed that this was an oversight as the legislator was aware of the fact that the court did not have the power of reduction in relation to administrative contracts in the former legislation. Furthermore when the legislator gave the court the power to reduce the amount of agreed penalty, he aimed to restore the scales of balance and justice, which are violated by imposing unfair clauses in contracts.

It should be noted that most of the contracts in which the government is one of the parties are contracts of adhesion<sup>610</sup> and as a result it imposes its terms upon the other. For economic reasons the supplying companies always find themselves have no option but to accept the terms of the government not least where there are many firms competing to win the bid of the government. The government can sometimes resort to impose a very excessive sum of money to be payable in the event of non-performance by the other party. As a result it may receive a disproportionately high sum not least that the Court of Cassation in its judgment raised irrefutable presumption<sup>611</sup> in favour of government.

However it is thought that this position of the Court of Cassation is unfounded as it is full of unfairness which the discretionary power of reduction given to the judicial authority to remove its effects. The judgment cannot be founded on the fact that the administrative

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<sup>610</sup> Contract of adhesion seeks always to impose severe and onerous conditions on a person who has no choice but to agree to them. very often the weaker party will find himself in a position that he can not both negotiate the contract and go elsewhere since such contracts may be common to all operator within a particular industrial activity.

<sup>611</sup> That its loss is presumed and may not be displaced.

contracts are of high significance, due to their relation to public interest<sup>612</sup>, and thus the justice scale does not apply. It is accepted and legal to say that the damage suffered by the government is presumed, but it is unacceptable to deprive the claimant the right to rebut this presumption. This means that there is no need for the government body to prove its actual loss, however it is fair to provide the other contracting party with the opportunity to show that the agreed penalty is excessively greater than the actual loss sustained. It might be asserted that the government body suffers no loss, for example, in the event of delay. However that is wrong in fact as it usually suffers a loss if only in extra supervision costs or financing charges or expenses incurred to find another supplier. Thus in giving the courts the power to reduce the agreed penalty in administrative contracts does not mean to deprive the government body the right to receive the amount of penalty. The court can exercise its authority of reduction only if the defaulting party can supply a proof that the sum stipulated is disproportionately high in comparison with actual loss sustained. In other words, it is presumed that the government establishment always has the right of receiving the whole-agreed penalty for its actual loss unless otherwise proved.

As a result, and from the tenor of article 364, it can be concluded that Jordanian law does not differentiate between civil contracts and administrative ones. Therefore article 364, governing the penalty clause, should apply to both kinds of contracts. This leads to the conclusion that the court should have the power to reduce the agreed penalties in all cases inclusive of where the penalty clause is provided for the government in administrative contracts.

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<sup>612</sup> It might be argued that when things are related to public interest the law should allow the government to exact a high sum to make sure that the running of public utilities is not affected by anything. However that can be done by another way than to permit a manifestly large penal sum to be exacted. The court can assess the damage that sustained by the government including that suffered from as a result of not working out another arrangement, i.e. not finding another supplier to supply the subject matter on time, or from paying more money to ensure the supplying on time. Also the government may take its own motion by excluding the X firm which has caused much trouble in not doing the job on time.

## **2.2 Analysis of courts' power to intervene under article 364**

### **2.2.1 Courts power to reduce penal sum: in all cases and make penalty equal to judicial damages**

Article 364 of Jordanian law only permits a moderation of a penalty clause, not its complete elimination. What is noticeable that this article gives the court unconditional power to modify the agreed penalty. On one hand, it simply leaves the amount of reduction to the discretion of the court or to its sense of what is required to make equality between agreed penalty and the recoverable loss suffered. Meanwhile on the other hand, it does not determine the cases in which the court can exercise its power to adjust the penalty amount. The fact that the agreed penalty is in excess of loss suffered is a sufficient reason for the court to exercise its discretionary power of reduction. In other words, there is no need for a defaulting party to show that the stipulated sum is disproportionately excessive in relation to the damage actually sustained on breach in order to claim the reduction of a penalty.

This rule is justified in the explanatory notes of Jordanian law on the grounds that:

“If agreed damages is in excess of actual damage the court has a power to reduce it as the Islamic jurisprudential judgment states that the compensation must be equal to the damage”<sup>613</sup>

However, is it really that Islamic Jurisprudence doesn't recognize the rule that agreed damages could not be more than the actual damage? And does it seem sound for the court to base its intervention merely because the sum stipulated is more than the actual loss? These two questions will now be considered in the next section.

#### **2.2.1.1 Illogical and unreasonable justification**

Though Islamic Jurisprudence does not consider the penal provision as integral theory, some jurisprudential diligences which dealt with this matter can be found. These views convey the fact that part of the Islamic Jurisprudence endorses penalty clauses as well as respects the assessment of damages determined in advance by the parties. For example Al-Bokhary reported from Ibn Sireen that a man agreed with another to travel with him to

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<sup>613</sup> Explanatory note of Jordanian Civil Law of 1976. P 403.

a certain place and that if he did not travel on such and such a day, he would pay to the injured party 100 Dirhams. The promisor not having performed, the judge decided that he “who stipulated on himself willingly must execute”<sup>614</sup>. In addition, part of the Islamic Jurisprudence had a rule that new conditions, which have not been in existence at Al-Risalah age<sup>615</sup>, may be put forward for the tradition states that “Muslims are obliged to do their provisions, except if they forbid lawful things or legalise sins”<sup>616</sup>. As a result of this so long as the penalty clause is a contractual one the parties should apply it.

Moreover, as the Islamic Jurisprudence is characterised as progressing and able to develop and respond to the recent demands of the people it should demonstrate such ability to develop over the time. This has prompted some Muslim jurists to pass the following rule that “The change of the legal rules changes with time”<sup>617</sup> and it therefore became important that the legal rules should also progress with the current, huge developments. Because of this some Muslim scholars have delivered views, which accept simple unfairness that may occur at the time of contracting. Consequently the partiality of Jordanian legislator to the point of view which says that the compensation must always be equal to the damage sustained has no justification. This is because the legislator, when enacted the Jordanian civil law, does not restrict itself to a particular ideology of the Islamic Jurisprudence. Therefore the view<sup>618</sup> which allows the agreed penalty to be more than actual loss should be preferable.

Accordingly the existing penalty clause rules under Jordanian law are open to a number of objections:

1-The rule that gives courts a power to reduce agreed penalty in all cases without limitations is flawed. The stipulated sum will be subject to reduction merely because it is

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<sup>614</sup> This event has been included in the decision issued by the Council of greater scholars and trustees in Kingdom of Suidia Arabia about the legality of penalty clause. This decision is published in Islamic Journal vol. 1 No.2 1975/1976. P 140.

<sup>615</sup> The time in which the Islamic principles were first established.

<sup>616</sup> Ibn Teemah. Al-Fatawa Al-Kobra”. Compiled by the scholar Abd-Arahman bn Gassim and his son Mohammed. Vol.29 No. 9. Arabian Dar for publication and distribution. Beirut. 1<sup>st</sup> ed. P 147.

<sup>617</sup> Al-shatiby Al-Mowafiqat. Vol.3. Dar Al-Ma’rifah. Beirut. 2<sup>nd</sup> ed. 1975. P 17.

<sup>618</sup> Which the legislator seems to have not paid any attention to it.

in excess of the actual loss suffered as a result of breach. The application of this rule will lead the clause to lose its true meaning and function, for the parties might have different reasons to stipulate for agreed penalty clearly more than the actual loss suffered upon breach. Parties to a contract might agree that an agreed penalty clause is to cover what court does not award damages for<sup>619</sup>. The legal rules for the assessment of recoverable loss under Jordanian law envisage that the injured party can only claim the loss he has suffered but not the loss of prospective profits, which he has missed upon non-performance. Therefore, the agreement on damages in advance on compensating him for such missed profits should be regarded as sound and valid. Besides the penalty clause might seem quite excessive at the time of breach and trial, though it was not at the time of contracting. The promisee might have paid a higher price for the subject matter to buy a high-agreed penalty clause that should be paid by the promisor on default. Such agreements should be considered as otherwise the injured party will be undercompensated, as supported by the New Approach suggested for English law, provided that the injured party could not avoid his losses by taking reasonable steps as expected from a reasonable man.

Therefore the question which should be asked is whether the sum to be paid is disproportionately large in amount when compared with the actual loss that has followed from the breach. If there is such clear disproportion, the court will then use its discretionary power to reduce the agreed penalty in line with the actual loss. The mere fact that the agreed sum is in excess of the actual loss should not be a sufficient reason for reduction. This judgment affirms and respects of the freedom of contract doctrine and the value of pre-estimated damages not least where the loss is difficult to assess . Put another way, this suggestion could be justified on the fact, as Diplock LJ put it, that: "It is good business sense that parties to a contract should know what will be the financial consequences to them of a breach on their part, for circumstances may arise when further performance of the contract may involve them in loss. And the more difficult it is likely to prove and assess the loss which a party will suffer in the event of breach, the greater

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<sup>619</sup> See for more details the interpretation of New Approach introduced in the first chapter. Supra. P 23.

the advantages to both parties fixing by the terms of the contract itself an easily ascertainable sum to be paid in that event”<sup>620</sup>.

2-As for giving court a power to make agreed penalty *equal* to loss sustained the following objections should be noted. If this rule was based on the justice principle, as argued by legislator; the application of the absolute justice will put people in an embarrassing position and trouble. It is not always possible to accurately measure the meeting of obligations so that the contracting party can take exactly what he gives. Put another way, it is asserted that the problem of the notion of *equity of damages* with the recoverable loss is the difficulty of determining the equity with the necessary degree of accuracy and certainty. Moreover what is the point of inserting article 364, which entitles parties to a contract to determine in advance, the damages payable in the event of defaulting party’s non-performance since such damages will be, at request of either party, modified by court to be equal to unliquidated damages?<sup>621</sup> In other words, it will always be a matter of estimating the damages by court due to the fact that there is always a right for defaulting party to claim the reduction of damages payable under penalty clause to be equal to what court awards in the normal way of damages. This makes the pre-estimated damages pointless, despite practical imperative for it and destructive of the principal purpose of it, which is to avoid the judicial estimation that may undercompensate injured party and court’s time and more money being wasted. Therefore, as mentioned above, greater latitude should be given to parties to agree on damages that can not be claimed under unliquidated damages action.

### **2.2.1.2 Result of the analysis**

As a result of the above analysis it may be concluded that Islamic Jurisprudence principles generally respect the will of the parties who agree upon a penalty clause. The parties are finally more aware of the elements of the assessment of the damages for the actual loss and so the court should not intervene to modify the parties’ agreement unless

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<sup>620</sup> *Robophone Facilities, Ltd v Blank* [1966] 3 All ER 128, at 142.

<sup>621</sup> Al.Abadi Mohammed and Abu Shana, Ahmed. “Effects of penalty clause”. *Almanarah Journal*. (2000) vol.5, 61 at 80. Also Sultan, Anwar. “Commentary on the Theory of Contract in the Jordanian Civil Law”.

the disproportion between the agreed penalty and the actual loss is clear. Therefore it is submitted that in giving courts the power to reduce its amount in all cases the role of inserting a penalty clause in contract will be canceled. This is because the power to reduce an agreed penalty to be equal to unliquidated damages makes the authority of court, an authority of nullification rather than of modification<sup>622</sup>. In other words, when a court has the power to reduce a stipulated sum to be equal to damage sustained, the situation will become as if no penalty clause was stipulated in the contract. Such power totally invalidates the purpose of a penalty clause and renders null and void the agreement of the parties on damages. As a consequence, the situation will be the same as in English case law, which grants the courts the power to wholly disregard penalty clauses in contracts. Therefore it is suggested article 364/2 be amended by giving courts the power to reduce agreed penalty to be in line with the actual loss suffered by the injured party<sup>623</sup> inclusive the profits he has missed on default. Otherwise, the agreement on penalty clause would be pointless and hold the same role of judicial damages under which courts have no more power than to hold equality between damages and loss suffered.

### **2.2.1.3 What is suggested?**

It would be preferable to amend article 364 of Jordanian law to allow the court to make, when exercising its power of reduction, the agreed penalty in line with actual loss inclusive of the profit that the injured party naturally missed as a result of breach and determine the circumstances under which the court may reduce the sum stipulated<sup>624</sup>. The court when it exercises its power of reduction, should always aim to grant the injured party a just compensation. Thus, it should not be enough for the defaulting party to prove that the penal sum is merely larger than the actual loss in order to claim the reduction. Rather the sum should be disproportionately larger than the actual loss. This case is

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Bar Association Journal. (1987) 2. P 213. Swar, Mohamed Waheed Aldeen. "Effects of Contracts and Damages in Law of Civil Procedures". Bar Association Journal. [1977]. P 138-139.

<sup>622</sup> Swar, Mohamed Waheed Aldeen. "Effects of Contracts and Damages in Law of Civil Procedures". Bar Association Journal. [1977]. P 138-139.

<sup>623</sup> See the decision of the Council of greater scholars and trustees in Kingdom of Suidia Arabia about the legality of penalty clause. This decision is published in Islamic Journal vol. 1 No.2 1975/1976. P 140.

<sup>624</sup> See the proposal suggested according to the New Approach. Supra. P 23.

suggested for both legal systems concerned in the comparison after considering the effect of New Approach, which will be dealt with after approaching the next section.

Besides this case the commentators<sup>625</sup> always suggest a reduction of the penal sum where there is partial non-performance. This is already one of the cases that the court has a power of reduction under the current article 364 of Jordanian civil law. In the event of partial performance of obligation the court has the judicial authority to reduce the amount of penalty clause in proportion to the part that was performed, provided that the defaulting party supplies evidence of the partial performance. This is totally a direct application of article 364 of Jordanian law, which allows the court to modify agreed penalty clause in all cases. There has never been a case in which the Court of Cassation has exercised its discretionary power to reduce the agreed penalty where the obligation has been performed in part. However it should be noted that the test remains that the agreed damages being manifestly greater than the part that was not performed by the defaulting party. Therefore this case is included within the one where the agreed penal sum is manifestly higher than actual loss, and thus there is no need to be an independent case<sup>626</sup>. To clarify this interpretation this case is now examined.

#### **2.2.1.3.1 If the obligation is performed in part**

The penalty clause was established for cases of total breach. However the law, in certain cases, permits the court to reduce the amount of penalty where there is a partial performance. If the promisor performs a part of the obligation, the court will respect the will of the parties if it reduces the agreed penalty in proportion to the part that has been performed<sup>627</sup>. In this case the court assesses the promisee's interest that he has from partial performance, and the interest which he would have in the event of the promisor

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<sup>625</sup> Al-Juboori, Yaseen. "Commentary on the Jordanian Civil Law". Vol. 2. Effect of personal rights (Rules of Obligations). First edition. Irbid-Jordan. 1997. P 159. Adel Majeed Al-Hakeem. "Rules of Obligations". Baghdad. 3th ed. P 42. Abu Aso'od, Ramadan. "Rules of Obligations", Dar Almatbo'at press. 1998. P87 Al.Abadi Mohammed and Abu Shana, Ahmed. "Effects of penalty clause". Almanarah Journal. (2000) vol.5, 61 at 79

<sup>626</sup> This case will be suggested for both legal systems concerned in the comparison after approaching the effect of New Approach. Intra. P 166.

<sup>627</sup> Al-Sanhoori, Abdel Razag. "Al-Waseet in The New Civil Law". Vol.2. Evidence and Rules of Obligations. P870.

completely performed his obligation. Then the agreed penalty is reduced in proportion to the difference between the two interests and obliges the defaulting promisor to pay the rest of the sum to the promisee.

Thus partial performance is the reason for the reduction and according to the general rules it is the defaulting party who should provide proof of this part performance. However even if he does so, the court is not obliged to reduce the amount of penalty, as reduction's power is only applicable where the stipulated sum is disproportionately high. If the court decided what was performed was insignificant, derisory or the injured party did not get any interest, it would not reduce the agreed penalty. Moreover even in the case where the injured party benefits from a partial performance the court cannot exercise its discretionary authority to reduce the agreed penalty unless he profits from the partial performance and can proceed with his contract in making another arrangement. To say otherwise means that the defaulting party, especially who acts in bad faith, may resort to perform a part of his obligation in order to avoid paying the whole agreed penalty. This leads to the termination of contracts before their times without achieving the purposes for which they have been made. Eventually such a result harms the parties' will which was originally focused on the total performance of the obligation and leads to both private and public damage.

### **3-Effect of New Approach on court's power over penalty clause**

It has been pointed out in this chapter to the rules that have been developed by the courts to distinguish penalties from liquidated damages. To reiterate the technical application of these rules result in knocking down all penalty clauses in contracts leaving the injured party to resort to the court again to claim his damages for the loss he has suffered on breach. However all this can be evaded, as was shown, by adopting the New Approach. To show the effectiveness of the New Approach it is worthy to examine the other possibilities as solutions for the unsatisfactory existing law. Therefore can the enforcement all stipulated damages clause without any judicial intervention be the solution or the non-enforcement of all these clauses is the best treatment for the current law rules of penalties? In other words, the effectiveness of the New Approach will now

be shown in exploring the two possibilities of preventing the contracting parties of agreeing on damages in advance and leave the matter to the court or allowing them to do so and enforcing all agreed damages without court intervention.

### **3.1 Enforcement of all stipulated damages clauses**

This approach seeks to enforce all agreed damages clause without any intervention by the courts. Where parties to a contract agree in advance that a certain sum of money is to be payable in the event of breach and the defaulting party does not perform his obligations he is obliged to pay the agreed amount to the injured party without any court intervention. Under this approach if there is to be any such intervention it is only to uphold the clause and binding the defaulting party to pay what he has agreed upon even if it is manifestly excessive. The benefits to the parties of this approach of avoiding the judicial process of determining the damages is self-evident via saving time and money. It also allows the parties to correct what the parties perceive to be inadequate judicial remedies by agreeing upon a rule which may include losses that too remote to be recovered under unliquidated damages action. The essence of this approach is the application of freedom of contract by leaving the parties to their own devices. However does such an approach achieve justice between the parties? Unfortunately enforcing all agreed damages clause will not sometimes result in achieving justice between the contracting parties.

This is because firstly, the contracting parties will often not have the same bargaining power, which can result in the imposition of a great sum of money by the stronger party to be payable in the event of non-performance by the weaker party. This is a particular problem where the stronger party has the economic advantages of controlling the contracting process such as having adequate information, monopolising supplies of the subject matter of the contract or using a pre-drafted contract to make any deal with others<sup>628</sup>. Consequently it would be unjust to apply the absolute doctrine of freedom of contract to this a situation for the weaker party will have no choice under the pressure of circumstances, but to accept the proposal extended by the stronger one with all its terms

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<sup>628</sup> Very often the weaker party is forced to accept and also cannot go elsewhere so long as such contracts may be common to all contractors (stronger party) within a particular industrial activity.

and consequences. In such circumstances it would be preferable to pursue the policy of upholding what the parties have agreed upon, accompanied with the policy of judicial interference with agreed damages clauses on the grounds of unfairness. This is because it is not always reasonable to treat the agreement of the parties as a conclusive and definitive decision. There is nothing in freedom of contract doctrine that requires one party to accept without question the validity of agreed damages clause simply because it is agreed upon by contracting parties. This is in spite of whether they are consumers or even commercial organizations<sup>629</sup>.

Secondly even where the parties enjoy an equality of bargaining strength they could still face burdensome costs as the advantages of agreeing on damages are, to some extent, exaggerated. The saving of money and time of the court and parties is unconvincing as it ignores the transaction costs of negotiating the clause as well as any response to it; eg force majeure exculpatory provisions to protect the promisor<sup>630</sup>. As a result it should be noted that the enforcement of all clauses, for which stipulated damages are clearly much higher than actual damages may increase overall costs of economic actions. An important cost of these clauses results from wasteful activities such as breach inducement and activities to prevent breach inducement. Their enforcement will lead to contracting parties paying out extra resources to attain information about probable consequences and about possible actions of the other party<sup>631</sup>. In other words, an injured party will always resort to breach-inducing activity whenever he sees<sup>632</sup> the performance is less valuable for him than breach. He interferes to make performance difficult for the defaulting party whenever he would benefit from non-performance. This leads to not only unjust consequences but also gives more advantages to the stronger party in controlling contractual relations and unjustly enriching him at others' expense. Therefore, the

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<sup>629</sup> See for the idea of freedom of contract, Atiyah, P. S. "Freedom of Contract and the New Right". In *Essays on Contract*. Clarendon Press. Oxford. 1986. P 355, at 362-363.

<sup>630</sup> Halson, Roger. "Contract Law". First published in Great Britain. Longman. 2001. P 507.

<sup>631</sup> Clarkson, Kenneth and others. "Liquidated Damages v. Penalties: Sense or Nonsense? Wisconsin Law Review. [1978] 351, at 374 and 378. Rubin, Paul H. "Unenforceable Contracts: Penalty Clauses and Specific Performance". *The Journal of Legal Studies*. (1981) Vol. X 237, at 242.

<sup>632</sup> The injured party might know that the actual losses will be less than the stipulated sum at the time of making the contract or during the performance according to circumstances change which may make the sum stipulated more than the actual damage.

defaulting party will be forced to spend money and time monitoring the behaviour of the injured party in order to stop his interference to deter performance.

It would seem fair to conclude that this possibility of upholding all agree damages clause consolidates in a limited sense the doctrine of freedom of contract. However, enforcing all what the parties have agreed upon unconditionally<sup>633</sup> is significantly flawed for the above reasons. However is the non-enforceability of all stipulated damages clause preferable?

### **3.2 Non-enforcement of all stipulated damages clauses**

Under this policy the courts should reject the enforcement of all stipulated damages clauses blindly without carefully scrutinizing them. All the disadvantages of enforcing all these clauses are avoided by adopting this approach. It means there is no place for breach-inducing actions as the injured party knows that such clauses will not be enforceable, and also there will be no litigation over the enforceability of agreed damages clause. Moreover the court does not have to inquire whether the sum stipulated is valid liquidated damages clause or invalid penalty clause. However this approach leaves the process of determining the compensation completely in the hands of the courts which is financially costly, takes a long time and may undercompensate the injured party. Consequently this has its effect on both contracting parties and on society. Effects include reducing many economic activities since the agreed damages clauses will no longer be used where losses are costly to prove or can not be proved. This means the absence of stipulated damages clause will have detrimental effects in cases where losses sustained as a result of breach are very difficult or complex to be estimated<sup>634</sup>.

As demonstrated via the possibility of the enforcement of all agreed damages clauses for which the freedom of contract is the basis, absolute freedom has some disadvantages.

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<sup>633</sup> It means the application of absolute freedom of contract, i.e. without any judicial intervention to keep justice between the parties.

However the current approach ignores this principle at all by not paying any regard to the latitude of the parties to agree on their terms in the contract.

Therefore it may be concluded that the above two approaches, i.e enforcing all or non enforcing all agreed damages clause are considered less attractive than the New Approach. In other words, the New Approach that suggested in this work stands as the more preferable one to deal with penalty clauses. Accordingly it is apparent that the enforcement of agreed penalty clause, subject to reduction, is to be the straightforward and clear solution, as it will increase certainty and govern the matter of agreed damages clause on the real fact that occurs and not on guessing. The New Approach avoids uncertainty when the matter is left to the court to decide and avoid times and costs of judicial process<sup>635</sup>. However it should be emphasized that the court's power to reduce the agreed penalty is not unconditional power. Yet it would be preferable for the court to exercise its discretionary power in the case where the agreed sum is manifestly disproportionate to actual loss<sup>636</sup>.

### **3.3 When can the court exercise its power of reduction?**

#### **3.3.1 Where the agreed penalty is manifestly disproportionate to the actual loss<sup>637</sup>**

This situation presumes that the defaulting party has not performed his obligation at all or has delayed in performance. According to the New Approach the court should enforce the penalty agreed upon in favor of the injured party as the penalty clause was included in contract to compensate him for his loss because of non-performance. However, where the agreed penalty is manifestly disproportionate to the actual loss suffered it should be regarded as a proper justification for the court to reduce the amount to be in line with the damage that is actually inflicted on the injured party<sup>638</sup>. The exaggeration in assessing the

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<sup>634</sup> Clarkson, Kenneth and others. "Liquidated Damages v. Penalties: Sense or Nonsense?" Wisconsin Law Review. [1978] 351, at 374 and 378. Rubin, Paul H. "Unenforceable Contracts: Penalty Clauses and Specific Performance". The Journal of Legal Studies. (1981) Vol. X. p 237, at 374.

<sup>635</sup> See for the advantages of the New Approach see supra P. 29.

<sup>636</sup> The same test for the invalidity of penalty clauses under the existing law, but under the New Approach the sum stipulated would be compared with the actual loss.

<sup>637</sup> This circumstance should be read with the part that explaining in details the test for the invalidity of penalty clause in the existing Law. Therefore what has been showed there should be repeated in this place. The only difference that the sum stipulated should be compared with actual loss. Supra P. 54.

<sup>638</sup> Supra P.28 to find out what the actual loss might include under the New Approach.

amount of penalty to be manifestly disproportionate will make the clause function a task other than compensating the injured party for his losses. It will make its purpose threatening and pressurizing towards the defaulting party to perform or make it a punishment imposed by the injured party on his debtor in the event of non-performance. Therefore it would deem commensurate with justice principles to restore the balance to the contract in giving the court the power to lift the unfairness concerned by reducing the penalty amount to be proportionate to the actual loss sustained. This is because in binding the defaulting party to pay a manifestly large sum has the meaning of enriching the injured party at the expense of his debtor which justice and equity rules refuse to accept.

It should be emphasised that though the penalty is manifestly disproportionate to actual loss, the court cannot exercise its discretionary authority of reduction by its own motion. Rather the defaulting party should expressly demand the reduction.

The agreed sum might become manifestly disproportionate to the loss sustained for different reasons. The exaggeration in assessing the damages in advance might result from domination. It might originate from social or economic domination of one of the parties thereby enabling him to impose a manifestly disproportionate agreed penalty by way of damages. The outcome of this is that the particular stipulated sum is not the result of a bargain between the two contracting parties, but it is usually inserted in the contract without the consent of the promisor. In this situation, there is, of course, no real agreement between the parties concerning penalty clause, which is, in reality, the result of monopoly environment. Therefore the agreed penalty is regarded as arbitrary one set high without a genuine consent of the promisor and without relation to the actual damages<sup>639</sup>. This is particularly prevalent in adhesion contracts where the stronger party always inserts a penalty clause with a disproportionate sum and the other party finds himself compelled to accept this situation, as he has no choice but to do so. Therefore the clause in this form works as an effective method of pressure to force the promisor to fulfill his obligation.

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<sup>639</sup> Hatzis, Aristides. "Having the Cake and Eating it Too: Efficient Penalty Clauses in Common and Civil Contract Law". *International Review of Law and Economics*. (2003) 22 381, at 393.

On the other hand the amount in a penalty clause might reflect the true agreement on damages between the parties at the time of contracting. This is the case when the parties at the time of making the contract attempt to determine as fairly as possible the compensation that the injured party will collect as a result of non-performance. As is always pointed out, the parties resort to such an agreement of compensation in advance in order to avoid the judicial process and the difficulties surrounding it. However their agreement on damages in advance is still arbitrary when it is very difficult for them to pre-estimate the loss that might be suffered on breach. This results in the agreed damages clause to operate in favour of either party. Consequently, and due to subsequent and unexpected circumstances, the agreed damages might become more than the actual loss sustained. In this situation the clause works to the injured party's interest and its effect to put pressure and intimidate the defaulting party is considered as unexpected, unintended.

This is illustrated in lease contracts containing a penalty clause of paying a rent of 4 months in the event that the lessee terminates the contract before the end of its period. Initially such an arbitrary pre-estimation of damages cannot be regarded as grossly disproportionate to the loss sustained as the lessee can move-out of the property at any time. This is because when he decides to terminate the contract suddenly the lessor will start desperately looking for a new tenant whom the lessor may not find and thus cause him a loss in proportion to the agreed penalty or more. However the situation is different if the lessor finds a new tenant shortly after the lessee rescinds the tenancy agreement making the damage in this situation ridiculous in comparison with the agreed damages. Thereby the agreed penalty in this situation is clearly manifestly disproportionate to the loss sustained by the lessor. Therefore in this situation the role of the court comes to remove such sort of unfairness and restore the balance of contract by reducing the amount of penalty.

## **Chapter Five: Can more than penalty be claimed?**

### **0- Introduction**

Where an agreed sum is struck down as a penalty, the injured party can always recover his actual loss when it is less than the penalty. However, the mechanical application of the tests neatly put forward by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>640</sup> might result in a penal sum turning out to be less than the actual loss sustained. This paradoxical situation can arise either where a single lump sum is made payable on the occurrence of one or more or all of several events of varying importance or in circumstances where the conditions at the time of making the contract are different from those at the time of breach.

In the ordinary course the question of whether or not the sum stipulated is a genuine pre-estimate of damages arises when the sum fixed is grossly more than actual loss suffered as a result of breach. However, in the case in question the sum is conceived to be smaller than the actual loss sustained on breach. This leads to the question of: In the normal case relief against penalty is given to the defaulting party, but in this situation can this sum be dealt with as a penalty against the injured party and thus grant him a relief? Can the injured party ignore the penalty or liquidated damages and sue to recover the actual loss sustained? These issues will be now examined in two sections firstly by tackling the case where the sum stipulated is liquidated damages and secondly where it is a penalty set at less than actual loss.

### **1- Liquidated damages set at less than actual loss**

In this situation the stipulated sum is, at the time of contracting, a genuine pre-estimate of the probable actual loss which may be suffered as a result of breach. However, due to some circumstances the loss sustained turns out to exceed the sum fixed by the parties to a contract. For example parties to contract might have stipulated for £1000 to be paid in

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<sup>640</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 86-87.

the event of breach but the actual loss might have turned out to be £4000. Therefore can the stipulated sum be regarded as a limitation clause?

### 1.1 Distinction between a liquidated damages clause and a limitation clause

A small agreed sum of this kind is akin to a clause limiting the extent in damages of a party's liability<sup>641</sup>. However, there are still some differences between a liquidated damages clause and a limitation clause. The latter is quoted in the agreement to protect only the defendant from increasing his liability<sup>642</sup>, i.e. it limits the liability of the defendant<sup>643</sup>. Also in the limitation clause "the liability for damages is limited by a clause then the person seeking to claim damages must prove them at least up to the limit laid down by the clause"<sup>644</sup>. In other words, limitation clause specifies that damages should be limited to the maximum figure and the claimant must prove his actual loss. This figure can be exceeded under no circumstances. As a result the other party (defendant) can refuse to pay beyond the fixed sum. On the other hand, agreed damages clause is said to benefit both parties, "The party establishing breach by the other needs prove no damages in fact, the other must pay that no less no more"<sup>645</sup>. Hence, if the sum is a genuine pre-estimate of likely loss the injured party can recover the whole amount even though there is no loss suffered.

It should be emphasised that the question of whether a clause inserted in the contract is a limitation clause or an agreed damages clause (either a valid liquidated damages or invalid penalty) is a question of construction. The court should determine its nature by examining all events and circumstances surrounding the contracting process<sup>646</sup>. In *Suisse Atlantique Societe D'Armement Maritime v. N.V Rotterdamsche Kolen Centrale*<sup>647</sup>, The

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<sup>641</sup> For details see Halson, Roger. "Contract Law". First published in Great Britain. Longman, 2001. P 517-518. McGregor, Harvey. "McGregor on Damages". 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 460.

<sup>642</sup> *Suisse Atlantique Societe D'Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361, at 420 Per Lord UpJohn.

<sup>643</sup> Ibid. At 421 Per Lord UpJohn

<sup>644</sup> Ibid.

<sup>645</sup> Ibid. At 420 per Lord UpJohn. *Cellulose Acetate Silk Co Ltd v. Widnes Foundry (1925) Ltd* [1933] AC 20, at 25 per Lord Atkin.

<sup>646</sup> Ogus, A.I. "The Law of Damages". Butterworths. 1973. P 51.

<sup>647</sup> *Suisse Atlantique Societe D'Armement Maritime v. N.V Rotterdamsche Kolen Centrale* [1967] AC 361

House of Lords unanimously interpreted a demurrage clause<sup>648</sup> in the contract as a liquidated damages clause. What assisted the house to reach its verdict, other than the clause being so as a matter of commercial practice, the construction of this clause. A demurrage clause constitutes the exact amount payable so that no more no less than its amount may be awarded. Besides it is capable of benefiting both parties in the contract and that this is, as said in the *Suisse* case, one of distinguishing points between liquidated damages and limitation clause. A demurrage clause benefits the shipowner when there might be a delay of few days in unloading the cargo in which case the owner might lose nothing, as he could not have arranged employment for it or the freight might have dropped to be less than demurrage. On the other hand it will benefit the charterer where the lost freight for the owner will be in excess of the amount which he will receive under the demurrage clause<sup>649</sup>. Lord Wilberforce reasoned their verdict when declared that:

“The form of clause is of course not decisive, nor is there any rule of law which requires that demurrage clauses should be construed as clauses of liquidated damages, but the fact that the clause is expressed as one agreeing a figure, and not as imposing a limit; and...I reach the conclusion that the owners are clearly bound by it and can recover no more than the appropriate amount of demurrage”<sup>650</sup>

However, what is the effect a liquidated damages clause?

## 1.2 No less no more can be claimed

Where the court holds the stipulated sum as liquidated damages the law is clear as to the recovery of this sum. The injured party should be granted the entire amount, no more no less. In *Cellulose Acetate Silk Co. Ltd v. Widnes Foundry (1925) Ltd*<sup>651</sup> a contract for the delivery and erection of an acetone recovery plant, provided that if the work was not completed within a certain time, the contractors should pay to the purchasers, by way of penalty, a sum of £20 for every week that they were in default. The contractors were 30 weeks late in completing the work and in an action by them for the contract price, the

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<sup>648</sup> A demurrage clause is sum of money agreed by the charterer to be paid as liquidated damages for delay beyond a stipulated or reasonable time for loading or unloading. *Supra*. P 31. See also Halson, Roger, Bradgate, Robert and others. ‘The Law of Contract’. 2<sup>nd</sup> ed. Butterworth. 2003. P 1499.

<sup>649</sup> *Ibid*. At 436 where the shipowner claimed that his lost freight would be £900,000 and the amount due under demurrage clause was £150,000.

<sup>650</sup> *Ibid*. At 436-437 per Lord Wilberforce. See also Lord Upjohn at 421, who stated there that “ the demurrage clause with which we are concerned is a clause providing for agreed damages and is different from a clause excluding or limiting liability for damages by breach of contract by one party”.

purchasers contended that their actual loss was £5,850. The Court of Appeal upheld their contention. However the contractors took the case before the House of Lords and argued that they were only liable for £600 damages. On this stage it was held that the clause was not a penalty and the purchasers were only able to recover £600 and no more. The parties should have known that the actual loss would exceed £20 a week<sup>652</sup>. One might say that the clause seems to resemble a limitation clause. However the clause was by no means a pure limitation clause. Lord Atkin stated that "I entertain no doubt that what the parties meant was that in the event of delay the damages and the only damages were to be £20 a week no less and no more<sup>653</sup>". Therefore the clause was a valid liquidated damages clause and the purchasers were entitled to nothing more than the sum stipulated<sup>654</sup>.

Thus where the actual loss exceeds agreed damages, the claimant is confined to the stipulated amount<sup>655</sup>. It follows from this that in such a situation the claimant is not entitled to claim unliquidated damages besides liquidated damages to increase his compensation. Nor is he entitled to ignore the liquidated damages clause and sue only for unliquidated damages. However, what will be the position if the sum stipulated is held as a penalty?

## **2- How does the law stand for penalty set at less than the actual loss?**

### **2.1 When this situation arises?**

The main characteristic of the penalty clause is that the actual loss suffered is to be less than the sum stipulated in the contract. The test that governs this case is that the sum stipulated must be extravagant and unconscionable in comparison with the greatest loss which could be suffered as a result of breach at the time of making the contract<sup>656</sup>.

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<sup>651</sup> *Cellulose Acetate Silk Co. Ltd v. Widnes Foundry (1925) Ltd* [1933] AC 20.

<sup>652</sup> *Ibid.* At 25-26 where Lord Atkin stated, "I think it must have been obvious to both parties that the actual damages would be much more than £20 a week but it was intended to go towards the damage, and it was all that the sellers were prepared to pay"

<sup>653</sup> *Ibid.* At 25 per Lord Atkin.

<sup>654</sup> This fact was supported by Lord Upjohn in *Suisse Atlantique Societe D'Armement Maritime v. N.V Rotterdamse Kolen Centrale* [1967] AC 361. He stated there that "In my opinion the demurrage clause is a clause which the contract being affirmed, remains an agreed damages clause for the benefit of both parties and it is not a clause of exception or limitation.."

<sup>655</sup> To this effect see *Diestal v. Stervenson* [1906] 2 KB 345. Also *Talley v. Wolsey-Neech* (1978) 38 P & CR 45.

<sup>656</sup> *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd.* [1915] AC 79, at 87 per Lord Dunedin.

Therefore the penalty is held unenforceable and the injured party is limited to only recovering his actual loss, which is never more than the penal sum<sup>657</sup>. This has been clearly affirmed in the leading case<sup>658</sup> by Lord Parmoor who frankly pointed out that where a sum is:

“...inserted as a punishment on the defaulter irrespective of the amount of any loss which could at the time have been in contemplation of the parties, then such sum is a penalty, and the defaulter is only liable in respect of damages which can be proved against him”<sup>659</sup>.

However, in some circumstances the loss sustained as a result of breach might exceed the penalty. In other words, the clause may become a penalty though the agreed damages fall short of the injured party's loss. The possibility is not as remote as it might seem and it may apparently arise in two instances. It occurs when a single lump sum stipulated is held to constitute a penalty because it is provided for to be payable in event of any breach, regardless of whether it is serious or trifle. The claimant's actual loss may have resulted from the breach of the most important obligation<sup>660</sup>. It may also arise in the event that the conditions at the time of contracting are different from that at the time of breach<sup>661</sup>. This situation supposes that parties to a contract agree at the time of making the contract on a manifestly large sum of money, however due to changing conditions such an originally extravagant sum become inadequate, i.e. less than actual loss<sup>662</sup>. For instance suppose that X agreed to erect a building for Y. They provided in the contract that in the event of breach liquidated damages of £1500 per week. The market rate at the time of making the contract for comparative project is £500 per week. It seems that the amount of agreed damages is penalty. Assume that X commits a breach of contract, and that when this breach occurs, due to political and economic circumstances, the market rate becomes

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<sup>657</sup> *Wall v. Rederiaktiebolaget Luggude* [1915] 3 KB 66, at 72-73 per Bailhache J who stated there that: “the result of suing for the penalty is therefore that the plaintiff recovers proved damages, but never more than the penal sum fixed...one easily sees why in Charterparty cases no one sues on the penalty now. You cannot under it recover more than the proved damages, and if the proved damages exceed the penal sum you are restricted to the lower amount”.

<sup>658</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd.* [1915] AC 79.

<sup>659</sup> *Ibid.* At 100-101 per Lord Parmoor.

<sup>660</sup> *Elphinstone v. Monkland Iron & Coal Co* [1886] 11 AC 332 per Lord Weston, cited in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd.* [1915] AC 79.

<sup>661</sup> As the injured party has domination at the time of negotiation he imposes an extravagant agreed damages, however it turns out to be less than his actual loss due to change in circumstances.

<sup>662</sup> Treitel, S.G. “The Law of Contract”. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1003.

£3000 per week. This is to say that the injured party's actual loss exceeds the amount of damages agreed upon in the contract. Therefore, should the injured party be limited to damages up to the sum stipulated or be allowed to ignore the penalty and sue for his actual loss?

## **2:2 The current position: Ignoring penalty and suing for actual loss**

The situation in which the penal sum might be less than the actual loss is well illustrated in charterparty cases. The reason for this is that such kind of transactions has long included a clause to the general effect that the penalty for any breach of its provision, grave or trifle, is to be the amount of freight<sup>663</sup>. This clause in a number of cases<sup>664</sup>, in the event that the actual loss exceeds the amount of freight, was held to be penalty and may be ignored. The issue that was an object of debate in these cases is the variation of words of the agreed damages clause in the charterparties. The common form of this clause was "Penalty for non-performance of this agreement estimated amount of freight". This clause was treated as a penalty even before establishing the rule against penalties as it covers all breaches of various importances by either party. Subsequently the clause changed to run as follows "Penalty for non-performance of this agreement proved damages not exceeding estimated amount of freight". Such variation by adding new words to the clause posed the question: did this addition make the clause into a sort of limitation clause?

In *Wall v Rederiaktiebolaget Luggude*<sup>665</sup> the law in this area was cleared. The case confirms that a clause limiting the damages to the amount of freight cannot be reasonably regarded as a provision determining the damages the charterer may recover as a result of shipowner's breach. There should be a clear vision and knowledge that what the charterer will suffer is not a loss of freight. It is readily foreseeable that the loss will exceed the

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<sup>663</sup>See Chitty on Contracts, 29<sup>th</sup> ed. Vol. 1 General Principles. Sweet & Maxwell, 2004. P 1498 where it has been said that it is unsettled whether the principle of ignoring the penalty and suing for the actual loss when it exceeds penalty in charterparties could be applied of the other types of contracts. See also McGregor, Harvey. "McGregor on Damages". 17<sup>th</sup> ed. Sweet & Maxwell, 2003. P 445. Furst, Stephen and Ramsey, Vivian. "Keating on Building Contracts". 7<sup>th</sup> ed. Sweet & Maxwell, 2001. P 288. Hudson. "Penalties Limiting Damages". Law Quarterly Review. [1975] 25.

<sup>664</sup>*Sotrms Bruks Aktie Bolag v. Hutchison* [1905] AC 515. *Wall v Rederiaktiebolaget Luggude* [1915] 3 KB 66. *Watts, Watts and Co Ltd v. Mitsui and Co Ltd* [1917] AC 227.

<sup>665</sup>*Wall v. Rederiaktiebolaget Luggude* [1915] 3 KB 66.

estimated amount of freight. Losses of profits or uses of the commodities for the purpose of his business are expected losses<sup>666</sup>. Therefore, the *Wall* case confirms that the variation on the clause didn't alter the nature of it. It was still a penalty and not a limitation of liability or liquidated damages. The effect of this was to give the claimant the right to disregard penalty and recover his actual loss even though it exceeded the estimated amount of freight. It should be noted that the new clause "is nothing more than the common form writ large"<sup>667</sup>. In his reasoning of holding the clause as a penalty Bailhache J added that:

"I should require the strongest arguments to induce me to hold that a clause so like the common and undoubted penalty clause has been transformed by the addition of few words into a limitation of liability clause, to which in form it bears no resemblance...I would never strike (businessmen) that a clause beginning in that way was a limitation of liability clause"<sup>668</sup>

The English law position boils down that the injured party may ignore penalty and claim his full damages. The position in Jordanian civil law seems to be the same. Jordanian law gives the court in such a situation an authority to ignore the agreed penalty and increase the amount to what compensates the injured party for its actual loss. The court has, in this situation, unconditional power. The law empowers the court to increase in all cases<sup>669</sup>. As a result of this there is no need for the injured party to show that the sum stipulated is manifestly low to claim the increase of it. The court may increase a penal sum merely because it is less than the actual loss sustained by the injured party<sup>670</sup>.

This approach is criticized<sup>671</sup> on the grounds that it has adopted the extreme position of Islamic jurisprudence. Therefore for this case per se, where penalty is less than actual loss, a new suggestion will be tentatively proposed to apply to both English and

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<sup>666</sup> Ibid. At 69.

<sup>667</sup> Ibid. At 74 per Lord Bailhache.

<sup>668</sup> Ibid.

<sup>669</sup> It should be noted that until the moment of doing this research it has been found no case in which the court exercised its discretionary power to increase the penal sum.

<sup>670</sup> Article 364/2 of civil law.

<sup>671</sup> The analysis and the criticism of this approach, which has been examined in the situation where the penalty is more than the loss suffered, may be fully repeated here. *Supra*. P 156.

Jordanian law. This suggestion will be underneath showed<sup>672</sup> after analysing the position of English case law?

## **2.2.1 Analysis of the law after *Wall* case**

### **2.2.1.1 Penalty clause must be unenforceable for all cases**

According to the *Wall* case<sup>673</sup> it has been concluded that the penalty is penalty in all cases and the clause that is unenforceable because it is a penalty must necessarily be unenforceable for all purposes. This approach asserts that a penalty clause cannot be dead for one purpose when it is struck out of the contract and alive for another when it operates as a “cap”. In other words, it is a penalty if as to one breach it is greater than the probable loss, and it is immaterial that, in the events that happen, another breach occurs encompassing an actual loss greater than the sum stipulated<sup>674</sup>. This view is consistent with the legal principle that invalidity of penalty clause should be determined by reference to the time at which the contract is made, i.e. it is unenforceable *ab initio*<sup>675</sup>. Under this principle, if an agreed damages clause was originally struck out as a penalty in view of the circumstances at the time of contracting, it could not become valid as a limitation simply because of the change of circumstances. Since penalty clause is void and unenforceable from the outset, it does not function as an upper limit to the sum stipulated. As a result the claimant can ignore penalty and sue for his actual damages. However this view favours the party who stipulate for a penalty over the one who inserts a liquidated damages clause in the contract.

### **2:2.1.2 The current English case law is unsatisfactory**

The situation in question leads to bizarre and different consequences from the ordinary course of the operation of penalty clause. The defaulting party, who is supposed to be penalised by the clause, benefits from it and seeks to uphold. And the injured party who

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<sup>672</sup> When approaching the Effect of New Approach. *Infra*. P. 187.

<sup>673</sup> *Wall v. Rederiaktiebolaget Luggude* [1915] 3 KB 66.

<sup>674</sup> Furmston, MP. “Cheshire, Fifoot and Furmston’s Law of Contract”. 15<sup>th</sup> ed. Butterworths 2001. P689. Treitel, Sir general. “The Law of Contract”. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1003. Jacobs, Sydney. “Damages in a Commercial Context”. LBC Information Services. 2000. P 263. Brown, Nicholas. “Liquidated Damages: Is One Man’s Floor Another Man’s Ceiling?” *Construction Law Journal*. (2001) 17(4) 302, at 304.

is supposed to benefit from seeks to ignore it and claim his full damages. Therefore, the view (ignoring the penalty and suing for the actual damages) which, has been decided in *Wall* case<sup>676</sup> (with respect) should not be preferred because the view expressed in this case is contrary to principle and productive of injustice. One might argue that the penalty clause when it is struck out of the contract becomes as though it was never formed part therein, and thus it should be unenforceable and of no effect for all purposes. In response, it should be noted that in restricting the damages recoverable up to the penalty, the law can avoid the absurdity and paradoxical element that arises from preferring the party who intentionally inserts a penalty over the one who inserts a genuine pre-estimate of loss<sup>677</sup>. This situation is illustrated when one of the parties to a contract works in compliance with the legal rules and acts accordingly. He includes in his contract a liquidated damages clause at the time of making the contract, however subsequently its actual loss exceeds the agreed sum. In this instance the injured party may, under the existing law, recover his damages up to the sum stipulated, no more no less. In contrast if one party stipulates a penalty he can benefit from such provision twice. Firstly in terrifying the other party to force performance and on the other by ignoring penalty when it works against his advantage, i.e. when the actual loss sustained turns out to be more than sum fixed<sup>678</sup>. Furthermore, it can also be argued against the view of ignoring penalties and claiming for actual loss that basically the unenforceability of penalty clauses is a rare departure from the freedom of contract and is designed to prevent unfairness to the defendant. Therefore, where there is no such unfairness, there is no justification for holding penalties invalid<sup>679</sup>.

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<sup>675</sup> Treitel, G. H. "The Law of Contract". 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1003. Beatson, J. "Anson's Law of Contract". 28<sup>th</sup> ed. Oxford University Press. 2002. P 630.

<sup>676</sup> *Wall v. Rederiaktiebolaget Luggude* [1915] 3 KB 66.

<sup>677</sup> Hudson, AH. "Penalties Limiting Damages". *Law Quarterly Review*. [1974] 31. Hudson, AH. "Penalties Limiting Damages". *Law Quarterly Review*. [1985] 480. Burton. "Penalties and Damages". *Law Quarterly Review* (1976) 92 20, at 25-26.

<sup>678</sup> See The Law Commission, Working Paper No 61 "Penalty Clauses and Forfeiture of Monies Paid". London. Her Majesty's Stationery Office. 1975. P 35. The Commission remarks that "striking down the clause because it appeared to penalize the party in breach at the earlier time will be to his disadvantage at the later time because instead of only having to pay the agreed sum he will be liable for the full amount of damages suffered by the party who sought to impose the invalid penalty".

<sup>679</sup> Burrows, Andrew. "Remedies for Tort and Breach of Contract". 2<sup>nd</sup> ed. Butterworths. 1994. P 327.

Hence, the idea of giving the claimant a right to sue for his damages limited up to the amount of penalty seems more persuasive<sup>680</sup>. There are many dicta this proposition. In *Wilbeam v. Ashton*<sup>681</sup> there was an agreement in which the defendant contracted to serve as a dresser of Spanish leather for four years under a penalty of £50. Lord Ellenborough affirmed that the penalty constitutes the upper amount that the injured party can sue for by stating: “the legal construction of such an agreement is this: beyond the penalty you shall not go; within it, you are to give the party any compensation which he can prove himself entitled to”<sup>682</sup>. In addition there is the dictum of Lord Dunedin in *Commissioner of Public Works v. Hills*<sup>683</sup>. In this case the contract included a provision to the effect that if the contractor failed to complete the construction of a railway within the time agreed upon, he would pay a certain sum of money as liquidated damages. However, when the contractor failed to perform its obligation the Privy Council held that the government was not entitled to the sum fixed as it was not a genuine pre-estimate of loss suffered. Then, the Council gave the Government the right to sue for the damages however to: “prove such damages not exceeding the sums in the penalties, as they can make out”<sup>684</sup>

In reality this approach accords also with the most effective and important decision of the Canadian Case of *Elsley v. JG Collins Insurance Agencies Ltd*<sup>685</sup>. This case was concerned with an employment agreement in which the employee undertook not to compete with his employer. It was provided that if the employee breached the agreement he would be liable to pay \$1000 as liquidated damages. The default having been made, an action brought before the Supreme Court of Canada, which held that the sum was not a

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<sup>680</sup> Halson, Roger. “Contract Law”. First published in Great Britain. Longman. 2001. P 517. Burrows, Andrew. “Remedies for Tort and Breach of Contract”. 2<sup>nd</sup> ed. Butterworths 1994. P 328. Hudson, AH. “Penalties Limiting Damages”. Law Quarterly Review. [1974] 31. Hudson, AH. “Penalties Limiting Damages”. Law Quarterly Review. [1985] 480. See also Burton. “Penalties and Damages”. Law Quarterly Review (1976) 92 20, at 25-26.

<sup>681</sup> (1807) 1 Camp 78.

<sup>682</sup> See also in *Elphinstone v. Monkland Iron & Coal Co* [1886] 11 AC 332, at 346 where Lord Fitzgerald stated that: “The penalty is to cover all the damages actually sustained but it does not estimate them, and the amount of loss (not, however, exceeding the penalty) is to be ascertained in the ordinary way”. Also In *Cellulose Acetate Silk Co. Ltd v. Widnes Foundry (1925) Ltd* [1933] AC 20, at 26. Lord Atkin left: “open the question whether, where a penalty is plainly less in amount than the prospective damages, there is any legal objection to suing on it, or in a suitable case ignoring it and suing for damages”.

<sup>683</sup> *Commissioner of Public Workers v. Hill* [1906] AC 368.

<sup>684</sup> *Ibid.* At 376 per Lord Dunedin

<sup>685</sup> *Elsley v. JG Collins Insurance Agencies Ltd* (1978) 83 DLR (3ed) 1.

genuine pre-estimate of likely actual loss and so was an unenforceable penalty. The question of whether the penal sum, which is smaller than the actual loss suffered, constitutes a ceiling, beyond which the injured party cannot have damages for his loss, was raised before the court. In delivering the judgment of the court, Dickson J pointed out that, where the penal sum is smaller than the actual loss sustained, there were authorities in which it was held that the injured party could ignore the penalty and sue for actual damages even though it exceeded the penalty. His Honour commented that: "To that extent, the proposition appears to me to be contrary to principle and productive of injustice"<sup>686</sup>. He went on to express his view of applauding the proposition of considering the penalty as 'cap' by stating that:

"If the actual loss turns out to exceed the penalty, the normal rules of enforcement of contract should apply to allow the recovery of only the agreed sum. The party imposing the penalty should not be able to obtain the benefit of whatever intimidating force the penalty clause may have in inducing performance, and then ignore the clause when it turns out to be to his advantage to do so. A penalty should function as a limitation on the damages recoverable, while still being ineffective to increase damages above the actual loss sustained when such loss is less than the stipulated amount"<sup>687</sup>

Therefore the justice principle calls for giving the same effect to penalty clause and liquidated damages clause<sup>688</sup> when actual loss turns out to be more than stipulated sum in contract. In other words a penalty clause would operate as an upper limit upon the damages recoverable by the injured party, i.e within the penalty, no more no less. This approach has paved the way for tentatively suggesting the New Approach. In other words, application of the notion of the New Approach as suggested in this work, i.e the literal enforcement of agreed penalty in granting the injured party the amount of penalty no more. However in one case, i.e. a narrowly restricted circumstance, the court is to have the authority to increase the agreed penalty where its amount is too low to be a just compensation provided that there is an inequality of bargaining power.

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<sup>686</sup> Ibid. At 9.

<sup>687</sup> Ibid. At 15.

<sup>688</sup> The liquidated damages clause fixes the maximum amount recoverable. Supra. P 171.

### **2:3 Effect of New Approach: Power to increase in a narrowly restricted case**

It should be mainly pointed out that this case, where agreed penalty clause is less than the damages that could be recovered in an unliquidated damages action, is a rare possibility in the area of penalty clause. Under the New Approach the court should still award the agreed penalty to injured party. However where the amount is manifestly derisory, subject to the underneath points, the court may augment the agreed penalty but nevertheless less than actual loss<sup>689</sup>. The fact that the agreed penalty is merely less than the injured party's actual loss will not excite the court to award more than the penalty. The power given to court should be very limited. This is because the party imposing agreed penalty should not be able to obtain the benefit of whatever intimidating force a manifestly disproportionate penalty clause may have, and then give him the right to claim the increase of its amount when it turns out to be to his advantage to do so. Therefore the court, when exercising its power to increase the agreed penalty, should take into account the following:

1-The court should not be too adroit to conclude whether or not the stipulated sum is manifestly derisory to actual loss, to exercise its power of increasing. The parties' freedom to settle for themselves the rights and liabilities on breach should be protected in such a case. Therefore the derisory character should be clear. The character of the agreed penalty being manifestly derisory should be immediately obvious to anyone considering it.

2-The court should consider the amount at stake and the subject matter of contract. It is impossible to lay down any abstract rule as to what may or may not be derisory agreed penalty to insist upon without reference to the circumstances and particular fact of each case. However it is supposed it would be possible in the most ordinary case, where parties know what the loss will actually be suffered and what is agreed to be paid, to say whether the amount is manifestly derisory or not. For example, suppose that X agreed to erect a building for Y. Y's actual loss might be Million pounds. The contract stipulated

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<sup>689</sup> The court may award the recoverable loss, or simply leave it to the discretion of the court or to its sense of what is equitable.

that a £1000 should be payable in the event of breach. It seems that from the particular facts, terms and surrounding circumstances the agreed damages appears to be manifestly derisory and the court should intervene to award just compensation. But who can force a builder to accept such a loss penalty? In this situation the fact that the sum is manifestly derisory is inadequate to excite the courts' intervention. Therefore what should the court consider other than the amount of the clause?

3-Considering the particular facts of the case and conduct of the parties: under the New Approach the general rule is that all agreed penalty clauses are enforceable. The court will therefore award no larger or smaller amount. As the promisee may misuse this principle when stipulating for a manifestly disproportionate sum it may also be misused by the promisor in stipulating for a manifestly derisory sum. This largely depends on which party has the greater bargaining power over the other. Accordingly as the promisor is given the right to recourse to the court to have the agreed penalty reduced, the promisee has the same right to be effectively protected as a victim of the inequality of bargaining power. Thus the first step, in order to depart from the presumption that the agreed penalty clause should be given effect and that no larger sum can be awarded, is to determine whether the contract has been individually negotiated. If it is not so then the court would look at the stipulated sum to see whether it is manifestly derisory to have the right to exercise its power of increase. In construction contracts, for instance, a clause might be included to provide for a minimum penalty<sup>690</sup> to be payable in the event of contractor's non-performance or delayed performance. Such a penalty clause results from the promisee having inferior bargaining power which should be protected against. However even in the case where there is an unequal bargaining power the court should still award the stipulated penalty if it is merely less than actual loss suffered. The criterion is the sum being manifestly derisory to the actual loss suffered. A hypothetical instance is given in point 2 above. As the extravagance is quite clear the court would find itself compelled to intervene in order to increase the stipulated sum.

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<sup>690</sup> Because of the fact that the promisee has inferior bargaining position.

However penalty clause might be inserted in the contract after a fair negotiation between the parties. This is to say that in the presence of equal bargaining power it could be presumed at least that the parties have had the *intention* of agreeing to a low penalty, as they should have known that the actual loss would exceed their figure. Therefore it is generally reasonable to carry through the parties' intention. To reach this conclusion the court should consider the construction of the contract, its inherent circumstances and any other matter as it think fits to reach justice. The court may consider the following factors<sup>691</sup>: the genesis of the clause and discussions related to it<sup>692</sup> and whether a penalty clause was imposed upon a party with inferior bargaining position and whether the party, who seeks to ignore the clause and get his actual loss, appreciated the likely imposition of stipulated sum on breach, but nevertheless agreed to the clause because of some perceived benefits. This is illustrated not in a hypothetical instance but in the English case of *Cellulose Acetate Silk Co Ltd v. Widnes Foundry (1925)*<sup>693</sup>. In this case all agreed damages that the parties have agreed on were £600 and the actual loss suffered on breach was £5850. After examining all particular facts and circumstances surrounding the case from point of negotiation to making the contract<sup>694</sup> the court reached the conclusion that what the parties meant was that in the event of delay the damages and the only damages payable to the injured party was £600. The parties should have known that the actual loss would exceed the amount agreed upon. On the basis of the foregoing discussion it would seem fair to conclude that the court will not also have, under the New Approach, a power to increase agreed sum in such situations. The court should not be astute to upset what the parties have agreed upon in order to preserve the weight and value of agreeing on damages in advance. This is especially the case where there is a contract negotiated at arm's length. The fairness inquiry should address itself to the fairness of the whole contract process from negotiation until the time of breach.

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<sup>691</sup> See for these factors the case of *Multiplex Constructions v. Abgarus Pty Ltd* (1992) 33 NSWLR 504, at 513. See also Jacobs, Sydney. "Damages in a Commercial Context". LBC Information Services. 2000. P 261-262.

<sup>692</sup> It could be detected from the documents used at the time of negotiations.

<sup>693</sup> *Cellulose Acetate Silk Co. Ltd v. Widnes Foundry (1925) Ltd* [1933] AC 20.

<sup>694</sup> According to the documents provided by the parties. When the fact of the case at 21-24 is read through it can be discovered that the parties were negotiating at arm' length and reached the agreement on damages with full satisfaction of the parties. In other words, there was no pre-drafted contract imposing one parties' terms and the other had no choice but to accept them.

## Chapter Six: Forfeiture of Money Already Paid (Deposit and Paid Instalments)<sup>695</sup>

### 0-Introduction

In a liquidated damages clause parties to a contract agree in advance on the damages due to the injured party should a breach of contract occur. Such a provision without doubt runs the risk that the parties' original estimation will be held to be a penalty clause. Closely related to this rule are those, which govern the grant of relief against forfeiture of advance payment. Parties to a contract may agree that one party is to immediately pay a certain sum of money at the time of formation of the contract<sup>696</sup> or to pay the price by instalments. The payee then might, in the event of the payer breaking the contract, refuse to return the money he has obtained in advance.

In such a case what relief is there for the payer? It is established that where the payment is held to be a deposit it is generally irrecoverable by the party in breach. The forfeiture of such a payment might operate in a similar way to penalty clauses and be out of all proportion to the likely loss suffered. Therefore in the case of *Workers Trust & Merchant*

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<sup>695</sup> The researcher is aware of the fact that the forfeiture clause might also go, in addition to the money already paid, to the forfeiture of the equitable interest of the subject matter. In brief, equity has jurisdiction to grant relief against forfeiture if the forfeiture clause was inserted to achieve a stated result other than the payment of money and this result could effectively be attained when the matter comes before the court. A nice consideration of this subject was provided in the leading case of *Shiloh Spinners Ltd v Harding* [1973] AC 691. See also *Nutting v Baldwin* [1995] 1 WLR 201, where Rattee J decided that the court had no jurisdiction to grant relief against the forfeiture clause because though the clause was inserted to secure a stated result, this result was not attainable when the matter came before the court. Though it has been mostly developed through them, the jurisdiction has not been confined to the cases of an interest of land but the court has "power to relieve against forfeiture under any conceivable lease of a chattel". See for this *Barton Thompson and Co. Ltd v Stapling Co.* [1966] 1 Ch. 499. *Starside Properties Ltd v Mustapha* [1974] All ER 567. *BICC Plc v Burndy Corp* [1985] 1 All ER 417. The exercise of this jurisdiction will depend on certain factors including the conduct of the parties, the nature and gravity of the breach and its relation to the value of the property which is to be forfeited. In the leading case of *Shiloh Spinner* the House of Lords decided that the case was not suitable for relief because of the respondent's clear and wilful breaches of covenant and his inability to make good the consequences of his breach. The form of relief that the court is entitled to grant will vary. Relief against forfeiture of property is normally provided in the form of declaring specific performance or granting the debtor, who is willing and able to perform, extra time to proceed with the contract. The court might, in exceptional cases where granting extra time is not possible, order a sale of the property subject to forfeiture with payment out of the proceeds (*Jobson v Johnson* [1989] 1 WLR 1026). Further consideration of this topic is beyond the scope of this thesis.

<sup>696</sup> It is generally called deposit.

*Bank Ltd v. Dojap Investments Ltd*<sup>697</sup> the Privy Council limited the right of the payee for forfeiture of deposit up to 10% of the purchase price. This percentage is widely accepted as is likely to form a genuine pre-estimate of damages. However, is the 10% deposit a reasonable percentage for the vendor to forfeit in the event of default by the purchaser in a sale of land?

Where the payment is held to be a part payment it is generally recoverable by the party in breach. However, what will be the position if parties to a contract provided in their agreement that in the event of failure to pay any one of the instalments, those already paid by the purchaser would be forfeited in favor of the vendor? In such cases is it appropriate to apply penalty clause jurisdiction to those payments already paid?

The purpose of this chapter is to scrutinise the position of the law regarding forfeiture of money already paid and the possibility of application of penalty rules to them. Therefore the following issues will now be considered:

- 1- What is advance payment
- 2- Distinction between forfeiture clauses and penalty clauses
- 3- Forfeiture of instalments already paid
- 4- Forfeiture of deposits

### **1-What is advance payment?**

Advance payment is payment of a sum of money paid beforehand by the payer to the other party under the contract. Such payment might be paid as a deposit thereby acting as a guarantee for performance or as a part payment on account. The recoverability of the advance payment depends upon the purpose for which it is required<sup>698</sup>. The deposit is regarded as a guarantee that the contract shall be performed and a part payment of the contract price in the event of performance. Where the advance payment serves this

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<sup>697</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>698</sup> *Gallagher v. Shilcock* [1949] 2 KB 765, at 768. See also Beatson, J. "Discharge for Breach: The Position of Instalments, Deposit and other Payments due before Completion". Essay in "The Use and Abuse of Unjust Enrichment, Essays on the Law of Restitution". Clarendon Press. Oxford. 1991. P 47.

purpose it is a deposit<sup>699</sup>. A deposit is generally (unless it is unreasonable<sup>700</sup>) forfeited on a payer's default, unless there is a provision to the contrary in the contract<sup>701</sup>. A part payment on the other hand is not forfeited and can be recovered even if the person who paid it is himself in default<sup>702</sup>.

Thus, the recoverability of advance payment depends upon the purpose for which it is required. The contract might state frankly that the payment is exacted as a security for the performance, but this is often inferred from the parties' language used in the contract. This is to say that the actual words of the contract should be taken into account to determine the recoverability of advance payment. Therefore parties to a contract may use the word "deposit" to indicate the nature of the advance payment<sup>703</sup>. However, placing the word deposit in the contract is not decisive in determining the recoverability of the advance payment for using this term might hide the true nature of penalty<sup>704</sup>. As a result it should be emphasized that the difference between a deposit and a part payment is a matter of construction. Where the language of the contract is neutral, i.e. there is no indication to infer whether the advance payment has the purpose of being a deposit, the payment will be dealt with as a part payment and so recoverable. This has been clearly affirmed in *Dies and Another v. British and International Mining and Finance Corporation Ltd*<sup>705</sup>. This case concerned a contract to purchase certain rifles and ammunition for the total price of £270,000. The contract was written in French but subject to English Law. The purchaser paid £100,000 and then admitted that he could not proceed with the contract. In breach of his contractual obligations he refused to accept delivery. The vendor terminated the contract and the purchaser took an action in order to reclaim his money back. It was held that the £100,000 was not in the nature of a deposit, but rather a part payment as there was nothing in the contract to indicate that the

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<sup>699</sup> *Howe v. Smith*. (1884) 27 Ch.D. 89, at 95 per Cotton LJ. And at 101 per Fry LJ.

<sup>700</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>701</sup> *Howe v. Smith* (1884) 27 Ch.D 89, at 95 per Cotton LJ. And at 101 per Fry LJ. *Union Eagle Ltd v. Golden Achievement Ltd*. [1997] AC 514, at 518.

<sup>702</sup> That follows from *Howe v. Smith* (1884) 27 Ch.D 89. *Dies and Another v. British and International Mining and Finance Corporation Ltd* [1939] 1 KB 724. Also *Gallagher v. Shilcock*. [1949] 2 KB 765, at 768.

<sup>703</sup> *Gallagher v. Shilcock* [1949] 2 KB 765.

<sup>704</sup> *Linggi Plantations v. Jagatheesan* [1972] 1 Malayan LJ 89; available also on <web.lexis-nexis.com/professional/document?\_m.>.

£100,000 payment was intended as a guarantee of performance. On this basis the court decided that the purchaser was entitled to recover the money paid. This was clearly inferred from the words of Stable J. who delivered the judgment stating that:

“Where the language used in a contract is neutral, the general rule is that the law confers on the purchaser the right to recover his money, and that to enable the seller to keep it he must be able to point to some language in the contract from which the inference to be drawn is that the parties intended and agreed that he should”<sup>706</sup>

## 2- Forfeiture clauses and penalty clauses

### 2.1 Forfeiture clauses and penalty clauses distinguished

Both forfeiture clauses and penalty clauses are closely related<sup>707</sup>. In a forfeiture clause, parties to a contract agree to immediately pay a sum of money, which shall be forfeited on the payer’s default. This, like penalty clauses, might result in intimidating the payer and therefore the treatment, which should be given to such clauses by the courts, should be the same<sup>708</sup>. However, special rules have been put forward to govern the forfeiture clauses, namely, the separation of the rules that control the forfeiture clauses from penalty clause rules. This is clearly revealed in *Linggi Plantations Ltd v. Jagatheesan*<sup>709</sup>, where Lord Hailsham stated: “...The truth is that a reasonable deposit has always been regarded as a guarantee as well as a payment on account, and its forfeiture has never been regarded as a penalty in English Law or common English usage”<sup>710</sup>. Again it should be noticed that there is a common feature between forfeiture clauses and penalty clauses and the dissimilarities between them are of form rather than of substance. Both of them can operate in terrorem of the defaulting party to fulfill his contractual obligations. However, forfeiture clauses of deposit and part payment can be distinguished from liquidated damages and penalties in the following ways:

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<sup>705</sup> *Dies and Another v. British and International Mining and Finance Corporation Ltd* [1939] 1 KB 724.

<sup>706</sup> *Ibid.* At 743.

<sup>707</sup> Atiyah, P. S. “An Introduction to the Law of Contract”. 5<sup>th</sup> edition. Clarendon Press. Oxford. 1995. P437. Waddam, S M. “The Law of Damages”. Canada Law Book Limited. 2004. P 448.

<sup>708</sup> McGregor, Harvey. “McGregor on Damages”. Sweet and Maxwell. 17<sup>th</sup> ed. 2003. P 463.

<sup>709</sup> *Linggi Plantations v. Jagatheesan* [1972]1 Malayan Law Journal 89. For this case see: [web.lexis-nexis.com/professional/document?\\_m](http://web.lexis-nexis.com/professional/document?_m)

<sup>710</sup> *Ibid.*

1-Penalty clause is a sum of money which becomes payable after breach, while forfeiture clause is a sum of money that parties to a contract might agree to be forthwith paid at the time of making the contract<sup>711</sup>. The sum of money under forfeiture clause is paid before the breach and considered as a part payment of the purchase money for which it is deposited. The payment of penalty is something different from the payment of the transaction money in the contract.

2-In agreed damage clauses it is the claimant, who is the victim of the breach and seeks to uphold the sum stipulated as liquidated damages and the defendant who seeks to be relieved from penalties. In contrast the claimant who breaks the contract and seeks the recovery of his deposit and part payment in the event of forfeiture clause<sup>712</sup>.

3-The advance payment is not the maximum that can be sued for as one can claim for more damages according to the loss he has suffered. However under liquidated damages the claimant cannot claim more than the stipulated sum.

4- In the event of penalty “one party<sup>713</sup> seeks to exact a penalty from the other, he is seeking to exact payment of an extravagant sum either by action at law or by appropriating to himself moneys belonging to the other party”<sup>714</sup>. This contrasts to a forfeiture of deposit and part payment where the sum paid in advance belongs to the payee as soon as it is paid. The payee in this case seeks to keep money, which had previously belonged to him. Thus “It is not the case of a seller seeking to enforce a penalty, but a buyer seeking restitution of money paid”<sup>715</sup>. However, the payee might be the claimant, as in the liquidated damages case in the event that the sum of money, which should have been paid as a deposit, has not been paid at the time of the principal breach upon which suit is brought before the court<sup>716</sup>.

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<sup>711</sup> Halson, Roger. “Contract Law”. First published in Great Britain. Longman. 2001. P 519-520. Treitel, G. H. “The Law of Contract”. Sweet and Maxwell. 11<sup>th</sup> edition. 2003. P 1008.

<sup>712</sup> Ogus, A I. “The Law of Damages”. Butterworths. 1973. 52.

<sup>713</sup> The contemplated payee.

<sup>714</sup> *Stockloser v. Johnson*. [1954] 1 QB 476, at 488 per Lord Denning. His Lord gave an instance for that as in *Commissioner of Public Workers v. Hill* [1906] AC 368.

<sup>715</sup> *Stockloser v. Johnson*. [1954] 1 QB 476, at 489 per Lord Denning.

<sup>716</sup> *Hinton v. Sparkes* (1868) LR 3 CP 16, at 166 per Willes J.

5-It is a practical difference that in forfeiture clause, the payer of a deposit is more conscious of the fact that he is at risk of not getting his money back in the event of his default to perform his contractual obligations. This is because parties to a contract expect that the contract shall be performed. On the other hand, in penalties the party agreeing to pay a sum of money on his breach is less conscious than the one in forfeiture of deposit. This is because he merely promises to pay that sum in the future which might be considered remote and unlikely eventuality<sup>717</sup>. Therefore what is expected is that the contract might not be performed as agreed damages are supposed to be compensation in the event of non-performance.

## **2.2 The differences disappeared**

In spite of the above points it should be clarified that all the aforementioned differences are of form and not of substance. As a consequence there might be little or no practical distinction to justify the radical difference in treatment between the two forms of clauses. This is particularly the case where the deposit has fallen due for payment under the contract but remains unpaid by the purchaser. In spite of this fact the courts, until comparatively recently, have been slow to grant relief in cases of forfeiture<sup>718</sup>. The reasons for such reserve by the courts are suggested to be there because in forfeiture clause it is the contract-breaker who is the claimant trying to undo a situation, which is blessed by the maxim that possession is nine-tenths of the law<sup>719</sup>. There is no doubt that it is the policy of the law that wrongdoers must not be heard to complain, but this policy should not be applied uncritically<sup>720</sup>. As a result it has been said that even in the case where the deposit has not been paid until the time of the principal breach,(so that the victim of the breach becomes once again, as in the normal liquidated damages case, the

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<sup>717</sup> The law Commission. Working paper No. 61. "Penalty Clauses and Forfeiture of Monies Paid". Her Majesty Stationery Office. 1975. P 44.

<sup>718</sup> McGregor, Harvey. "McGregor on Damages". 17<sup>th</sup> ed. Sweet and Maxwell. 2003. P 463. The law commission. Working Paper No. 61. "Penalty Clauses and Forfeiture of Monies Paid". Her Majesty's Stationery Office. 1975. P 44.

<sup>719</sup> McGregor, Harvey. "McGregor on Damages". 17<sup>th</sup> ed. Sweet and Maxwell. 2003. P 463.

<sup>720</sup> Ogus, A I. "The Law of Damages". Butterworths. 1973. P 53.

claimant,) this should not prejudice him. In *Hinton v. Sparkes*<sup>721</sup>, the vendor sued to recover £50, which should have been paid by way of deposit, after a default was committed by the purchaser. The default was worth £10. The court enforced the provision of contract to pay the money as a deposit and held that if £50 had been agreed to be paid as liquidated damages, the provision would have held to constitute an invalid penalty clause. Therefore the £50 was still regarded as a deposit and the vendor should not have been in any worse position because the money was not paid when it should have been. Lord Waller's stated that: "I cannot see why the rights of the vendor should be affected by the purchaser's having committed two breaches of contract instead of one"<sup>722</sup>. This means that the contract-breaker (the payer) should not be better off by the fact of having committed two breaches<sup>723</sup> instead of one.

### 3- Forfeiture of instalments already paid

It is common that parties to a contract might provide for the price to be paid by instalments whereby the subject matter does not transfer from the vendor to the purchaser unless the last instalment is paid. The purpose of this sale is to let the vendor keep the ownership of the subject matter until the purchaser pays the entire price. This means that before paying all the instalments the purchaser cannot sell the subject matter to another party as it is not his. Accordingly, if the contract is determined before the completion of performance<sup>724</sup>, the parties should come back to the position that they were in had the contract not been made in the first place. In other words, the vendor should return the instalments already paid to the purchaser and can seek damages for the loss he has sustained by subtracting it from the instalments and return the rest<sup>725</sup>. However, the

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<sup>721</sup> *Hinton v. Sparkes* (1868) LR 3 CP 16. See also the fact of *Damon Compania Naviera SA v. Hapag-Lloyd International SA* [1985] 1 WLR 435 where the vendors were given the right to recover a greatly large deposit.

<sup>722</sup> *Ibid.* At 166.

<sup>723</sup> The first breach is the non payment of a sum of money which should have been paid by way of a deposit and the second one is the failure to perform his contractual obligations.

<sup>724</sup> Even for the purchaser's breach.

<sup>725</sup> *Dies and Another v. British and International Mining and Finance Corporation Ltd* [1939] 1 KB 724, at 744 per Stoble J. however, in *Hyundai Heavy Industries Co Ltd v. Papadopoulos*. [1980] 1 WLR 1129 the house of lord said that the advance payments made in a shipbuilding contract could not be recovered. This judgment was justified by the nature of the contract where in the contract of sale the right of the vendor to retain the money is conditional on subsequent performance by delivery. This result should be met in order the vendor to keep the money, otherwise it would be returned to the purchaser. But in shipbuilding contract

parties might provide in the contract that in the event of default in paying any of the instalments, those already paid would be forfeited in favor of the payee. Where there is such express forfeiture clause, the payee, upon the payer's breach, becomes entitled to terminate the contract and forfeit the payment already paid. In such a case can the payer, who is the party in breach, recover the pre-paid instalments?

As far as Jordanian civil law is concerned its judgment is clear in this situation as it regards the instalments as rent payments. As a result if purchaser fails in a hire-purchase contract to complete the instalments, all previous instalments would be considered as rent payments to the subject matter<sup>726</sup>. However, what will be the position of the law if the instalments are not reflecting the true rent of subject matter? In other words, what will be the position if the instalment excessively exceeds the damage the vendor has sustained as a result of breach by the purchaser? Therefore the following discussion as regards the position in English law will be of great significance and benefit to Jordanian law.

Two sorts of relief are particularly relevant to be discussed: Firstly: the extension of time to make payment. Secondly: the recovery of paid instalments, i.e. ordering the repayment of instalments already paid.

### **3.1 Extension of time to make the unpaid instalments**

The courts have the jurisdiction to grant the defaulting purchaser a relief against the forfeiture clause by giving him extra time to proceed with the contract<sup>727</sup>. This would be

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the money already paid was viewed as unconditional payment as it includes payment for services in the inspection, test, classification of survey and all costs and expenses for designing and supplying of the vessel. The same result was reached in *Hyundai Shipbuilding & Heavy Industries Co. Ltd v. Pournaras*. [1978] 2 Lloyd's LR. 502. See for that Halson, Roger. "Contract Law". First published in Great Britain. Longman. 2001, PP 523-524. Beatson, J. "Discharge for Breach: The Position of Instalments, Deposit and other Payments due before Completion". Essay in "The Use and Abuse of Unjust Enrichment, Essays on the Law of Restitution". Clarendon Press. Oxford. 1991. P45. Beale, H G; Bishop, W D and Furmston, M P. "Contract Cases and Materials". 4<sup>th</sup> edition, Butterworths 2001. P590. Chitty on Contracts. 29<sup>th</sup> ed, vol. 1 General Principles. Sweet & Maxwell. 2004. P 1503.

<sup>726</sup> Article 487 of Jordanian Civil Law.

<sup>727</sup> This jurisdiction was unequivocally observed in *Stockloser v. Johnson* [1954] 1 QB 476. After he had nicely reviewed all cases concerned (at 496-498), Romer L.J (at 499) reached the point that: "The cases establish that if a purchaser defaults in punctual payment of instalments of purchase-money the court will, in proper case, relieve the purchaser from his contractual liability to forfeit instalments (apart from the deposit) already paid to the extent of giving him a further chance and further time to pay the money which

on the grounds that the forfeiture clause will prejudice him as he stands to lose all pre-payments irrespective of the loss sustained by the vendor because of the breach.

This method of relieving the purchaser in breach by way of an extension of time to pay the unpaid instalments has obtained clear judicial support<sup>728</sup>. It is implicit in these cases that the payment within the extended period would preserve all contractual rights for the purchaser as he has made the payments in the original time of the contract<sup>729</sup>. In other words, the purchaser proceeds with the contract as nothing has happened.

The first authority of genuine significance with regard to the equitable jurisdiction to granting such kind of relief is the decision in *Daghenham (Thames) Dock Co. RE*<sup>730</sup>. In this case a relief was given to the defaulting purchaser by way of extra time to perform his contractual obligation. This case was concerned a contract for the sale of land for £4000 to be paid in two instalments. It was provided that £2000 should be paid at once and the remaining £2000 on a certain date in the future. As well as with a provision that if the entire of second instalment was not paid on time (paying on time was of the essence of the contract), the vendors would have the right to re-possess the land and forfeit the £2000 instalment already paid. The purchaser did not pay the second instalment on time and the vendors as entitled under the contract, repossessed the land and retained the money already paid. The vendors brought an action for ejectment.

It was suggested that the agreement in this case on the forfeiture clause was *ultra vires* and void<sup>731</sup>. Consequently, The Court of Appeal in Chancery, regarding the conduct of vendors in the nature of penalty, granted the defaulting purchaser an extra time to make the unpaid instalment of £2000<sup>732</sup>. It appears that the court in this case has granted an

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is in arrear if he is able and willing to do so; but the cases do not, in my judgment, show that the court will relieve such a purchaser to any further extent than this ”.

<sup>728</sup> *Daghenham (Thames) Dock Co. RE* (1873) LR 8 Ch. App. 1022. *John H. Kilmer v. British Culombia Orchard Lands Ltd* [1913] AC 319 and this case was cited in *Union Eagle Ltd v. Golden Achievement Ltd*. [1997] AC 514, at 521. *Stockloser v. Johnson* [1954] 1 QB 476, at 497-499 per Romer LJ. *Starside Properties v. Mustapha*. [1974] 1 WLR 816.

<sup>729</sup> Chitty on Contracts. 29<sup>th</sup> edition. Vol.1, General Principles. London Sweet & Maxwell. 2004. P 1503.

<sup>730</sup> *Daghenham (Thames) Dock Co, RE* (1873) LR 8 Ch. App. 1022.

<sup>731</sup> *Ibid.* At 1025 per Sir W. M. James.

<sup>732</sup> *Ibid.* At 1025 per Sir W. M James L.J and Sir G. Mellish, L.J.

extension of time to the purchaser, who was able and willing to proceed with the contract, in spite of the stipulation in the contract that time was to be of the essence of the contract. However what are the requirements of giving this sort of relief?

### **3.1.1 Prerequisites for granting relief by way of an extension of time**

If the purchaser seeks to claim for relief against the forfeiture of his instalments already paid, it is necessary for him to demonstrate that the forfeiture clause is in the nature of penalty and that he was willing and able to perform the contract.

#### **3.1.1.1 Forfeiture clause should be in the nature of penalty**

When the defaulting purchaser resorts to the courts to seek relief against the forfeiture clause he should prove that the retention of the instalments already paid constitutes a penalty. This means that the court should take into account that it has no jurisdiction to grant extra time for the defaulting purchaser unless the forfeited payment is disproportionately high in comparison with the loss suffered by the vendor as a result of breach. Therefore if the forfeiture is successfully construed as a penalty, the court then has the power to disregard the stipulation and grant the purchaser extra time for performance<sup>733</sup>. In *Starside Properties Ltd v. Mustapha*<sup>734</sup> a contract for the sale of a house at £5,950 provided for the payment of a deposit by instalments. After the payment of £1250 of the purchase price the purchaser was to be entitled to completion on payment of the balance. A clause in the contract provided that if the purchaser defaulted on payment of an instalment for more than 14 days the vendor would be entitled to terminate the contract and forfeit all the sums paid by the purchaser. The purchaser having fallen into arrears, the vendor terminated the contract and retained all money that had been

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<sup>733</sup> *Dagenham (Thames) Dock Co. RE* (1873) LR 8 Ch. App. 1022. In this case when their Lordships considered the matter emphasized that the claimant should be relieved from forfeiture clause on the ground that such clause, in reality, "is an extremely clear case of a mere penalty for non-payment of the purchaser-money at 1025 per Sir W. M. James, L.J. See also *John H. Kilmer v. British Culombia Orchard Lands Ltd* [1913] AC 319. In this case Lord Moulton delivering the judgment of the board stated, at 325-326, that: "The circumstances of this case are such to bring it entirely within the ruling of the *Dagenham* one. it seems to me to be an even stronger case for the penalty if enforced according to the letter of the agreement, becomes more and more severe as the agreement approaches completion, and the money liable to confiscation becomes even larger". See also *John H. Kilmer v. British Culombia Orchard Lands Ltd* [1913] AC 319. *Starside Properties v. Mustapha*. [1974] 1 WLR 816.

<sup>734</sup> [1974] 1 WLR 816.

made. In this case the Court of Appeal decided<sup>735</sup>, confirming the jurisdiction of the court of granting such relief, that the justice of this case required to grant the purchaser relief against forfeiture by way of an extension of time. In considering the ground of granting such relief, Edmund Davies L.J. stated that: “The contract between the parties imposed a penalty is unchallengeable, and the nature or dimension of the penalty were such as to satisfy the court that justice required the relief therefrom should be granted...”<sup>736</sup>.

### **3.1.1.2 The purchaser should be ready and able to perform the contract**

The second requisite, which the court should ascertain from to grant relief against forfeiture clause by way of extra time, is that the purchaser should show evidence that he is ready, willing and able to perform the contract.

One might argue that the purchaser is supposed to be ready and able to immediately pay the arrears for this kind of relief is given as another chance to him to perform his contractual duties. However, it should be noted that this condition “is applicable not only when an extension of time is asked for but also when the original application for relief is made”<sup>737</sup>. Therefore, it is submitted that it is adequate for the purchaser to provide a “reasonable prospect” or anticipation that he will be able to pay off the arrears to the vendor if he is granted an extension of time to do so. Otherwise, there is no convincing reason to give the purchaser already in debt a further opportunity to perform the contract<sup>738</sup>. In other words, once the purchaser is given such relief it does not mean he should be able to pay immediately. It is a relief, which grants the purchaser extra time to pay the outstanding instalments within the period of extension. It would not be appropriate if it is conditioned that the purchaser should be able to pay forthwith. In other words, why should, and what is the point of the court granting the purchaser a period of time to perform the contract if he is supposed to be immediately able to pay the

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<sup>735</sup> Ibid. At 824 per Edmund Davies L.J. 825 per Cairns L.J and Lawton L.J.

<sup>736</sup> Ibid. At 820 per Edmund Davies L.J.

<sup>737</sup> *Starside Properties v. Mustapha*. [1974] 1 WLR 816. Per Cairns L.J. See also for this condition *Stockloser v. Johnson* [1954] 1 QB 476, at 499 per Romer L.J. his Lord after he had stated the possibility of granting the purchaser an extra time to pay the arrears, he emphasized that that would be given to the purchaser “if he is able and willing to do so”.

outstanding balance? Therefore, if the court grants the defaulting purchaser a relief to pay the arrears in 4 months this means that he may be able to pay after days or weeks or by the end of the period. In one case the tenants failed in obtaining relief against forfeiture clause by way of extra time to perform their contractual obligations, as they had not showed any evidence or indication that they would ever be able to pay the unpaid instalments<sup>739</sup>. Hence the prerequisite of readiness and willingness “is a requirement of law rooted in the principle on which relief is granted. It follows that readiness to pay arrears within such time as the court shall think fit is a necessary condition of the tenants for relief”<sup>740</sup>. This is a key point for otherwise, why should the court grant a defaulting person a relief to proceed with the contract if he cannot, in reality, do so? Is it to reward such person on breaching the contract? Therefore if the defaulting party is unable or not anticipated in being able to perform and he is in breach of contract at the same time, he is in a negative situation in the both respects. As a result there is no point of relieving him by way of an extension of time, as there is no indication that its position will change.

Therefore both preconditions, namely, the forfeiture of instalments in the nature of penalty and the defaulting party is willing and able to pay the arrears, should be met to grant the purchaser an extension of time to proceed with the contract. Therefore, if the defaulting party performs the contract within the period of extension, i.e. paying the delinquencies within the extra time granted, he shall be permitted to proceed with the contract by resuming instalment payments under the contract as if nothing had happened. In other words, justice requires that credit should be given to the instalments already paid by the purchaser<sup>741</sup>.

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<sup>738</sup> *Stockloser v. Johnson* [1954] 1 QB 476, at 497 per Romer L.J. Harpum, Charles. “Relief against Forfeiture and the Purchase of Land”. (1984) 43(1). Cambridge Law Journal. 134, at 146-147.

<sup>739</sup> *Barton Thompson Ltd v. Stapling Machine*. [1966] 2 All ER 222.

<sup>740</sup> *Ibid.* At 225 per Pennycuik J.

<sup>741</sup> *Mussen v. Van Diemen's Land Co* [1938] 1 Ch. 210, at 218.

### 3.2 Recovery of paid instalments forfeited by the vendor

Sometimes the court may grant a positive relief to a defaulting party in the form of an order to recover the pre-payment<sup>742</sup> in the event of his failure to benefit from the chance given to him by way of extra time to pay. However the recovery of instalments already paid is subject to the subtraction of damages for the actual loss sustained by the injured party as a result of breach of contract<sup>743</sup>. This situation was clearly illustrated in the case of *Steedman v. Drinkle*<sup>744</sup>. This case concerned a contract of sale of land worth \$16000, of which \$1000 was paid at the time of making the contract and the rest was agreed to be paid by six annual instalments. The contract provided that if the purchaser defaulted in paying any of the instalments the vendor had the right to terminate the contract and keep the payments already paid as liquidated damages. Time was of the essence of the contract. The purchaser defaulted to meet the first payment leading the vendor to terminate the contract. However the purchaser claimed specific performance, as he was willing and able to proceed with the contract. The Privy Council ruled out the possibility of specific performance, as this remedy is not granted to a purchaser who breaks a stipulation of which time was of the essence. However the Council accepted that the forfeiture clause in the agreement was of penal nature and the purchaser should receive a relief against forfeiture of the sum paid by him<sup>745</sup>.

According to the decision of the *Steedman* case<sup>746</sup>, it has been asserted that in order to grant relief to a purchaser by way of returning his money, he should be willing and able to proceed with the contract and the vendor refuses to accept late performance<sup>747</sup>. At this

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<sup>742</sup> This kind of relief has been completely rejected by Romer LJ in *Stockloser v. Johnson* [1954] 1 QB 476, at 501. To confirm that no relief other than extra time to pay the arrears, he stated (at 499) that: "The cases do not, in my judgment, show that the court will relieve such a purchaser to any further extent than this".

<sup>743</sup> *Steedman v. Drinkle* [1916] AC 275.. See also, Treitel, G. H. "The Law of Contract". 11<sup>th</sup> edition. Sweet & Maxwell. 2003. P 1009.

<sup>744</sup> [1916] AC 275.

<sup>745</sup> The Privy Council has applied the decision of (*Steedman v. Drinkle*) in the case of *Brickles v. Snell* [1916] 2 AC 599, where the Council expressed regret that the purchaser failed to claim for the return of the money already paid by him as it appears that the Council would have ordered its repayment if the purchaser claimed such relief.

<sup>746</sup> *Steedman v. Drinkle* [1916] AC 275.

<sup>747</sup> This is what has been explained and taken by Farwell, J in *Mussen v. Van Diemen's Land Co* [1938] 1 Ch. 210, at 219. He stated that: "I think, however- I say it with the utmost regards- that that case (*Steedman v. Drinkle*) really turns on the particular circumstances there existing...the appellant was ready and willing

view if the purchaser is unable to perform the contract, he will not become entitled to return the money already paid by him to the vendor. Is the ability of purchaser to perform really relevant to claim the recovery of his money?

### 3.2.1 The relevance of defaulting purchaser's ability

#### 3.2.1.1 *Mussen case*<sup>748</sup> affirms the relevance

*Mussen v. Van Diemen's Land Co*<sup>749</sup> was concerned a contract for the sale of land worth £321,000 to be payable in instalments. Time was of the essence and it was provided that the purchaser to be let into possession of certain parts of land according to the instalments paid. As well as upon purchaser's default the vendor was given the right to terminate the contract and retain all money paid by the purchaser. After the purchaser paid £139,500 he was permitted a possession of land worth £99,300, i.e. the value of the part of the land was smaller than the sum paid. Default having been made by the purchaser, the vendor terminated the contract and retained about £40,200 being the amount that the purchaser paid in excess of the value of the part of land that conveyed to him. The purchaser demanded his money back after two years but the vendor refused. He claimed the prepayment again after six years but the vendor also rejected this demand. Finally the purchaser brought an action suing for a relief against the forfeiture on the basis that the forfeiture clause was of penal nature. The court accepted that there was jurisdiction to grant relief against a penal provision in unconscionable circumstances (where it is unconscionable for the vendor to retain the money)<sup>750</sup>. However, this jurisdiction to grant relief against forfeiture can be only applied in the event that there is readiness and ability on the purchaser's part for specific performance. Thus, on the basis that the purchaser was unable to perform the contract and delayed to ask for specific performance 6 years without any smallest attempt to ask for such relief,<sup>751</sup> it was held that: "The plaintiff

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to perform the contract and the respondents were refusing to permit specific performance, and the court itself was unable to decree specific performance because of the term of the contract (which made time of the essence)...the board thereupon thought that it was unconscionable for the respondents to take up the attitude of saying, "we will not complete, but we will retain the money," and on that ground the board granted relief".

<sup>748</sup> *Mussen v. Van Diemen's Land Co* [1938] 1 Ch.D. 210.

<sup>749</sup> [1938] 1 Ch.D. 210.

<sup>750</sup> *Ibid.* At 217.

<sup>751</sup> *Ibid.* At 219. Farwell, J said that: "the mere delay, which is due wholly to the plaintiff, renders it quite impossible for the court to consider specific performance, even if the plaintiff asked for it. The plaintiff has

should have no relief, and the defendants are entitled to retain the money, which they have received from the plaintiff<sup>752</sup>.

Therefore, in this case<sup>753</sup> and according to the Farwell J. who delivered the judgment that such kind of relief (ordering the repayment of money already paid) should not be granted unless the defaulting purchaser is ready, willing and able to proceed with the contract. Consequently, regards should not be given to the fact that the purchaser is unable to proceed with the contract as he found some difficulties in keeping up with paying the instalments or became unwilling to proceed with the contract as it turned out to be a poor bargain according to his interests. There are no grounds for invoking relief against forfeiture of instalments paid in such circumstances as the purchaser should have been aware that if he fell into this position he would not have the chance to return his money back<sup>754</sup>. In brief the view runs as follows: readiness, willingness, ability of the defaulting purchaser to proceed with the contract is a precondition to grant equitable relief against forfeiture of instalments already paid<sup>755</sup>. However this view is open to a number of objections, which will now be stated.

### **3.2.1.2 The relevance undermined: it is only essential in specific performance**

The prerequisite<sup>756</sup>, which has been argued by Farewell J in *Mussen v. Van Diemen's Land Co*<sup>757</sup> when discussed the crucial decision of the only case (*Steedman case*<sup>758</sup>) in which the defaulting party received an order for the return of his money, was refuted in

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chosen to stand by for all these years, and has not made the smallest attempt to complete the contract, and, in those circumstances, for myself, I am wholly unable to see any ground on which the plaintiff can say that it is unconscionable for the defendants to retain the possession of the money which he had agreed by the contract that they should have in the events which have happened”

<sup>752</sup> Ibid. At 220.

<sup>753</sup> *Mussen v. Van Diemen's Land Co* [1938] 1 Ch. 210.

<sup>754</sup> Ibid. At 217-218. Where Farwell J stated when rejected to grant the purchaser relief against the forfeiture of the instalments already paid by him that: “It is no ground for giving relief to a person from the effect of the contract which he himself has made to say that he has, through no fault of the defendant whatsoever, found himself in difficulties, or that it may turn out to be not a good bargain from his point of view. considerations of that sort are wholly irrelevant”

<sup>755</sup> Ibid. At 217 per Farewell. J.

<sup>756</sup> Readiness, willingness and ability to perform.

<sup>757</sup> *Mussen v. Van Diemen's Land Co* [1938] 1 Ch. 210.

<sup>758</sup> *Steedman v. Drinkle* [1916] AC 275.

*Stockloser v. Johnson*<sup>759</sup>. In this case it was confirmed that the decision in *Steedman* case<sup>760</sup> had not been based on the ground that the purchasers were ready and willing to proceed with the contract. But Denning L.J stated that:

“The basis of the decision in *Steedman v. Drinkle and another* was, I think, that the vendor had somewhat sharply exercised his right to rescind the contract and retake the land, and it was unconscionable for him also to forfeit the sums already paid. Equity could not specifically enforce the contract, but it could and would relieve against the forfeiture”<sup>761</sup>.

Thus the approach, which makes willingness and ability a pre-condition to grant relief by way of returning the paid instalments, is not free from doubt and accordingly can be undermined by the following reasons:

1-The outcome of *Steedman* case<sup>762</sup> suggested that the court would not grant specific performance to purchaser, who breaks a stipulation of which time is of essence. As a result of this if a vendor terminated a contract on a purchaser’s failure to pay on time the latter would know that he could not obtain thereafter a decree of specific performance. It would be an exercise in futility to require such purchaser to prove his ability to proceed with the contract<sup>763</sup>. Therefore the precondition which requires a defaulting purchaser to be ready and willing to perform the contract is relevant and essential in the event of demanding a specific performance or granting an extra time to perform. Somervell, LJ, *Stockloser v Johnson*<sup>764</sup> confirmed this fact stating that: “In my opinion the cases do not establish (1) that relief could never be given unless the plaintiff could show that he is financially in a position to complete and would be willing to do so if the defendant were himself prepared to waive the breach and complete the contract”<sup>765</sup>. This is to say that if a vendor is not prepared to waiver the breach and terminated the contract, the ability of a

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<sup>759</sup> [1954] 1 QB 476.

<sup>760</sup> *Steedman v. Drinkle* [1916] AC 275.

<sup>761</sup> *Stockloser v. Johnson* [1954] 1 QB 476, at 491.

<sup>762</sup> *Steedman v. Drinkle* [1916] AC 275.

<sup>763</sup> Harpum, Charles. “Relief Against Forfeiture and The Purchaser of Land”. Cambridge Law Journal (1984) 43(1) 134, at 158.

<sup>764</sup> *Stockloser v. Johnson* [1954] 1 QB 476.

<sup>765</sup> *Ibid.* At 487-488.

purchaser to perform became immaterial for claiming relief from forfeiture of pre-payment<sup>766</sup>.

Therefore the view that no relief can be granted in the event that the defaulting purchaser is unable to perform the contract ignores the fact that what is demanded by the defaulting party in such a case is an order to return his money. The purpose of this kind of relief is to return the money already paid by the defaulting party subject to subtraction by the injured party of his damages for the loss suffered because of the breach. That is to place the defaulting party in a position, which he would have been in had the contract not been made. Therefore so long as the grant of specific performance is concerned, it is easy to see what relevance the defaulting purchaser's ability to perform can have, otherwise it is not.

2-Though the defaulting purchaser's manner may have a role on whether relief is granted, the court when viewing a demand by a defaulting purchaser to relieve him from a forfeiture clause is mainly concerned to determine whether the injured party claims to retain a sum disproportionately high in comparison with his actual loss. If the amount is so the court will be keen to grant the defaulting party relief against forfeiture by ordering the repayment of instalments already paid subject to giving the injured party damages against his actual loss. However if the sum forfeited is merely in excess of the loss sustained the court will not hesitate to deny the defaulting purchaser relief.

3-Denying relief to the defaulting party who is not ready and able to proceed with the contract will affect the distinction between penalty clauses and forfeiture clauses of a penal nature. It leads to inessential and harsh distinction between the two kinds of clauses<sup>767</sup>.

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<sup>766</sup> Ibid. At 489 and 491 per Denning L.J. who clearly affirmed the irrelevance of such precondition in granting relief to the purchaser by returning the instalments already paid. He declared that: "Readiness and willingness is essential in specific performance, and in relief from forfeiture of leases, but not in relief from forfeiture of sums paid".

<sup>767</sup> Ogus, A. I. "The Law of Damages". Butterworths. 1973. P 56.

If willingness and ability of the defaulting party to perform is confirmed as a precondition, this will make the penalty clauses unenforceable against all defaulting parties whilst forfeiture clauses might be enforced against a defaulting party who is not willing and able to proceed with the contract. In other words, the defaulting party can claim relief against forfeiture of instalments already paid if he is willing and able to perform the contract whereas relief can be granted against a penalty clause and it is immaterial whether or not the defaulting party is willing and able to perform.

Therefore equity is necessary even though the defaulting party is not ready and willing to proceed with the contract. For example, suppose that the purchaser has contracted to buy a vehicle of £25,000 and agreed to pay the money by instalments of £5000 per month as payment. It was provided that if the purchaser defaulted in paying any one of the instalments, the vendor had the right to terminate the contract, retake the subject matter and forfeit the instalments already paid. Thus, if the purchaser paid 4 instalments, i.e. £20,000, and failed to pay the last one as he became unable to perform the contract because he could not find the money. The vendor was able to terminate the contract, retake the subject matter and resell it at a higher price. It has been said that: "Surely equity will relieve the buyer against forfeiture of the money on such terms as may be just"<sup>768</sup>.

### **3.2.2 The penal nature is sufficient to grant relief: unconscionability condition is without great advantage**

The principle is that in order to grant relief against forfeiture of instalments already paid, the sum forfeited must be of a penal nature, in the sense that the forfeited instalments are wholly out of all proportion to the likely loss suffered by the vendor<sup>769</sup>. There is a judicial approach to assume, without discussion, that the forfeiture clause is penal in nature since the defaulting party stands to lose all previously paid instalments irrespective of the

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<sup>768</sup>*Stockloser v. Johnson* [1954] 1 QB 476, at 490 per Denning LJ.

<sup>769</sup> *Ibid.* At 484 where Somervell LJ mentioned that in order to grant relief against forfeiture of instalments already paid, "Two conditions must be satisfied. First, the effect of the clause must be penal...". And at 490 where Denning LJ said that "Two things are necessary: first, the forfeiture clause must be of a penal nature..."

extent of the loss suffered by the injured party as a result of the breach<sup>770</sup>. In determining the penal nature of the sum forfeited, the court should apply the principles laid down in *Dunlop* case<sup>771</sup>. Since the established rule in the ordinary case of penalty clause is to be viewed at the time when the contract is entered to, this condition (the forfeiture clause should be of penal nature) therefore depends on the circumstances existing at the time when the contract is made<sup>772</sup>. However this does not mean that what occurred after the formation of contract is immaterial.

It has been asserted that it is not adequate for the defaulting party to succeed in his claim for relief against the forfeiture of instalments already paid by him to show that that forfeiture was of penal nature. However, that condition should be met with another to the effect that it must be unconscionable for the injured party to forfeit the instalments, which the defaulting party has paid under the contract<sup>773</sup>. As a consequence, if the sum was of a penal nature and however conscionable for the injured party to retain the pre-payment, no relief could be granted to the defaulting party, as the two necessary conditions have not been met. This situation has been clearly well defended in *Stockloser v. Johnson*<sup>774</sup> where the purchaser failed in his action to return his money back. In this case the contract was concerned with a purchaser who agreed to buy a plant and machinery at two quarries on a royalties basis. The contract provided that the purchase price would be paid in instalments and so the ownership of the subject matter would not be passed to the purchaser until he has paid all the required instalments. And in the event that the purchaser defaulted in paying any single payment, the vendor had the right to terminate the contract, retake the subject matter and forfeit the paid instalments. Default having been made by the purchaser, the vendor terminated the contract and forfeited the previously paid instalments. The purchaser did not offer or express his ability or willingness to proceed with the contract, but claimed relief against the forfeiture clause to

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<sup>770</sup> This was illustrated by the majority of the court of appeal in *Stockloser v. Johnson* [1954] 1 QB 476. See also McGregor, Harvey. "McGregor on Damages". 17<sup>th</sup> ed. Sweet & Maxwell. 2003. P 469.

<sup>771</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79, at 86-87 per Lord Dunedin.

<sup>772</sup> *Stockloser v. Johnson* [1954] 1 QB 476, at 484 per Somervell LJ.

<sup>773</sup> *Ibid.* At 490 per Denning L.J and at 484 per Somervell L.J.

<sup>774</sup> *Stockloser v. Johnson* [1954] 1 QB 476.

have his money returned. He based his claim on the ground that the forfeiture clause was penal and unconscionable.

The Court of Appeal unanimously rejected the claimant's claim, as he failed to show that it was unconscionable for the vendor to retain the instalments paid because he had himself received substantial benefits by way of royalties<sup>775</sup>. However, the fact that the purchaser has gambled on the royalties to pay the instalments is irrelevant and does not make what the vendor received was unconscionable to keep. Denning LJ stated that:

“The buyer seems to have gambled on the royalties being higher than there were. He thought that they would go a long way to enable him to pay the instalments; but owing to bad weather they turned out to be smaller than he hoped and he could not find the additional amount necessary to pay the instalments”<sup>776</sup>.

The reasoning of the verdict in this case, with all respect, seems unconvincing. When the court decided that the retention of the previously paid instalments was not unconscionable, it seemed that it added a new condition to endorse its reluctance to apply penalty clause jurisdiction to forfeiture clause. This is because when the court held that it was conscionable for the vendor to keep the pre-payment, the amount was not actually a penal in nature. Namely, the forfeited instalments were not disproportionately greater than the loss sustained by the vendor. This comment will now be proved in the following points.

1-It is important to highlight that the supporters of the view that unconscionability<sup>777</sup> is the basis for granting relief by way of returning the instalments already paid argue that it should not rest solely on the terms of the contract. To establish unconscionability, the court takes into account the actual loss suffered by the vendor when he exercised his right of forfeiture. Thus, it is examined with reference to all conditions and circumstances existing at the time when the relief is invoked. Somervell LJ stated when mentioned the two conditions for granting this relief that:

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<sup>775</sup> Ibid. At 484 Somervell LJ and at 492 per Denning LJ. The same conclusion was reached in *Mussen v. Van Diemen's Land Co* [1938] 1 Ch. 210.

<sup>776</sup> Ibid. At 492.

<sup>777</sup> It means that it should be unconscionable for the vendor to retain the pre-payment.

“The court must be satisfied that, in the circumstances of that particular case, that is, looking not merely at the contract, but at the circumstances at the time of the breach, it would be unconscionable to allow the recipient to retain the money notwithstanding the power to do so contained in the clause”<sup>778</sup>.

The reason for testing the unconscionability at the time when the relief is invoked is that the subsequent circumstances, which occur after making the contract, largely affect the determination of whether or not it is unconscionable for the vendor to retain the money<sup>779</sup>. Thus, when the contract provides that instalments are to be paid over a certain period of time and the purchaser uses or benefits from the subject matter, it becomes difficult to show that the forfeiture of instalments paid and keeping them by the vendor is unconscionable<sup>780</sup>. In response to this argument, it can be observed that the time to determine whether the sum stipulated is penal or not is the time of contracting and the events occur afterwards are not disregarded. What happened after the time of formation might be of valuable evidence of what was within the contemplation of the parties then. In the *Stockloser* case itself when the purchaser profited from the subject matter, the penalty nature was undermined by the fact that the benefits he had gained made the sum retained by the vendor compatible and not excessively higher than the actual loss sustained.

2-Also the purchaser might delay in applying relief against that forfeiture, which will mean that it is not unconscionable for the vendor to retain the instalments already paid. In *Mussen* case<sup>781</sup> it seems that the court was much influenced by the fact that the purchaser delayed for six years to claim his money back. During those six years he might have had a good deal of the land conveyed to him in proportion to the money he had paid and the value of the land has changed (fallen) so that it might be that he had had his money's worth. Does that not mean that the sum retained was not disproportionately higher than the loss suffered? And therefore penalty clause rules have not been applicable.

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<sup>778</sup> *Stockloser v. Johnson* [1954] 1 QB 476, at 484.

<sup>779</sup> See for more details Pawlowski, Mark. “Relief against Forfeiture of Instalments”. Estate Gazette. 27 March, Issue 9312. [1993] 122, at 123-124.

<sup>780</sup> *Stockloser v. Johnson* [1954] 1 QB 476, at 484 per Somervell LJ.

<sup>781</sup> *Mussen v. Van Diemen's Land Co* [1938] 1 Ch. 210. It has been referred to this case to explain this point by Somervell LJ in *Stockloser v. Johnson* [1954] 1 QB 476, at 492.

It might, also, be thought that in the application of penalty rule to forfeiture clause, many forfeiture clauses of instalment contracts will be categorised as penalties and there is a judicial tendency to assume that the forfeiture clause is of penal nature. In most cases the retention will be disproportionately higher than the loss suffered as a result of breach especially where the purchaser has paid many instalments and the subject matter was still resold. Therefore the forfeiture clause is of a penal nature not least where the sum is forfeited without giving a proper credit to the number of instalments paid and the profit of the resale of the subject matter. In response, it should be emphasized that the application of penalty jurisdiction will not affect the injured parties' right to claim his compensation. Where the forfeiture of pre-payment amounts to a penalty the courts will apply penalty jurisdiction subject to the right of the vendor to receive damages for the loss he has suffered as a result of breach<sup>782</sup>.

It is appropriate to conclude that it is often enough for the forfeiture clause to be of penal nature to grant a defaulting purchaser relief. The second condition of that it should be unconscionable for the vendor to retain the money already paid<sup>783</sup>, would be suggested to be of "no great advantage"<sup>784</sup>. Where the money already paid is held to be of penal nature it always means that it would be unconscionable for the vendor to forfeit the instalments already paid. Moreover it has been proved above that the word unconscionability included in the test for the invalidity of penalty clauses is no more than a synonym to the word extravagant.

This view is vastly strengthened if the New Approach is to be applied to forfeiture clause. In other words, the principle becomes that all forfeiture clauses are enforceable, but if the instalments forfeited were excessively higher than the loss suffered by the injured party, the court has the power to reduce the amount in line with the actual loss sustained.

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<sup>782</sup> This is quite strengthened by the fact that the vendor will be granted damages for his ACTUAL loss under the New Approach suggested in this thesis.

<sup>783</sup> *Stöckloser v. Johanson* [1954] 1 QB 476.

<sup>784</sup> See The Law Commission. Working paper No 61. "Penalty Clauses and Forfeiture of Monies paid". London. Her majesty's Stationery Office. 1975. P 47.

## 4- Forfeiture of Deposit

### 4.1 What is deposit?

Parties to a contract usually include a provision to the effect that one of the parties is to pay a certain sum of money as a deposit. This usually occurs at the time of making a sale contract<sup>785</sup> where purchaser agrees to pay a deposit to vendor in order to demonstrate his seriousness about proceeding with the transaction and to provide extra guarantee to vendor in the event of breach<sup>786</sup>. Put another way, the basic reason for the deposit is to impress the payee that the payer 'earnestly' intends to purchase the property. However, does the provision for the payment of a deposit affect the birth of contract or is it merely a term of the contract? This question was only first directly in issue in *Myton Ltd v Schwab Morris*<sup>787</sup>, which was in favour of holding that the provision for the payment of deposit states a condition precedent to the contract taking effect. The effect of this approach means that paying a deposit is a pre-requisite to the formation of the contract, failure to fulfill of which will result in preventing the contract from coming into the existence at all. As a result the vendor is not entitled to recover the sum which should have been paid by way of deposit. However the outcome of this case was strongly criticised on the grounds that the Goulding, J who delivered the judgment in *Myton* case "did not have, and, indeed, could not have had, before him the guidance afforded by the judgement[s]"<sup>788</sup> of the cases cited to support its proposition. Consequently, the obligation to pay a deposit on the signing of the contract should only be regarded as a term of the contract and accordingly the contract is treated as having come into existence even though the deposit was not paid. However failure to meet the payment of deposit will entitle the vendor to consider the purchaser in breach of contract. As a consequence the vendor will have a right to terminate for breach and to sue for damages including the sum, which should have been paid by way of deposit<sup>789</sup>. However there is nothing to stop the parties from expressly agreeing that the payment of deposit will constitute a condition precedent. This position was well illustrated in *Damon Compania Naviera SA v. Hapag-*

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<sup>785</sup> Also in lease contracts.

<sup>786</sup> "The vendor, in the normal case, never intends to be bound by the contract without having the deposit in his own or his stakeholder's possession as a protection against possible loss from default by the purchaser". Per Goulding, J in *Myton Ltd v Schwab Morris* [1974] 1 WLR 331.

<sup>787</sup> *Myton Ltd Schwab Morris* [1974] 1 WLR 331.

<sup>788</sup> *Millichamp v Jones* [1982] 1 WLR 1422, at 1431 per Warner J

*Lloyd International SA*<sup>790</sup>. In this case an argument, that failure to pay the deposit meant that there was no enforceable contract, was presented before the Court of Appeal. The Court unanimously rejected this argument. Lord Justice Fox confirming the view that the payment of deposit is not condition precedent stated that:

“I see no reason for inferring that no contract arises until the deposit is paid. The provision for the payment of a deposit is simply a term of the contract. In the absence of a special provision it does not seem to me to carry with it any implication that it is a condition precedent to the existence of contractual relations”<sup>791</sup>

It is concluded that the contract is still binding upon the payer (purchaser) in the event of not paying the deposit for the stipulation for the payment of a deposit is merely regarded as a term of contract. Therefore on breach the payee (vendor) becomes entitled to rescind immediately and sue for damages, which “Must include the value of the right to recover and retain the deposit and hence the value of the deposit itself”<sup>792</sup>.

#### 4.2 Nature of deposit

The historical origin of the law of deposits can be traced to the Roman law of *arrha*, and possibly further back still it is an earnest money given at the time when the contract is entered into to guarantee<sup>793</sup> performance of a contract duty<sup>794</sup>.

It has settled that the deposit, under this nature, serves two purposes. It plays the role as an earnest to protect payee against a certain event, namely the failure to perform by payer. In that event payee is intended to be secured by forfeiture of the sum, which will have been paid as a deposit. This means that the deposit creates an incentive to payer to perform the rest of the contract and in the event of non-compliance the deposit will be forfeited. Therefore, the deposit symbolizes the seriousness of the payer’s intention to fulfil his contractual obligations. If a purchaser enters into a contract to buy real property

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<sup>789</sup> Ibid.

<sup>790</sup> *Damon Compania Naviera SA v. Hapag-Lloyd International SA* [1985] 1 WLR 435.

<sup>791</sup> Ibid. At 446.

<sup>792</sup> Ibid. At 449.

<sup>793</sup> This is still a deposit’s nature even in the absence of a frank stipulation on this.

<sup>794</sup> See for the history *Howe v. Smith* (1884) 27 Ch.D 89, 102 per fry L.J. For more discussion see also Stoljar, S.J. “The Defaulting Purchaser: The Recovery of Deposits and Instalments”. *The Australian Law Journal*. (1957) Vol. 31. 510, at 512.

without taking in to account whether he can pay for it or not, that this is the classical circumstance in which a deposit is rightly forfeited<sup>795</sup>. The purchaser when enter into transaction to buy something should know, either actually or through his advisers, that certain consequences will follow, i.e. the risk of losing his deposit, in the event of his failure to complete the contract. On the other hand, a deposit also acts as a part payment if the contract was performed in accordance with its term. Lord Macnaghten in *Soper v. Arnold*<sup>796</sup> stated that: “Everybody knows what a deposit is...The deposit serves two purposes- if the purchase is carried out it goes against the purchase money- but its primary purpose is this, it is a guarantee that the purchaser means business<sup>797</sup>”.

Hence the payment of deposit has two advantages to vendor. On one side he may use or benefit from the sum, which has been paid by way of a deposit in another transaction. He on the other side, if the contract is not completed by purchaser, has full and immediate access to the deposit whether or not there is an express stipulation to this effect in the contract<sup>798</sup> and whether or not he has suffered any loss<sup>799</sup>. In other words, it has been clearly established that in the event of a vendor terminating the contract as a result of a purchaser’s breach, the sum which has been paid by way of deposit is forfeited in full by the former<sup>800</sup>. In *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd*<sup>801</sup> Lord Browne-Wilkinson made it clear that: “...in the event of the purchaser’s failure to complete in accordance with the terms of the contract, the deposit is forfeit.”<sup>802</sup>. However in case of forfeiture of deposit what relief is there for the payer?

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<sup>795</sup> *Tennaro Limited v Majorarch Limited* [2003] EWHC 2601; [2003] 47 E.G.C.S. 154 (Ch D). *Omar v. El-Wakil* [2001] EWCA Civ 1090. (2001) Times, November 2, 2001. It is available on WestLaw website 2001 WL 753309. *Soper v. Arnold*. [1889] 14 AC 429, at 435.

<sup>796</sup> *Soper v. Arnold* [1889] 14 AC 429.

<sup>797</sup> *Ibid.* At 435. See also *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573, at 578 –579 per lord Browne-Wilkinson.

<sup>798</sup> *Hall v. Burnel* [1911] 2 Ch.D 551.

<sup>799</sup> *Linggi Plantations v. Jagatheesan* [1972] 1 Malayan LJ 89; available also on <web.lexis-nexis.com/professional/document?\_m.>. *Hinton v. Sparkes*. (1868) LR 3 CP 161. See Harpum, Charles. “Deposits as Penalties”, Case and Comment. Cambridge Law Journal. [1993] 389, at 390. Oakley, A J. “Deposits: Still a Guarantee of Performance”. Part 2. The Conveyance and Property Lawyer. [1994] 100.

<sup>800</sup> *Howe v. Smith* (1884) 27 Ch.D 89.

<sup>801</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>802</sup> *Ibid.* At 578-579 per lord Browne-Wilkinson.

### 4.3 Relief against forfeiture of deposit

To reiterate a defaulting purchaser stands to lose his deposit on default. In such a case can he return such a forfeited deposit? As the nature and purpose of a deposit is a security for performance, it was recognised at an early time in *Depree v. Bedborough*<sup>803</sup> by Sir John Stuart V.C that:

“How can the person who is in default, upon that default, acquire any right to the money which he parted with as a security that there should be no default, it is difficult to conceive”

However is this true in all cases? For instance the deposit might be grossly in excess of the loss suffered by the injured party, so how is the defaulting party entitled to get relief against the forfeiture of such deposit? Is there any possibility for the application of penalty clause jurisdiction to grant relief to the defaulting side? The courts have developed various methods of relief against the forfeiture of deposit and will be discussed in the following sections. This will be approached in accordance to the position of the law before and after *The Workers Trust* case.

#### 4.3.1 Law of deposit before *Workers Trust* case

In spite of the fact that one of the oldest doctrines in English case law is the relief against penalties, the traditional view of the courts have been to treat the forfeiture of deposits as quite distinct and separate from rules relating to liquidated damages and penalties. The English courts have showed an obvious reluctance to apply the law of penalties to forfeiture of deposits. This is even in circumstances where a deposit was wholly disproportionate to the likely loss sustained. Instead the judicial view has concentrated on whether or not the parties intended that the deposit should not be recoverable in the event of defaulting party's default. This is illustrated in *Wallis v. Smith*:<sup>804</sup>:

“There is a class of cases relating to deposits. Where a deposit is to be forfeited for the breach of a number of stipulations, some of which may be trifling, some of which may be for the payment of money on a given day, in all cases the judges have held that this rule does not apply, and that the bargain of the parties is to be carried out “<sup>805</sup>

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<sup>803</sup> *Depree v. Bedborough* (1863) 4 Giff. 479; 66 ER 795.

<sup>804</sup> *Wallis v. Smith* (1882) 21 Ch.D 243.

<sup>805</sup> *Ibid.* At 258. Per Jessel MR

Combined with this case there were another two cases, *Hinton v. Sparkes*<sup>806</sup> and *Lock v. Bell*<sup>807</sup> which they were concerned a contract of sale of public house. In both instances the purchaser paid a deposit and agreed to forfeit its amount on default. Once the purchaser defaulted in performing his contractual obligations, the vendor forfeited the deposit. In both cases the courts rejected the recovery of the deposit. Both decisions were strongly founded because the contracts contained a stipulation that a further sum must be paid on default. However, the court in both instances, while allowing the vendor to forfeit the deposit, decided that the further sum could not be considered recoverable damages but rather a penalty which the vendor cannot claim.

As was discussed in the second chapter, the criterion which, the courts have adopted in early cases of determining whether the stipulated sum was of a penal nature, was the intention of parties to a contract<sup>808</sup>. In looking at the existing position of the courts with regard to deposit it has been confirmed that the courts have applied the same line in seeking to implement the intention of the parties collecting from the whole contract<sup>809</sup>. However this approach has been criticized on the grounds that the cases cited in *Wallis v. Smith*<sup>810</sup> for this approach do not obviously back its outcome<sup>811</sup>. Therefore this case, and also this approach have offered no compelling reason for excluding deposits from the general rule against penalties<sup>812</sup>.

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<sup>806</sup> *Hinton v. Sparkes* (1868) LR 3 CP 16.

<sup>807</sup> *Lock v. Bell* [1931] 1 Ch 35, at 46 per Maugham J.

<sup>808</sup> *Supra*. P 49.

<sup>809</sup> In *Palmer v. Temple* (1839) 9 Ad & E 508, it was clearly stated (at 520) that: "In absence of any specific provision, the question, whether the deposit is forfeited, depends on the intent of the parties to be called from the whole instrument". See also to the same effect *Hinton v. Sparkes* (1868) LR 3 CP 16, at 165 per Bovill, C.J. In general it has been emphasized in *Union Eagle Ltd v. Golden Achievement Ltd*. [1997] AC 514 by Lord Hoffmann that: "In many forms of transaction it is of great importance that if something happens for which the contract has made express provision, the parties should know with certainty that the terms of the contract will be enforced".

<sup>810</sup> *Wallis v. Smith* (1882) 21 Ch.D 243.

<sup>811</sup> *Pye v. British Automobile Commercial Syndicate, Ltd*. [1906] 1 KB 425, at 430 per Bigham J.

<sup>812</sup> Harpum, Charles. "Relief against Forfeiture and the purchases of Land". *Cambridge Law Journal*. 1984 (43)1 134, at 163-164.

As a consequence in the early twentieth century the courts developed a new method to grant equitable relief where the deposit is of penal nature<sup>813</sup>. At this stage it has been pointed out that the fact that the sum in question had been deposited when the contract was entered into does not force the court to treat it as liquidated damages<sup>814</sup>. Therefore, the courts had the power to grant relief against deposit forfeiture in circumstances where the forfeiture of the deposit would be of penal nature. In *Commissioner of Public Works v. Hills*<sup>815</sup> the Privy Council held that claimant, who had failed to complete a building contract punctually, was entitled to the return the deposit for the forfeiture provision in contract was of a penal nature and not a genuine pre-estimate of loss subject to a deduction in respect of the actual loss suffered by the defendant.

This case is an effective example of the application of penalty clause rules to forfeiture of a deposit. The fact that the parties in this case have used in their condition that a certain sum should be paid as a liquidated damages, should not prevent the sum of being a deposit. Parties to a contract might include a provision in their agreement to the effect that if the purchaser does not comply with the terms of the contract all money already paid (by way of a deposit) shall be forfeited as liquidated damages. Such an agreement does not deprive “the deposit of its character as a deposit, an earnest of performance, which was liable to forfeiture on rescission”<sup>816</sup>.

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<sup>813</sup> *Pye v. British Automobile Commercial Syndicate* [1906] 1 KB 425 and *Commissioner of Public Workers v. Hill* [1906] AC 368. *Steedman v. Drinkle and another* [1916] AC 275. Where it has been held that the forfeiture of the money paid was a penalty from which relief should be granted. It was said also that *Brickles v. Snell* [1916] 2 AC 599 supports this approach. In this case the Privy Council expressed regret that claim for the return of the deposit had not been made by the purchaser. Thus it may be inferred from this that if the deposit had been paid the court would have ordered its repayment on the basis that the forfeiture clause was of a penal nature. See also, *Bridge v. Campbell Discount Co* [1962] AC 600, at 631 per Lord Denning when said that: “Likewise, even when the sum had already been paid over in the shape of a deposit to secure performance, equity would be prepared to grant restitution if it was a penal sum.” And at 624 per Lord Radcliffe. See for this view Pawlowski, Mark. “Relief against forfeiture of deposits”. Estate Gazette. Issue 9246. [1992] 76.

<sup>814</sup> *Pye v. British Automobile Commercial Syndicate* [1906] 1 KB 425.

<sup>815</sup> [1906] AC 368.

<sup>816</sup> *Union Eagle Ltd v. Golden Achievement Ltd.* [1997] AC 514, at 518.

### 4.3.2 How the law of deposit stands after *The Workers Trust case*<sup>817</sup>?

It was affirmed that the deposit is subject to the forfeiture under the contract, whether or not that the injured party suffered any loss, if the defaulting party fails to perform his part of the contract. A reasonable deposit has always been regarded as a guarantee of performance and its forfeiture has never been subject to the rules of liquidated damages and penalties in English law<sup>818</sup>. The existing position of the law is best illustrated in *Workers Trust & Merchant Bank Ltd v Dojap Investments*<sup>819</sup>. Lord Browne-Wilkinson made it clear, when delivered the opinion of the board, that the deposit: “In the event of purchaser’s failure to complete...the deposit is forfeit, equity having no power to relieve against such forfeiture”<sup>820</sup>. Therefore this case will now be subject to the following analysis.

#### 4.3.2.1 The facts of the *Workers Trust case*

This case<sup>821</sup> was about a contract for the sale of bank premises in Jamaica at an auction. Clause 4 of the contract provided for payment of the deposit of 25% and the balance within 14 days of the date of the auction. It was provided that such a deposit would be forfeited to the bank in the event that the purchaser failed to perform his part of the contract. Having the purchaser failed to make the payment on time, the bank terminated the contract and forfeited the sum paid by way of a deposit. The purchaser claimed for equitable relief against forfeiture of the deposit from the Supreme Court of Jamaica. Zacca C.J refused to grant such relief. However, on appeal the Court of Appeal in Jamaica granted part relief from forfeiture by allowing the return of 15% of the originated purchase price. The bank appealed against the verdict and the purchaser extended a cross-appeal on the partial relief that have been granted to him. The judicial committee of the Privy Council held that since 25% was not a reasonable deposit, the court has the jurisdiction to grant full relief to the purchaser by ordering the repayment of the whole deposit as the forfeiture was a penalty. This decision reinforced the fact that deposit is

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<sup>817</sup> *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd*. [1993] AC 573.

<sup>818</sup> *Linggi Plantations v. Jagatheesan* [1972] 1 Malayan LJ 89; available also on <web.lexis-nexis.com/professional/document?\_m.> and *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd*. [1993] AC 573.

<sup>819</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>820</sup> *Ibid.* At 578-579.

only subject to forfeiture where its amount is reasonable even though it can bear no relation to the contemplated loss of the vendor. It is important firstly to highlight that the position with regard to the deposits under contracts for the sale of land remained uncertain until the recent consideration of this issue in *Workers Trust & Merchant Bank Ltd v Dojap Investments*<sup>822</sup>. Thus, how does the law stand after the decision in this case?

#### 4.3.2.2 General rule

The position of a deposit after the *Workers Trust* case has become based upon the following rule. In general any stipulation agreed upon between parties to a contract to pay a sum of money as damages or to forfeit a sum of money paid by way of deposit<sup>823</sup>, is subject to the general rule against penalties. Such provision is regarded as invalid penalty clause unless it is proved that it is a genuine pre-estimate of the loss, which might flow from breach of contract<sup>824</sup>. However, a deposit on the purchase and of sale of land, is exempted, by ancient practice, from the equitable rule against penalties, i.e. it is not paid back to purchaser. It is normal practice for a purchaser to pay 10% of the purchase price and for the contract to stipulate forfeiture of that deposit if such purchaser defaults in performing his contractual obligations. This rule is based on the fact that such percentage is likely to constitute a genuine pre-estimate of loss sustained. Therefore it is agreed that the courts will accept the forfeiture of 10% deposit even though it is more than the actual loss suffered by the vendor. This exemption from the general rule of granting relief against penalties was described as anomalous in the *Workers Trust* case<sup>825</sup>. Lord Browne-Wilkinson stated that:

“One exception to [the] general rule is the provision for the payment of a deposit by the purchaser on a contract for the sale of land. Ancient Law has established that the forfeiture of such a deposit (customarily 10 per cent of the contract price) does not fall within the general rule and can be validly forfeited even though the amount of the deposit bears no reference to the anticipated loss to the vendor flowing from the breach of contract”<sup>826</sup>

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<sup>821</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>822</sup> *Ibid.*

<sup>823</sup> Unreasonable deposit.

<sup>824</sup> *Ibid.* At 578.

<sup>825</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573, at 578.

<sup>826</sup> *Ibid.* At 578.

However what is the test for the validity of the forfeiture of a deposit in transaction of sale of land?

#### 4.3.2.3 Test for the validity of forfeiture: deposit should be reasonable

The courts established that in order to entitle a vendor to retain a deposit on the default of a purchaser it should be reasonable. *Stockloser v. Johnson*<sup>827</sup> confirmed that the court would have an equitable jurisdiction to relief against the forfeiture of a deposit of 50% of the purchase price. The courts would not accept the conduct of disguising a penalty in the form of deposit by describing an extravagant sum as a deposit<sup>828</sup>. This was reflected in *Linggi Plantations Ltd v. Jagatheesan*<sup>829</sup>, where the contract frankly provided for the forfeiture of the 10% deposit paid by the purchaser in the event of his failure to perform his contractual obligations. The default having occurred meant the vendor forfeited the deposit in spite of the fact that he had suffered no loss. The purchaser sought relief against forfeiture on the grounds of the forfeiture clause was actually a penalty clause. However, Lord Hailsham affirmed the position that the forfeiture of reasonable deposit “has never been regarded as a penalty in English law or common English usage”<sup>830</sup>. It was this dicta which the Privy Council relied upon in the *Workers Trust* case<sup>831</sup> to decide that a relief is given against forfeiture of a deposit where its amount is in excess of a reasonable sum in order not to allow the vendor to abuse the special treatment<sup>832</sup> offered to a deposit.

The special treatment afforded to such a deposit might be abused if parties to a contract affixed the brand “deposit” to any penalty in order to avoid the application of penalty jurisdiction. However, heed has been riveted to such a situation in *The Workers Trust* case<sup>833</sup> which confirmed that: “It is not possible for the parties to attach the incidents of a

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<sup>827</sup> *Stockloser v. Johanson* [1954] 1 QB 476.

<sup>828</sup> *Ibid.* At 491.

<sup>829</sup> *Linggi Plantations v. Jagatheesan* [1972] 1 Malayan LJ 89; available also on <web.lexis-nexis.com/professional/document?\_m.>.

<sup>830</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573, at 94.

<sup>831</sup> *Ibid.* At 578.

<sup>832</sup> That deposits are not subject to equitable relief against penalties.

<sup>833</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

deposit to the payment of a sum of money unless such sum is reasonable”<sup>834</sup>. In other words, despite the fact that the sum paid by way of deposit is not in general subject to penalty jurisdiction, this is only the case where the amount of the deposit is reasonable. Thus, where the deposit is reasonable it can be forfeited particularly if the loss cannot be accurately estimated in advance<sup>835</sup>. However, there is some difficulty in establishing what constitutes a reasonable deposit. This is because even a reasonable deposit does not need to be a genuine pre-estimate of the loss likely to be suffered by the injured party. In fact, he can forfeit the reasonable deposit even though he has suffered no loss.

The starting point for determining and assessing the reasonable deposit would be the ancient practices in the United Kingdom of a 10% deposit. This percentage first came into the law by the Privy Council in *Linggi Plantations Ltd v. Jagatheesan*<sup>836</sup> when it has been decided that: “There is nothing unusual or extortionate in a 10% deposit on a contract for the sale of land”. Some years later this was reaffirmed in *Windsor Securities Ltd v. Loreldal Ltd and Lester*<sup>837</sup> and in 1993 a rule of this percentage has been well established in the *workers Trust* case<sup>838</sup>. However, it is admitted that this method of assessment was carried out “without logic” but felt that it could be justified “by the long continued usage” in the United Kingdom<sup>839</sup>. In the *Workers Trust* case itself the sum demanded was 25% of the purchase price, which the vendor claimed to retain when the purchaser defaulted in performance. The Privy Council held that a deposit of 25% was unreasonable, despite evidence that it was usual for financial institutions in Jamaica selling property at auction to ask for a deposit ranging between %15 and %50<sup>840</sup>. The Council rejected such evidence as reasoning for such deposit because:

“In order to be reasonable a true deposit must be objectively operating as “earnest money” and not as a penalty. To allow the test of reasonableness to depend upon the practice of one class of vendor, which exercises considerable financial muscle,

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<sup>834</sup> Ibid. At 579-580

<sup>835</sup> *Pye v. British Automobile Commercial Syndicate* [1906] 1 KB 425.

<sup>836</sup> *Linggi Plantations v. Jagatheesan* [1972] 1 Malayan LJ 89; available also on <web.lexis-nexis.com/professional/document?\_m.>.

<sup>837</sup> *Windsor Securities Ltd v. Loreldal Ltd and Lester* (1975) Times LR. Sept 9.

<sup>838</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>839</sup> Ibid. At 580 per Lord Browne-Wilkinson.

<sup>840</sup> Ibid. At 579. per Lord Browne-Wilkinson.

would be to allow them to evade the law against penalties by adopting practices of their own”<sup>841</sup>

Even in the situation where a reasonable deposit is determined to be 10%, this true deposit might still operate as a penalty since the vendor is able to forfeit the reasonable deposit even though it bears no relation to the loss suffered<sup>842</sup>. In this instance it is hard to distinguish between a penalty, which is permissible by the law (10% deposit) and one, which is not. This means that the deposit might not be a genuine pre-estimate of the loss suffered, however it is still reasonable and its forfeiture is still valid by the law and there is no relief granted against such forfeiture.

Furthermore even the rule, which regards any deposit in excess of 10% as unreasonable and consequently in the nature of penalty can be departed from if special circumstances are showed to justify the departure of this rule by taking a deposit of higher level<sup>843</sup>. In the *Workers Trust* case<sup>844</sup> an attempt was made to justify the larger deposit (25%) on the grounds that there were special circumstances for stipulating for such a deposit. The vendors claimed that such a deposit demanded because of the 7.5% transfer tax, which in practice the vendor had to pay within 30 days of the date the contract was made. This claim failed as it was reasonable to provide for an advance payment to cover this tax but it was not reasonable for it to be forfeited since the tax would be returned if the contract had not been completed.

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<sup>841</sup> Ibid. At 580. per Lord Browne-Wilkinson.

<sup>842</sup> See for example *Damon Compania Naviera SA v Hapag-Lloyd International SA* [1985] 1 WLR 435. in this case the vendors were awarded damages of \$ 236, 500 (The amount of deposit) in spite of the fact that their true damages was worth \$60, 000. In his contrary opinion Lord Goff (At 458) expressed his dissent to grant the vendor the 10% deposit as follows: “If the sellers are entitled to recover the deposit, they can recover \$236, 500 being 10 per cent. of the purchase price; but if they are only entitled to recover damages, they can recover only \$60, 000, being the sum so assessed by the arbitrator as the damages suffered by them...in that way they would be over-compensated for the loss”. This dissenting opinion was supported by Carter, J. W. “Deposits, Accrued Rights and Damages”. *Law Quarterly Review*. (1988) 104 207, who stated (At 212) that: “Had the contract contained an agreed damages provision, requiring the buyers to pay \$236, 500 after termination for breach on their part, it would have been unenforceable as a penalty. The sellers would have recovered only \$60, 000”

<sup>843</sup> *Stockloser v. Johanson* [1954] 1 QB 476, at 491. *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573, at 580.

<sup>844</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573, at 580.

### 4.3.3 Analysis of the law after *Workers Trust* case

The following issues will now be addressed to clarify the law after *The Workers Trust* case and make the proper suggestions.

- 1- Which rules should be applied to unreasonable deposit?
- 2- What is the position when deposit paid in contracts other than land sale?
- 3- Did penalty clauses and deposit rules amalgamate after *Workers Trust* case?
- 4- Deposits as penalties
- 5- What is concluded?

#### 4.3.3.1 Which rules should be applied to deposits beyond 10 per cent?

It remains unclear whether unreasonable deposit is subject to the penalty jurisdiction or to equitable relief against forfeiture<sup>845</sup> as suggested by Denning and Somervell L. JJ in *Stockloser v Johnson*<sup>846</sup>. In the latter both L.JJ suggested two conditions to grant relief against forfeiture of instalments. The forfeiture should be of penal nature and it should be unconscionable for the vendor to retain the previously paid amount. As the second condition (unconscionability) was above undermined, the matter is best viewed for the application of penalty doctrine to unreasonable deposits. Some reasons can be put forward to support this proposition<sup>847</sup>. According to the current law where a deposit is held to be unreasonable the entire sum should be returned to the defaulting purchaser. Therefore if the whole sum cannot be regarded as a deposit, but a penalty, the vendor is not even entitled to retain 10% as the courts cannot rewrite the contract<sup>848</sup> by inserting into it a reasonable deposit. This inability by the court to rewrite the terms of the contract serves as a caution to the contracting parties not to set a deposit above that which is considered a reasonable. Namely, parties to a contract are to expect that a deposit will be regarded as unreasonable and so unenforceable if it is more than 10%. Since the vendor

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<sup>845</sup> Beale, Hugh. "Unreasonable deposits". *Law Quarterly Review*. (1993) Vol. 109 524, at 528. Beale, HG, Bishop, WD and Furmston, MP. "Contract Cases and Materials". 4<sup>th</sup> edition. Butterworths. 2001. P 794. Poole, Jill. "Casebook on Contract". 6<sup>th</sup> edition. Blackstone press. 2003. P 391.

<sup>846</sup> [1954] 1 QB 476, at

<sup>847</sup> This discussion should be read with the approach titled (deposits as penalties) where it is suggested the application of penalty rules to all kind of deposits. *Infra*. P 228.

fails to stipulate for a reasonable deposit in the first place, he will have no right to forfeit even that amount. This is completely the effect of the application of penalty clause jurisdiction. The application of this jurisdiction simply makes penalties invalid and thus the entire disproportionate sum would always have to be returned and then the injured party has the right to sue for the loss he has actually suffered on breach. In the *Worker Trust* case itself the vendor was ordered to return the whole %25 deposit and then he was given the right to claim damages for the loss has suffered.

Besides, the *Workers Trust* case position that unreasonable deposit is subject to the penalty rule has been followed in a subsequent case. Although it has been asserted that the *Workers Trust* case has not been followed in any English case<sup>849</sup>, this case still represents the law of deposit. In other words, it has been surprisingly said<sup>850</sup> that the Privy Council in *Bidaisee v. Sampeth and Others*<sup>851</sup> has withdrawn from the position that it adopted in *Workers Trust* case. However this view seems to be unconvincing and hard to endorse<sup>852</sup> for it is settled that penalty jurisdiction was applied to unreasonable deposit.

#### 4.3.3.2 What is the position when deposit is paid in contracts other than sale of land?

The law is still puzzling with regard to deposits that are paid in contracts other than the sale of land. In such transactions there is no established custom as there with transactions

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<sup>848</sup> As with penalty clauses: "The courts have always avoided claiming that they have any general jurisdiction to rewrite the contracts that the parties have made..." *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>849</sup> Harris, Donald, Campbell, David and Halson, Roger. "Remedies in Contract and Tort". 2<sup>nd</sup> edition. Butterworths. 2002. P 60.

<sup>850</sup> Ibid.

<sup>851</sup> *Bidaisee v. Sampeth and Others* Transcript available through WestLaw. 3 April 1995.

<sup>852</sup> It should be noted that when the Privy Council cited the *Workers Trust* case in the *Sampeth* case it did so to demonstrate and apply the principles laid down in that case. It confirmed that a reasonable deposit, which is paid by the purchaser, is regarded as a security for the completion of the contract and therefore can be retained by the vendor in the event of purchaser's default. Thus the Privy Council in *Workers Trust* case did not regard only the traditional 10% deposit as a penalty against which it grants relief. But this is not the case as to what exceeds this percentage. It therefore may be said that the Privy Council did not cite the *Workers Trust* in *Sampeth* case only as an authority to confirm that equity has never determined deposits as a penalty against which it granted relief. This is because the judgment of the Council in the *Workers Trust* case was so clear regarding what can be considered as a penalty and thus worthy of relief. It clarifies that an unreasonable deposit, which exceeds the traditional deposit of 10%, should be subject to penalty doctrine and thus hold the return of the entire deposit in such an event. As a result it can be said that the *Workers Trust* case has been followed in *Sampeth* case and it seems to be unconvincing and hard to endorse the view that the Privy Council has departed from its 1993 position in the *Workers Trust* case.

of sale and purchase of land. Therefore, what will the position be if the injured party forfeited a 10% deposit or more in transaction other than sale of land? Suppose that X contracts to purchase a vehicle from Y and agrees to pay a deposit of 10% of the purchase price and the balance on delivery. X does not proceed with the contract, i.e. breaches his contractual duties to deliver and pay the balance. As a result Y forfeits the 10% deposit and resells the vehicle for the agreed price. In other words, the vendor resells the vehicle with no loss<sup>853</sup> or its loss is much less than the deposit. In such a case can the purchaser claim relief by way of returning the deposit less the difference between the contract price and the market or current price? The law as to this situation is unclear.

It may be interpreted that Lord Browne-Wilkinson in the *Workers Trust* case<sup>854</sup>, when he stated the general rule above<sup>855</sup>, envisaged the use of a deposit only in the case of the sale of lands. In any transaction of sale of land the injured party can forfeit the 10% deposit even though he has suffered no loss. A possible implication from his Lordship's observations reveals the impression that all other deposits, i.e. deposits in transactions other than sale of land, are subject to the general rule, which asserts the applicability of penalty jurisdiction to deposit<sup>856</sup>. The courts in such transactions will therefore consider whether a deposit is a genuine pre-estimate of the loss suffered in order to decide whether the deposit is forfeited.

As a consequence of this interpretation the distinction becomes that the deposit, paid under contracts of sale of land is not subject to the penalty jurisdiction where it is reasonable, while the deposit (reasonable or not) that is paid under the other transactions, is subject to penalty jurisdiction. One might justify this distinction by the fact that it is possible that some purchasers who pay deposits under contracts other than of land (such as purchasers of coaches or any other vehicle) do not understand the difference between part payments, which are not subject to forfeiture and a deposit. Such purchasers often imagine that they pay the deposit to show their seriousness to make the transaction and it

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<sup>853</sup> See *Charter v. Sullivan* [1957] 2 QB 117 where a car was resold without any loss sustained by the vendor.

<sup>854</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573, at 578.

<sup>855</sup> *Supra*. P 219.

will be a part of the purchase price in the event of the completion of the transaction. That is to say the position of the deposit is understood more poorly than in a transaction of the sale of land and in most cases there is no accessibility of legal advice, which reduces the possibility of domination and oppression in such transactions<sup>857</sup>.

The current case law justifies this distinction on the fact that the special treatment or status which, was given to the deposit paid in land transaction, derives from an ancient custom of 10% of the purchase price. This is true if it is taken into consideration that the historical status of such a deposit can be traced back to the law of roman of *arra*<sup>858</sup>. However, do these grounds justify the difference in treatment between a deposit paid in contracts of sale of lands and a deposit paid in other kinds of contracts, considering that they are operating the same function as a guarantee for the performance of other contractual obligations? As this was the decision of the *Workers Trust* case, one commentator has doubted that this interesting case now represents the English law. He asserts that the same principle can be applied to either the transaction concerning a sale of land or any other transaction. Oakley AJ states that: "Indeed, the principles contained therein may well also be applied to contracts for the sale of goods, where there is no "long continued usage" for the payment of a 10 per cent deposit"<sup>859</sup>. It could be generally agreed with this view, however *the Workers Trust* case absolutely still represents the law for the case was absolutely concerned of sale of lands and there was, as said above, an implication that the Privy Council has considered the other transaction subject to the penalty clause jurisdiction. However, were penalty rules and deposit rules completely merged?

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<sup>856</sup> Beale, Hugh. "Unreasonable Deposits". *Law Quarterly Review*. [1993] Vol. 109 524, at 529.

<sup>857</sup> The Law Commission, in its working paper No 61. "Penalty Clauses and Forfeiture of Monies Paid". London. Her Majesty's Stationery Office. 1975, p 49, has confirmed this when proposed that: "Land transaction, however, stand on a somewhat different footing. The position with regard to the status of the deposit is probably better understood and in most cases the vendor and purchaser will be acting with legal advice. It may therefore be that deposits paid in connection with sales of land and houses merit special treatment"

<sup>858</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573, at 578.

<sup>859</sup> Oakley, A J. "Deposit: Still a Guarantee of performance". Part 2. *The Conveyancer and Property Lawyer*. [1994] 100, at 107.

#### 4.3.3.3 Did penalty clause and deposit rules amalgamate after *Worker Trust* case?

It is difficult to see any sufficient policy rationalises the difference between the rules as to penalties and the deposits rules. The judgment of the Privy Council in *The Workers Trust* case recognizes “The inelegance and goes some way to mitigate”<sup>860</sup> the effect of distinction between penalties and deposit but not expunging it<sup>861</sup>. The decision is a clear indication that penalty jurisdiction was applied to a sum of money, which is paid by way of a deposit, and so it remains no justification for such difference, which seems to be the result of the two sets of rules developing in isolation from each other<sup>862</sup>. This is particularly the case since the function of the two devices is similar, although one is paid in advance and the other is payable on breach. The deposit is operating as a guarantee of performance, while penalty clause is a sum of money stipulated in terrorem of the defaulting party. Therefore deposit as penalty may act to intimidate the defaulting party who will act in response to fears and worries that he will lose his advance payment in the event of non-performance. As was said<sup>863</sup> it seems that the only difference in activating this function lies in the emotive terms used in the contract by the parties. The law as to penalties has therefore been held to apply to deposits.

However, it cannot be said that penalty clause rules and deposit rules have been completely amalgamated, as the opportunity to get rid of the distinction was not taken in the *Workers Trust* case<sup>864</sup> at least for the sale of land cases. The sum stipulated in a contract is regarded as a penalty where it is extravagant and unconscionable in comparison with the greatest loss, which might conceivably be sustained as a result of breach. Therefore, the stipulated sum will be regarded as valid liquidated damages if it is

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<sup>860</sup> Furmston, MP. “Cheshire, Fifoot and Furmston’s Law of Contract”. 15<sup>th</sup> ed. Butterworths. 2001. P 695.

<sup>861</sup> This is true not least that unreasonable deposit in sale of land transactions was held to be subject to penalty rules and if the possible implication is upheld these rules are also applied to deposits in transaction other than sale of land. However a reasonable deposit, which might be of penal nature relief against its forfeiture would not be granted.

<sup>862</sup> Koffman, Laurence. “The Law of Contract”. 4<sup>th</sup>.edition. 2001 493. McKendrick, Ewan. “Contract Law”. 5<sup>th</sup>.edition. Macmillan. 2003. P 451. McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> edition. Sweet and Maxwell. 2003. P 472. Furmston, MP. “Cheshire, Fifoot and Furmston’s Law of Contract”. 15<sup>th</sup> ed. Butterworths. 2001. P 695. Pawlowski, Mark. “Forfeiture and Unconscionability”. *Litigation*. [1999] 24, at 29.

<sup>863</sup> Treitel, G. H. “The Law of Contract”. 11<sup>th</sup> edition. Sweet & Maxwell. 2003. P 1008.

<sup>864</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

a genuine pre-estimate of the loss sustained. However in the event of forfeiture of deposit the vital test to determine whether the forfeiture is legitimate or not depends on whether a deposit is reasonable (10% or less). In *Union Eagle Ltd v. Golden Achievement Ltd*<sup>865</sup> the purchaser claimed that the deposit was in the nature of penalty and was thus entitled to its return as it was not a genuine pre-estimate of damages suffered by the vendor as a result of breach. However, on the basis of the *Workers Trust* case such a claim presented by the purchaser failed as the deposit was reasonable and it was considered irrelevant to inquire whether or not it was a genuine pre-estimate of the loss suffered<sup>866</sup>. However it is tentatively suggested that this approach is unconvincing. In the *Workers Trust* case<sup>867</sup> it was observed that in sale of land transaction although a reasonable deposit may not constitute a genuine pre-estimate of the loss suffered by the vendor it is still forfeited<sup>868</sup>. In such circumstances it is clear that there is no practical distinction between deposits and penalties. However, the courts have showed a clear reluctance to apply the law of penalties to deposits even though they can be wholly out of proportion to the actual likely loss sustained. Therefore, what is the possibility of the application of penalty jurisdiction to deposits?

#### 4.3.3.4 Deposits as Penalties

To remove the idea of having two sets of rules it is tentatively suggested to make all kind of deposits subject to penalty jurisdiction. That is to say that a sum of money, which is paid by way of deposit, may be considered in all cases as a genuine pre-estimate of the loss suffered. However it is open to the party seeking relief to prove otherwise.

It is true that the parties' main objective when agreeing on damages beforehand is to compensate the injured party in the event of default. However though when agreeing on deposits they might not go through the same process, the main purpose is also still to compensate the injured party in the event that the transaction goes off as a result of breach. However, why parties to a contract not take into consideration that a deposit

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<sup>865</sup> *Union Eagle Ltd v. Golden Achievement Ltd* [1997] AC 514.

<sup>866</sup> *Ibid.* At 518 per Lord Hoffmann.

<sup>867</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>868</sup> *Ibid.* At 580.

should be a genuine pre-estimate of potential compensation? The parties may take into account all measures and circumstances that can take place when agreeing upon the liquidated damages. In both devices (agreed damages and deposit) the injured party seeks to ensure that he will receive compensation for the possible losses that he may subsequently suffer. Goulding, J in *Myton Ltd v Schwab Morris*<sup>869</sup> states that: “The vendor, in the normal case, never intends to be bound by the contract without having the deposit in his own or his stakeholder’s possession as a protection against possible loss from default by the purchaser”. Therefore the sole aim of providing for a deposit is to empower the injured party to have his damages for a breach of contract in his hands<sup>870</sup> and hence avert any necessity to return to judicial proceedings. Consequently, there is no appropriate or necessary reason to treat the deposit in a special category governed by its own rules. This proposition is based on the following points:

1-When a law allows the injured party to forfeit a deposit in the event of a payer’s default, means that the law permits one party to penalise the other particularly where there is no loss suffered. The result is that though the law prevents penalty provisions in some cases, when the sum is payable after breach, it enforces them in other areas of the law where the sum agreed is payable in advance. This raises the question, does the law adopt a policy of achieving fairness and thus disallowing the parties to punish each other in one area of the law but allow it in others? Does the difference in the time of paying the sum stipulated either in advance or on breach justify the application of different rules? Some commentators<sup>871</sup> remarked on this saying that:

“It seems strange enough that the innocent party is entitled to retain a deposit, or forfeit payments made, even though the effect is to penalise the party in breach; stranger still that the innocent party can recover damages as well if the loss he suffers exceeds the deposit”<sup>872</sup>.

2- On what base the law allows the vendor to forfeit 10% deposit of the purchase price in sale of land transactions on the default of the purchaser? Is it a good or indeed a legal reason to justify the forfeiture of deposit by the fact that this has happened so many years?

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<sup>869</sup> *Myton Ltd Schwab Morris* [1974] 1 WLR 331.

<sup>870</sup> Thus he can forfeit his damages in a simple and easy fashion.

<sup>871</sup> Beale, HG, Bishop WD and Furmston MP. *Contract: “Cases and Materials”*. 4<sup>th</sup> ed. Butterworth. 2001.

Accordingly though the decision in the *Workers Trust* case<sup>873</sup> can be welcomed in finally making it clear that the penalty clause rules do have a role to play in the deposit area, however, the acceptance that the 10% deposit can still be forfeited by the vendor in a sale transaction is perhaps less welcome. The allowance of the forfeiture of this percentage of a deposit will often lead the vendor being over compensated at the purchaser's expense. Furthermore, the acceptance of the present law, which has settled without logic<sup>874</sup>, in allowing the vendor to extract a penalty from the purchaser on the grounds that this has happened for very many years is on the one hand "suggested, to take rather too conservative an approach"<sup>875</sup>. On the other hand the case in sale of land transactions is unacceptable for there is a gross inequality between the positions of the two parties. When the purchaser pays his deposit it is supposed that he means business, but what safeguards him against the non-completion of contract by the vendor? The purchaser should go through judicial proceedings in order to get his deposit back in the event of breach by the vendor. Thus the purchaser has, firstly, nothing in his hand to protect him against the risk of non-performance by the vendor and secondly the vendor can in a simple and easy manner forfeit the deposit on purchaser's default. In sum, it is time that the too passive position that defaulting purchasers have been in to be got rid of by law. The application of penalty jurisdiction provides rather the protection a purchaser needs and is preferable to be applied to all deposit without any exception<sup>876</sup>.

3-It might be argued against the application of the penalty jurisdiction to deposits that many sums, which are paid by way of deposits, will fall as penalties<sup>877</sup>. This is particularly the situation in the events of land purchase and sale where the custom remains to compel the purchaser to pay 10% of the purchase price. As a result of this a

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<sup>872</sup> *Ibid.* At 795.

<sup>873</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>874</sup> *Ibid.*

<sup>875</sup> Thompson, MP. "Unravelling Agreement". *Conveyancer and Property Lawyer*. [1994] 58, at 62.

<sup>876</sup> That is the application of penalty clause rules to the forfeiture of 10% deposit in sale of land transaction, which has become well established and strengthened by the customary practice.

<sup>877</sup> Even it might be argued that "deposits are usually arbitrary sums" and do not represent a genuine pre-estimate of the loss suffered. See The Law Commission. Working paper No 61. "Penalty Clauses and Forfeiture of Monies Paid". London. Her majesty's Stationery Office. 1975. P 49.

suggestion has been made to reduce the percentage of the deposit to 5%<sup>878</sup> or 7%<sup>879</sup>, as the 10% is still too high and unreasonable. In other words the 10% is still high and immune from the equitable rule against penalties in spite of the fact that forfeiture of a 10% deposit often does not reflect the true compensation of vendor for his loss. This is mainly true<sup>880</sup> when a purchaser of a high value property fails to complete his contractual obligation at a time when there might be other purchasers easily available and who might be willing to pay a considerably greater price than agreed with the original purchaser. Therefore, in this situation, when the purchaser defaults in performing the contract, the vendor can forfeit the substantial deposit and resell at a greater price<sup>881</sup>.

However following to what was said above that the parties should agree on a deposit payable at the time of making the contract and its amount should be- as much as the parties can- a genuine pre-estimate of the loss that might be suffered as a result of breach. If deposit, either in sale transactions or in the other transactions, is subsequently held not to constitute a genuine pre-estimate of the loss suffered it should be wholly returned to the purchaser<sup>882</sup>. This is of course subject to the right of the vendor to claim his compensation for the loss he has actually suffered. The New Approach comes to the same conclusion in the same suit by reducing the clearly large penalty to be in line with the actual loss suffered.

4- It might be thought that as the deposit functions as a security for the completion of the contract the application of the penalty jurisdiction would affect the nature of deposit. However it should be noted that the nature of deposit as a guarantee for performance does not preclude the courts from granting relief against its forfeiture based on penalty

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<sup>878</sup> The Law Commission. Working paper No 61. "Penalty Clauses and Forfeiture of Monies Paid". London. Her Majesty's Stationery Office. 1975. P 50.

<sup>879</sup> JE, Adams. "The Usual 10% Deposit-Can it be Justified still". Law Society's Gazette. [1983] 2811, at 2812.

<sup>880</sup> Wallace, H. "Deposit or Penalty?- The Price of Greed". Northern Ireland Legal Quarterly. [1993] 207, at 212.

<sup>881</sup> This was illustrated in *Windsor Securities Ltd v. Loreldal Ltd and Lester* (1975) Times LR. Sept 9. In this case a vendor had forfeited to the claimants a 10 per cent deposit of 235,000 in spite of evidence that the property could be resold of 2,500,000. This means at profit of 150,000 taking in the consideration that the original price was 2,350,000. Oliver J. said there that: "There was nothing in the facts of the present case to show that the forfeiture was unreasonable or in the nature of penalty".

<sup>882</sup> Even if it is often arbitrary this suggestion is still working for the realisation of justice and equity.

doctrine. It is irrelevant to the issue of equitable relief from forfeiture of deposit based on penalty doctrine that a deposit is a guarantee of performance, because the same could be said with regard to a penalty, which might serve the same purpose. This has been effectively supported by Lord Radcliffe who highlighted this issue and suggested in *Bridge v. Campbell Discount Co*<sup>883</sup> that in appropriate circumstances rule against penalties might be applied to deposit. He said that:

“I know, of course that, to travel to another branch of equity’s relief jurisdiction, the precise reason why a deposit made on a sale of land is not recoverable if the bargain goes off by the purchaser’s default is that it is treated as a guarantee...but nevertheless every penalty...is in some sense a guarantee for the due performance of the contract, and I do not see any sufficient reason why in the right setting a sum of money may not be treated as a penalty, even though it arises from an obligation that is essentially a guarantee ”<sup>884</sup>

Thus, penalty and deposit might act as a guarantee and compensation simultaneously. The application of penalty rule to deposit will by no means affect the nature of deposit as a security against breach and inducement for the contractual parties to perform. Therefore, the court can have the jurisdiction to hold whether or not it was in the nature of penalty by regarding all the circumstances surrounding the contracting process and those existing at the time of breach. This would not conflict with the penalty rule as it is clearly confirmed in *Philips* case<sup>885</sup> for what has happened after making the contract might give proper evidence of what was within the contemplation of the parties when they agreed on paying the amount of a deposit. This notion is strongly supported by the New Approach, which adopts the loss actually suffered to apply the power of the court to adjust the amount of agreed penalty.

5- There is a judicial approach supporting the suggested proposal. The Privy Council in *Commissioner of Public Works v. Hills*<sup>886</sup> has already applied the penalty doctrine to

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<sup>883</sup> *Bridge v. Campbell Discount Co* [1962] AC 600.

<sup>884</sup> *Ibid.* At 624 per Lord Radcliffe.

<sup>885</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41.

<sup>886</sup> *Commissioner of Public Workers v. Hill* [1906] AC 368. See for supporting the proposed approach the powerful dissenting judgment which was given by Hale J. in an Australian case of *Coates v. Sarich* [1964] WAR 2. In this case the plaintiff claimed his deposit back on the ground that its forfeiture was a penalty, however, the majority of the Supreme Court of Western Australia held that the return of deposit was outside the jurisdiction of equity to grant relief. Hale J. delivered his dissenting view saying (at p 14) that “the essential inquiry must, I think, always be whether the payment is a penalty or liquidated damages”.

determine whether the retention of money already paid can be treated as a genuine pre-estimate of the loss. As the Council held the sum should be returned to the claimant it has been said<sup>887</sup> that the *Hills* case<sup>888</sup> is “a further illustration that a clause identified by the courts as a penalty clause cannot be enforced so as to enable a party to recover or retain more than the actual loss”. Even in this case the Privy Council called the sum, which has been paid as security money, as liquidated damages when decided its return less what compensate the injured party according to his actual loss. Also the Privy Council in *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd*<sup>889</sup> referred to the *Hills* case<sup>890</sup> to support its approach in considering the deposits as penalties. In delivering the judgment of the board Lord Browne-Wilkinson stated that:

“There is clear authority that in a case of a sum paid by one party to another under the contract as security for the performance of the contract, a provision for its forfeiture in the event of non-performance is a penalty from which the court will give relief by ordering repayment of the sum so paid, less any damage actually proved to have been suffered as a result of non-completion”<sup>891</sup>

#### 4.3.3.5 What is concluded?

As a result of the above analysis it is hoped that the *Workers Trust* case<sup>892</sup> can be construed as the starting point of demising any rules that make deposit fall outside the penalty clause jurisdiction. Penalty should be a penalty either it is a sum of money paid or a sum of money retained or forfeited<sup>893</sup>.

After proving the possibility of application of penalty jurisdiction to deposit, the New Approach suggested in this work will be effectively applied. The application of the New Approach of penalty clause to deposits will achieve justice and remove the passive

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Consequently, Hale J view was that the rules provided for to decide whether the sum was a penalty or liquidated damages were of general application to all contracts and it was unessential and unsuitable to treat deposit as being in some special classification governed by its own rules.

<sup>887</sup> *Jobson v. Johnson* [1989] WLR 1026, at 1036 per Dillon L.J.

<sup>888</sup> [1906] AC 368.

<sup>889</sup> [1993] AC 573.

<sup>890</sup> *Commissioner of Public Workers v. Hill* [1906] AC 368.

<sup>891</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573, at 582.

<sup>892</sup> *Ibid.*

<sup>893</sup> McGregor, Harvey. “McGregor on Damages”. 17<sup>th</sup> edition. Sweet and Maxwell. 2003. P 472. Thompson, MP. “Unravelling Agreement”. Conveyancer and Property Lawyer. [1994] 58. The Law Commission.

position that the purchasers have been in since a long time. One of the advantages that this approach delivers relates to the genuine compensation that the vendor can receive through the amount of deposit. This is to say that there is no longer a rule that a vendor can forfeit %10 deposit even though there is no loss sustained for the court will have a power of reduction. Where the amount of deposit is grossly in excess of the loss suffered the court will reduce it in line with the actual loss. However the fact that the amount of deposit is just more than the loss suffered does not entitle the court to exercise its discretionary power of reduction. The application of New Approach of penalty clause to deposit is supported by the fact that it is already applied to a kind of deposit paid under a tenancy agreement. In such an agreement the lessee agrees to pay a deposit as a security to compensate the lessor for any losses occurring to the subject matter throughout the period of tenancy. There is no set percentage to be paid but in most cases the lessor imposes it. In all cases where the lessor suffers no loss during the tenancy he returns the whole deposit to the lessee. However if the damage sustained is less than deposit it will be scaled down to the extent that adequately compensates the lessor for his actual loss. Thus what prevents the application of the same rules to the other transactions especially in sale of land contracts?

#### 4.4 Legislative intervention

Section 49(2) of the Law of Property Act 1925, Unfair Terms in Consumer Contract Regulations 1999 and The Consumer Credit Act 1974 will now be considered.

##### 4:4:1 Section 49(2) of the Law of Property Act 1925

Section 49(2) of the Law of Property Act 1925 provides that: “where the court refuses to grant specific performance of a contract, or in any action for the return of a deposit, the court may, if it thinks fit, order the repayment of any deposit”. The main point of the enactment of this subsection appears to have been to remove the difficulty which, had previously stood in the way of a purchaser who, though in a position to successfully resist specific performance brought by the vendor, was at a law precluded from recovering his deposit because of the lack of legal ground for claiming rescission of the contract<sup>894</sup>. The initial reaction to the subsection has been to regard it as being aimed, at least in the first place, at certain circumstances. It was thought to be applicable where the court believes that it is inappropriate to exercise its discretion to enable the vendor to obtain specific performance, in spite of the fact that the purchaser was in breach<sup>895</sup>. This restriction on the scope of this subsection is rejected on the ground that purchaser’s breach may not cause vendor any loss; and to allow the latter nonetheless to retain deposit could be said to unjustly enrich him, while causing considerable hardship to the purchaser<sup>896</sup>. There will be no point whatever to the subsection if it will not be applied to remove the unfairness in such instance. Therefore subsequent cases seemed to have interpreted the subsection more liberally. Therefore it has become apparent that the jurisdiction of the court under the section 49(2) is not nearly so limited to the situation where the court

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<sup>894</sup> *James Macara Ltd v. Barclay* [1944] 2 All ER 31. See for the origin of section 49 (2) and nice exposition of the cases concerned Wilkinson, H W. “Returning the Purchaser’s Deposit”. New Law Journal. [1908] 668.

<sup>895</sup> *Ibid.* At 32. It should be noted that section 49(2) has no application where it is the vendor who is in breach of contract for in this case the sum paid by way of deposit must be paid back to the payer without any claim. See for this *Country & Metropolitan Homes Surry Ltd v. Topclaim Ltd.* [1997] 1 All ER 254. In this case it was held that: “the discretion under s. 49(2) of the 1925 Act was to enable the court to order return of a deposit to a defaulting purchaser. To exclude s. 49(2) did not affect the purchaser’s rights if the vendor defaulted. Therefore, [Purchaser] was entitled to the return of the deposit paid”. In this case the parties agreed to exclude the application of section 49(2). It should be pointed out that such attempt should be regarded as void and null for the subsection will pointless if the parties can agree to rule out its effect.

<sup>896</sup> Treitel, G. H. *The Law of Contract*. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1008-1009.

refuses to grant specific performance<sup>897</sup>. As the provision is not adequate to perform the task for which it was enacted it is certain that the court should therefore construe it in a broader interpretation, i.e in a way that is useful to realize fairness between parties<sup>898</sup>.

#### **4.4.1.1 The application of the jurisdiction in practice**

The first advocate of a broader and more flexible attitude to section 49(2) was Megarry J. in *Schindler v. Pigault*<sup>899</sup>. In this case Megarry J. considered that the subsection was generally available for use in mitigation of a vendor's right at law to forfeit deposit. In his view the provision gives the court a discretionary power to order the return of deposits "where justice required it"<sup>900</sup> and made it clear that the jurisdiction by the statute was: "...exercisable on wider grounds...including a general consideration of the conduct of the parties (and especially the applicant), the gravity of the matters in question, and the amounts at stake"<sup>901</sup>. In the case itself, a purchaser had failed to comply with a vendor's notice to complete the contract. This failure was in a large part attributable to vendor who had denied the purchaser access to the property, which caused the impossibility for purchaser to conclude a sub-sale on which he was relying to proceed with the contract. The Judge reached the conclusion that this was a proper situation to exercise the power under section 49(2) to order the repayment of purchaser's deposit. Therefore how was this view construed?

##### **4.4.1.1.1 How was the judgment of Megarry J interpreted?**

Megarry J's holding received two interpretations in subsequent cases. Some considered that the subsection is applicable in the event that the purchaser's conduct excites sympathy and others decided the subsection applicable where the order of the refund of deposit is the fairest course between the parties. The two views will now be examined.

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<sup>897</sup> *Universal Corporation v. Five Ways Properties Ltd* [1979] 1 All ER 552.

<sup>898</sup> Harpum, Charles. "Relief against Forfeiture and the Purchase of Land". *Cambridge Law Journal*. (1984) 43(1) 134, at 171, who said that the court should not construe the provision in a way that is futile. It will be futile if the vendor's damages for breach of contract equal or exceeds the amount of purchaser's deposit, because then the court would find itself ordering repayment of the deposit under s. 49(2) with one hand, and requiring the purchaser to pay it back as damages with the other. See also, Wallace, H. "Deposit or Penalty?- The Price of Greed". *Northern Ireland Legal Quarterly*. [1993] 207, at 213.

<sup>899</sup> *Schindler v. Pigault* (1975) 30 P&CR 328.

<sup>900</sup> *Ibid.* At 336.

<sup>901</sup> *Ibid.*

#### 4.4.1.1.1 Where it is unfair for the purchaser to lose his deposit

In *Cole v. Rose*<sup>902</sup> Mervyn Davies QC construed the above Mrgarry's judgment that there should be a certain condition to exercise the discretionary power given to the court under section 49(2). It was considered that the court has the power to order the return of a purchaser's deposit where there are special circumstances "suggest that it is perhaps unfair or inequitable that the purchaser should lose his deposit". The substance of this view gives the impression that the court should only investigate the conduct and circumstances of purchaser in order to decide whether his situation excites sympathy. If it is so the court may exercise its power to return his deposit back. A recent case indicated that the court has applied. In the case of *Omar v. El-Wakil*<sup>903</sup> the court rejected the claim of purchaser to refund his deposit by virtue to section 49(2) basing its judgment on many circumstances<sup>904</sup>. However a close reflection on the facts of the case reveals that the court has only considered the circumstances of the purchaser (Omar). The amount at stake, the conduct and circumstances of vendor and whether vendor has suffered any loss or not were circumstances the court considered irrelevant. Arden LJ stated that:

"Mr El-Wakil...may resell the property at a profit. Furthermore, Mr El-Wakil was probably not on the judge's findings able to complete the contract when he served notice to complete. Finally Mr El-Wakil took possession of the assets transferred to Visionhurst. It is also irrelevant that Mr El-Wakil has not sought to establish that he has suffered any loss as a result of the abortive Corringham contract: the parties agreed that the £110,000 was a deposit. It would moreover be wrong for Mr El-Wakil to be ordered to pay cash when the deposit was not paid in cash. The deposit is abnormally large but there has been no suggestion that the court could direct payment of part only of the deposit"<sup>905</sup>

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<sup>902</sup> *Cole v. Rose* [1978] 3 All ER 1121.

<sup>903</sup> *Omar v. El-Wakil* [2001] EWCA Civ 1090. (2001) Times, November 2, 2001. It is available on WestLaw website 2001 WL 753309.

<sup>904</sup> "Mr Omar entered into this transaction conscious that he was paying a deposit and he must be taken to have known either actually or through his advisers that certain consequences would follow if he failed to complete the contract or was unable to do so. It is correct that he caused assets of some value to be transferred to Visionhurst [a company controlled by Mr El-Wakil] but he never granted the lease he promised. He failed to pay debts which he had agreed to pay under the business transfer agreement and which on the judge's findings Mr El-Wakil was accordingly forced to pay for him. the judge also found. The judge also found that Mr El-Wakil trusted Mr Omar and that his trust was misplaced. In sum, Mr Omar's conduct does not excite sympathy". Per Andren LJ *Omar v. El-Wakil* [2001] EWCA Civ 1090. (2001) Times, November 2, 2001. It is available on WestLaw website 2001 WL 753309.

<sup>905</sup> Ibid.

Then Arden LJ decided that:

“In a situation where a purchaser could not himself perform, the circumstances which make it appropriate for the court to exercise its discretion under section 49(2) in his favour must be exceptional. Inability to complete is exactly the risk the deposit was intended to guard against”<sup>906</sup>

It seems that the court has based its judgment on the fact that the vendor should not be denied his right to forfeit deposit in the event of non performance as this is the classical situation in which a deposit is liable to be forfeited. Accordingly the fact that a purchaser would sustain a hardship of losing his deposit should not be a sufficient reason to exercise the power conferred on the court under the subsection. However it should be noted that the fact that deposit symbolizes a guarantee for performance should not entitle the injured vendor to extract a penalty in the shape of deposit. It was admitted that “the deposit paid was substantially in excess of the normal deposit. The sum of £110,000 represented about 31% of the total purchase price rather than the usual 10%”<sup>907</sup>. The amount at stake should be one of the most important circumstances, which the court should consider in order to decide whether the section 49(2) may be invoked. It would not be, it is submitted, a good policy to frankly prevent agreed damages clause of penal nature and implicitly upholds the penal nature of clauses elsewhere, i.e. the forfeiture of deposit. The court also relied on the fact that there has been no suggestion that the court would order to return part of deposit for it is established that the court should order the whole deposit or nothing. In response, this point is also not impressive as it has become established after *Dimsdale* case<sup>908</sup> that a deduction from the deposit is allowed in favour of injured vendor to compensate his wasted expenses. The court could have therefore ordered the deposit less compensation in relation to losses suffered by the vendor under the abortive contract. However the court seems to have taken “a slightly stricter” view<sup>909</sup> for it would have been preferable to have regard to all circumstances of the case

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<sup>906</sup> *Omar v. El-Wakil* [2001] EWCA Civ 1090. (2001) Times, November 2, 2001. It is available on WestLaw website 2001 WL 753309.

<sup>907</sup> *Ibid.*

<sup>908</sup> *Dimsdale Developments (South East) Ltd v. De Haan*, (1984) 47 P&CR 1 (Ch D).

<sup>909</sup> *Tennaro Limited v Majorarch Limited* [2003] EWHC 2601; [2003] 47 E.G.C.S. 154 (Ch D).

including the vendor's conduct and the amount at stake. Even when the court held that the exercise of courts' jurisdiction under section 49(2) should be exceptional, it did not give any indication to construe the meaning of the word exceptional. If in circumstances like these, where the penal nature of deposit is clear, the subsection can not be invoked, so what are the circumstances or what is the criterion that justifies the invocation of section 49(2)? However, was this narrow interpretation followed in the subsequent cases?

#### **4.4.1.1.2 Broader interpretation: when it is the fairest course between parties**

It is notable that the Court of Appeal rejected the notion that it should be necessary, in order to bring the case under the subsection, to be unfair or inequitable for the purchaser to lose his deposit<sup>910</sup>. Many subsequent cases took a broader view that the provision was "designed simply to do justice between vendor and purchaser"<sup>911</sup>. This was clearly illustrated in *Universal Corporation v Five Ways Properties Ltd*<sup>912</sup> where the court confirmed that it has a wide discretion under s.49 (2) to order the return of deposits "where the justice of the case requires"<sup>913</sup>. In this connection, Buckley LJ added that: "The word "justice" [is] to be used in a wide sense, indicating that repayment must be ordered in any circumstances which make this the fairest course between the parties"<sup>914</sup>. In this case the claimants agreed to purchase land in London and paid a 10% deposit. The transaction was financed from moneys deposited in Nigeria. The purchasers were unable to proceed with the contract on time and were given a 28 days completion notice to do so. Due to unexpected delays caused by Nigerian exchange regulations prevented the purchasers complying with the notice, as it was not possible to remit the moneys to London in time. As the money, even though, duly arrived within a few days of the expiry of the notice, the vendors had terminated the contract and forfeited the deposit paid. The purchasers brought an action to recover its deposit under section 49(2). The action was struck out at first instance by Walton J.<sup>915</sup> justifying that as the subsection was not

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<sup>910</sup> *Universal Corporation v. Five Ways Properties Ltd* [1979] 1 All ER 552.

<sup>911</sup> *Ibid.* At 555 Buckley LJ. The outcome of this case was applied in subsequent cases. See *Maktoum v. South lodge Flats* (1980) Times. April 22. *Dimsdale Developments (South East) Ltd v. De Haan*, (1984) 47 P&CR 1 (Ch D).

<sup>912</sup> *Universal Corporation v. Five Ways Properties Ltd* [1979] 1 All ER 552.

<sup>913</sup> *Ibid.* At 555 per Buckley LJ.

<sup>914</sup> *Ibid.*

<sup>915</sup> *Universal Corporation v Five Ways Properties Ltd.* [1978] 3 All ER 1131. (at the first instance)

applied to cases other than where the court would refuse a decree of specific performance. On appeal, the court reversed Walton J's decision. Preferring the view of Megarry J. in *Schindler v. Pigault*<sup>916</sup>, Buckley LJ clearly confirmed that the court had "an unqualified discretion to order the return of the deposit"<sup>917</sup>. His learned LJ stated that:

"It is not clear to me that...it would not be more just to order repayment of deposit, leaving the defendant such remedy in damages as may be available to it, than to allow it to retain the very substantial deposit which was paid in this case"<sup>918</sup>.

It is important to highlight that it is apparently impossible to determine all the standards and matters, which the court might take into consideration to exercise its power under section 49 (2). The court should therefore consider each case according to its circumstances, including the conduct of the parties and the amount at issue, in order to decide whether to grant relief or not. Then the subsection will only be invoked if there is a clear unfairness in the forfeiture of a deposit. In other words, the court should not therefore exercise its power to order the refund of a deposit unless it is the fairest course between the parties. However the court should not be astute to discover unfairness in every provision of a contract which stipulates for a deposit to be forfeited to vendor in the event of a breach by purchaser. The unfairness should be clear to any one considering it and it seems again that all turns on the facts of each particular case. In the more recent case of *Tennaro Limited v Majorarch Limited*<sup>919</sup> the court dealt with contracts related to three different flats (37, 31 and 32). In one case (flat 37) the court upheld the claim that the vendor should be entitled to forfeit the deposit for the value of the flat concerned had declined and the damages due for the vendor would have been close to, or may even be greater than the sum paid by way of deposit<sup>920</sup>. However in the other two cases (flat 31

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<sup>916</sup>*Schindler v. Pigault* (1975) 30 P&CR 328.

<sup>917</sup>*Universal Corporation v. Five Ways Properties Ltd* [1979] 1 All ER 552, at 555 per Buckley LJ.

<sup>918</sup> *Ibid.* At 555-556.

<sup>919</sup> *Tennaro Limited v Majorarch Limited* [2003] EWHC 2601; [2003] 47 E.G.C.S. 154 (Ch D).

<sup>920</sup> "It appears to me that the Buyer's claim for the return of the deposit under the first agreement, in relation to Flat 37, is very weak. On the agreed facts, and in light of my conclusions on the first three issues, the Buyer should have completed the first agreement by purchasing Flat 37 for £4.4m, and it failed to do so because it could not raise the funds...The value of Flat 37 was £4m, namely some £ 444,000 less than the consideration payable under the first agreement, during the second half of 2002, ie when completion should have taken place, and when the first agreement was validly rescinded by the Seller. Further, the value of Flat 37 has declined to £3.6m by today". *Ibid.* Per Neuberger J.

and 32), the values of the two flats have increased<sup>921</sup> and the vendor had the opportunity to sell them at price significantly higher than the contractually payable by the purchaser. Therefore as it was the fairest course between the parties the court considered that deposits, which were paid under the agreements of these two flats, should be, in principle<sup>922</sup>, returned<sup>923</sup>. Nevertheless, the circumstances in which the relief will be given are by no means clear. Therefore, should the application of penalty jurisdiction be the solution?

#### **4.4.1.2 Relation of section 49(2) with *Workers Trust* case and penalty jurisdiction**

It has become established that any unsatisfactory limitation (as it was first held in *James Macara Ltd v. Barclay*<sup>924</sup>) on the ambit of the discretionary power given to the court under section 49 (2) was rejected, as it would appear to be inappropriate in view of the wording of the section itself. However, it is unfortunate that the cases, in which the subsection was applied, gave no clear guidance of the general grounds in which the courts would justify the exercise of their discretion under the statutory provision<sup>925</sup>. Could the decision of *Workers Trust* case or the application of penalty jurisdiction be the solution?

##### **4.4.1.2.1 Relation between *The Worker Trust* case and section 49(2)**

The position after *Workers Trust* case<sup>926</sup> shows that relief against the forfeiture of a deposit may be given where it is unreasonable on the grounds that it is a penalty. However this is not the case where it is reasonable, i.e. does not exceed 10% of the

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<sup>921</sup> "The value of Flats 31 and 32 in the second half of 2002 significantly exceeded the respective sale prices under the later agreements. The contract price for Flat 31 was £443,740, and it was worth £525,000 in the second half of 2002; the equivalent figures for Flat 32 are £841,259 and £1.075m. Although the value of the two flats has now declined to £475,000 and £985,000 respectively, each of them is still worth significantly more than the respective contract price". Ibid. Per Neuberger J

<sup>922</sup> The court did not order the repayment of deposits for it was possible that the damages claim in relation to the contract of flat 37 may exceed the deposits in the contracts of flat 31 and flat 32 and therefore the right of set-off was available.

<sup>923</sup> See the case itself (*Tennaro Limited v Majorarch Limited* [2003] EWHC 2601; [2003] 47 E.G.C.S. 154 (Ch D) for a nice explanation why the court decided that the deposits in flats 31 and 32 were to be in principle returned.

<sup>924</sup> *James Macara Ltd v. Barclay* [1944] 2 All ER 31.

<sup>925</sup> The courts in each case applied the subsection have been considering the circumstances of each case without any attempt to determine the circumstances in which the subsection can be applied. In brief, there is no clear indication that such attempt was made. See all cases examined in the context.

purchase price. In contrast under section 49 (2) of the Law of Property Act 1925 the court has a wider jurisdiction to relief against forfeiture of deposits. Purchaser may be granted relief against the forfeiture of deposit by virtue to the statutory provision, whilst, at the same circumstances, may not at case law. This is clearly illustrated in *Universal Corporation v Five Ways Properties Ltd*<sup>927</sup> where the claimants had an order to return his 10% deposit that was paid to make the transaction<sup>928</sup>. This means that it is down to the court to decide if even a 10% deposit should be treated as a penalty.

#### **4.4.1.2.2 Relation between penalty jurisdiction and the court's discretion at s.49 (2)**

It seems that there is a good solution to pave the way for drawing the boundaries and grounds in which the purchaser has the right to invoke the discretion conferred on the court by the section 49(2) to recover the deposit. There is a real possibility to apply the penalty jurisdiction in the same way that was suggested before<sup>929</sup> for the position of a deposit at case law after the *Workers Trust* case. In this way, the power of ordering the repayment of a deposit under the subsection would be applied in circumstances where its retention by the vendor would give rise to a penalty<sup>930</sup>. It could even be said that the jurisdiction conferred on the court under section 49(2) is very similar to the equitable jurisdiction to relieve against penalties<sup>931</sup>. Under both jurisdictions the court may grant a defaulting purchaser a relief against paying a disproportionately high sum in comparison with the loss suffered. Put in another way, it means that the court may exercise its discretionary power under the statutory provision if the deposit retained by the vendor was substantially greater than what it is needed to compensate him. Further both jurisdictions entitle the court to grant such relief on terms that purchaser submitted to a

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<sup>926</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>927</sup> *Universal Corporation v. Five Ways Properties Ltd* [1979] 1 All ER 552.

<sup>928</sup> *Supra*. P 230 for the facts of the case. See also *Dimsdale Developments (South East) Ltd v. De Haan*, (1984) 47 P&CR 1 (Ch. D).

<sup>929</sup> *Supra*. P 218.

<sup>930</sup> This is, in reality the solution favoured by the Law Commission in its working paper No. 61 "Penalty Clauses and Forfeiture of Monies Paid". London Her Majesty's Stationery Office 1975. PP 42-45. See also, Treitel, G, H. "The Law of Contract". 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 1009. Pawlowski, Mark. "Relief against Forfeiture of Deposits". Estate Gazate. 21 November. Issue 9246. [1992] 76, at 78.

<sup>931</sup> Wallace, H. "Deposit or Penalty?- The Price of Greed". Northern Ireland Legal Quarterly. [1993] 207, at 214.

deduction representing the vendor's loss<sup>932</sup>. The court when exercising its inherent jurisdiction over penalty clauses, is not, as it was confirmed by the court of appeal in *Jobson v. Johnson*<sup>933</sup>, to enforce the penalty beyond the loss suffered by the claimant, i.e. scaling down the amount of penalty clause. Relief against forfeiture of deposit under the statute is clearly illustrated in *Dimsdale Developments (South East) Ltd v. De Haan*<sup>934</sup>. In this case the court decided to order the return of the deposit under section 49(2), for the vendor had sold the subject matter at a highly greater price that it would have received under the contract with the defaulting purchaser. Put another way, the court ordered the repayment of the deposit as it was greatly more than what was necessary to compensate the vendor for his actual loss. However it should be highlighted that the court in this case decided the repayment of deposit subject to an undertaking from the purchaser to compensate the vendor for the loss he had actually suffered<sup>935</sup>. Therefore "It is right to add that [the court] made deductions from the deposit, in favour of the seller, in relation to expenditure wasted by the seller under the abortive contract"<sup>936</sup>.

Consequently, section 49(2) of the Law of Property Act 1925 and the cases, which applied it are seen as a step forward in supporting the new proposal adopted in this work towards a harmony in the law of penalties and forfeiture of deposit and instalments<sup>937</sup>. What supports this proposition is that in all cases in which the court ordered the refund of 10% deposit was on the grounds that the deposit was substantially greater than the loss actually suffered<sup>938</sup>.

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<sup>932</sup> Initially the courts in exercising its discretion were ordering the return of whole deposit leaving the vendor to claim his damages for the loss suffered as a result of breach under an unliquidated damages action. This was clear in *James Macara Ltd v. Barclay* [1944] 2 All ER 31, at 34 where Clauson J stated that: "...the court may order the return of the whole of the deposit...it must be all or nothing".

<sup>933</sup> *Jobson v. Johnson* [1989] WLR 1026.

<sup>934</sup> *Dimsdale Developments (South East) Ltd v. De Haan* (1984) 47 P&CR 1.

<sup>935</sup> *Ibid.* At 12. The outcome of this case was very much suggested to remove the injustice caused by the application of case law rules to deposit in terms of the 10 per cent in sale of land transaction. See Thompson, MP. "Untrevelling Agreements". *Conveyance and Property Lawyer*. [1994] 58, at 62.

<sup>936</sup> *Tennaro Limited v Majorarch Limited* [2003] EWHC 2601; [2003] 47 E.G.C.S. 154 (Ch D)

<sup>937</sup> *Supra.* P 218.

<sup>938</sup> See *Dimsdale Developments (South East) Ltd v. De Haan* (1984) 47 P&CR 1.

#### 4.4.2 Unfair Terms in Consumer Contract Regulations 1999

In the context of transactions between consumers and sellers or suppliers, the artificial distinction in treatment at case law, between sums payable on breach and deposit paid before breach has been mitigated. The greater mitigation has occurred by the use of Unfair Terms in Consumer Contract Regulations 1999. These regulations generally apply a fairness test to non-“individually negotiated” terms in contract for the sale or supply of goods or services between consumers and sellers or suppliers<sup>939</sup>. A forfeiture clause in a consumer contract may be considered as unfair because “contrary to the requirement of good faith, it causes a significant imbalance in the rights and obligations of the parties arising under the contract to the detriment of the consumer”<sup>940</sup>.

Whether a term in a contract requires a sum of money to be payable as a result of breach or for deposit, it will be subject to the fairness test. Therefore, schedule 3 contains a “grey list” which encompasses both penalty clauses and deposit. The Regulations provided that a clause will be unfair when “permitting the seller or supplier to retain sums paid by the consumer where the latter decided not to conclude or perform the contract, without providing for the consumer to receive compensation of an equivalent amount from the seller or supplier where the latter is the party cancelling the contract”<sup>941</sup>. Such clauses might be regarded as unfair, and consequently unenforceable against the consumer. Accordingly, it can be said that the court has the discretionary power to order the return of a deposit if it is satisfied that it is unfair for the seller or supplier to forfeit it. This can be presumed “but not spelt out” in schedule 3 Paragraph 1(e)<sup>942</sup>. However, it is suggested that, as the application of section 49(2) of the Law of Property Act 1925 resulted to in *Dimsdale Developments (South East) Ltd v. De Haan*<sup>943</sup>, the court may order the

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<sup>939</sup> Section 3 (1) Unfair Terms in Consumer Contract Regulations 1999.

<sup>940</sup> Section 5 (1).

<sup>941</sup> Paragraph (d) Schedule 2. It has been said that this provision is based on civil law system where the payer who loses his deposit if he withdraws, while the payee returns the double if he does so. See for that Treitel, G. H. “The Law of Contract”. 11<sup>th</sup> ed. Sweet & Maxwell. 2003. P 982.

<sup>942</sup> Halson, Roger. “Contract Law”. First published in Great Britain. Longman 2001. P 522 including footnote 478.

<sup>943</sup> (1984) 47 P&CR. 1 (Ch. D).

repayment of a deposit at the Regulations provisions, with the injured party's provable actual loss deducted.

#### **4.4.3 The Consumer Credit Act 1974**

Under this act the court has the jurisdiction to review extortionate credit bargains to achieve justice between the parties<sup>944</sup>. The court therefore has, under section 139(2) the discretionary power under this act to order injured party, to repay the entire or part of any sum paid. This is a clear indication that the court has the power to grant relief against forfeiture of a deposit where it is grossly greater than what may be considered fair compensation to an injured party for the actual loss suffered as a result of breach. This judgment also accords with the new proposition that suggested the application of penalty jurisdiction to deposits.

### **5-Deposit in Jordanian Civil Law**

#### **5.1 Article 107**

Jordanian civil law has different rules from those in English law with regard to deposit. The amount paid as a deposit might have one of two functions. Firstly, it gives either party the right to withdraw from the contract. If, for example, a purchaser paid 1000 JD by way of a deposit at the time of formation of the contract and then withdrew from the contract he would lose the 1000 JD. But if it was the vendor who withdrew the purchaser would restore 2000 JD. Secondly, it might be a sign of the conclusion of the contract and extra security that the contract shall be performed. As a result of this it is assumed that neither of the parties has the right to withdraw from the contract. To give the sum, which was paid by way of a deposit this effect the parties should provide so in their agreement. In contrast English law does not have the rule that in the event of the withdrawal of deposit's payer he forfeits it. However in the contracts of the sale of land if the purchaser defaults he loses the customary 10% deposit; if the vendor defaults he should return the deposit but there is no rule that that double the amount should be paid back.

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<sup>944</sup> Section 138

As the deposit at Jordanian law gives each party the chance to withdraw from the contract by losing it or return double, it seems that this rule is regarded as imposing a penalty. However there are still some dissimilarities between deposit and penalty clause according to Jordanian law.

1-Deposit is in exchange for any withdrawal so that it is always due even though the injured party has sustained no loss or the loss was less than the amount of a deposit. This is because there is no default, but simply losing a certain sum of money paid by way of a deposit in return for the withdrawal from the contract. By contrast, penalty clause is a pre-estimate of damages for the losses, which the injured party suffers as a result of non-performance. Therefore there should be always a fault, damage and causal link for penalty clause to become due.

2-A deposit cannot be reduced as there is no link between it and the loss suffered, whereas the court has a full power to adjust penalty clause to be equal to the damage sustained.

3-Each party can discharge himself from the contract by paying the price of withdrawal, i.e the deposit. In comparison, in penalty clause system neither party can discharge himself from performing his contractual obligations by paying the amount of penalty for penalty provision is not an alternative obligation.

The general rule with regard to the deposit in Jordanian law is included in Article 107, which provides for:

“The payment of deposit at the time of entering into contract means that each party is free to withdraw from the contract, unless the contract provides otherwise. In the case of the party who has paid the deposit, he loses it, and in the case of the receiver he has to return double the amount”<sup>945</sup>

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<sup>945</sup> For example in sale contract the purchaser has to pay the price and receive the subject matter in the place where the sold thing is, however if he does not do so that means that he withdrew from the contract. This gives the vendor the right to retain the money he has received by way of deposit from the purchaser. See Civil Cassation No. 566/1982 Bar Association Journal. 1982, P 1680. Also Civil Cassation No. 2580/2001, Adalah Centre Publications (www.adalel.com), 2001.

## **5.2 Analysis of rule of deposit at article 107**

### **5.2.1 Time to use the right to withdraw**

It is inferred from Article 107 that Jordanian law considers the right to withdraw from the contract as the foundation rule. However can this right be used at any time? It should be noted that the time in which one party can use his contractual right to withdraw is regarded as an essential contractual matter. Recognizing the period in which each party can withdraw from the contract narrows the time of the contract's suspension and leads to the settlement of contractual relations. However, in spite of the significance of the time factor, Article 107, which includes the rules of deposit, does not determine the period of time in which the right to withdraw can be used. Therefore, the parties can agree upon the time during which the right to withdraw from the contract should be used. If it expires without either party expressing the intention to withdraw the contract becomes binding and neither party can then unilaterally discharge himself from the contract. However there might not be agreement between the parties and therefore the right to withdraw is still available until the performance of the contract. To avoid any problems that might occur as a result of this it would have been more preferable if the law determined the time in Article 107 JCL.

It should be also highlighted that if the contract is terminated by one of the parties before a complete performance, the other party has the right to retain the deposit if he is the payee or claiming twice the amount if he is the party who has paid the deposit<sup>946</sup>. As a result of this it seems that the deposit operates just like penalty clause, as it binds one party to pay a certain sum of money to the other even if there is no loss suffered. The only difference between penalty and deposit is (according to Jordanian law) that the court has no authority to increase or reduce the amount of a deposit if it is less or more than the actual loss sustained. However it is strange that where the loss suffered is excessively higher than the sum paid by way of deposit the injured party can sue for more

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<sup>946</sup> Even though there is no loss suffered. See Civil Cassation No. 2313/1999 Bar Association Journal 2001, p 2095. This case was concerned with a sale contract of big supermarket. It provided that the vendor should vacate his commercial place to the purchaser on certain time. The purchaser paid a sum of money by way of deposit, however the vendor then did not perform his obligation. Having the vendor broken his contract the purchaser sued him for the return of the double deposit. The Court of Cassation held that the vendor should restore twice the amount in accordance with article 107 of Jordanian civil law.

compensation. This means that the injured party needs to return to the court twice<sup>947</sup> to receive his just compensation together with the deposit. Unfortunately this costs both the parties involved in the case and the community as a whole. Also since the law gives the injured party the right to claim his damages where the deposit is less than the loss suffered, what prevents the law from giving the defaulting party the right to sue for a reduction of amount of deposit where it is excessively higher than the loss suffered? The case in English case law is almost the same where the injured party can retain 10% deposit in sale of land transactions whatever the actual loss<sup>948</sup>. However it is strange that if the actual loss is higher than the sum paid by way of deposit the injured party can recover the difference, i.e damages for uncovered loss<sup>949</sup>.

The effect of the New Approach suggested in this work appears clearly also in this place where the writer argues the application of the new approach of penalty clause to the amount of money already paid by way of deposit<sup>950</sup>.

### **5.2.2 Contract should be valid for the application of Article 107**

A problem arises where a deposit is agreed to be payable in sale contracts that requires the formal registration of the transaction, but one of the parties withdraws before the completion of such formalities. In this instance do rules of deposit laid down in article 107 of Jordanian law apply, taking into consideration that such contracts are regarded as void before meeting the requirement of registration? It has been argued<sup>951</sup> that to judge that the sale contract, which is made without formal registration, is invalid is something Jordanian law does not adopt. Article 1184 of this law provides that: "The ownership does not transfer to the purchaser without registration". Thus the article itself does not state that the contract is null and if the Jordanian Legislator wanted this result he would provide for that in the same article. This point of view goes on to suggest that sale

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<sup>947</sup> Twice in the event of dispute. The first is to claim to have the amount of deposit (if it has not been paid yet) if he is the payee or return twice the amount if he is the payer. The second is to get his compensation if the deposit does not suffice to compensate him. This has actually occurred Civil Cassation No. 722/1997, Bar Association Journal, 1997, p 1116.

<sup>948</sup> *Howe v. Smith* (1884) 27 Ch.D 89.

<sup>949</sup> *Lock v. Bell* [1931] 1 Ch 35.

<sup>950</sup> As this has been fully and in details approached there is no need to repeat it twice as what has been discussed when examined the rules of English Law applies to Jordanian Law.

contract in such a situation is valid. It reaches the conclusion that the rules of deposit applies when one of the parties breaches his obligation to accomplish the registration procedures. In response, it should be noted that the logic and the law require that the contract should be in a certain form to be valid. This is illustrated in article 168 of Jordanian law. This means that as the deposit is a condition in the contract it will be null and void if the contract does not meet the formality required and therefore the rules laid down in article 107 of Jordanian law will not be applicable.

Therefore in order to exercise the right of withdrawal as laid down in article 107 of Jordanian law the amount of money which has been paid by way of deposit should have been paid by virtue to a valid and legal contract. If the deposit was therefore paid by virtue to an invalid and null contract the payer of the deposit would have the right to regain his deposit even though he is the party who withdraws from the contract. This scenario is confirmed in the Court of Cassation in a case concerning a contract for the sale of land. The contract provided that the purchaser should pay an amount of 20,000 JD to the vendor by way of a deposit providing that the latter would complete all the necessary procedures to finish the transaction as soon as possible. This agreement should have been registered formally as a condition to the completion of the contract. However the vendor failed to do so leading the purchaser claiming the money he had paid by way of a deposit. The Court of Cassation, after reviewing all facts of the case, held that the contract was invalid and:

“Since the claimant has obligated himself to pay the 20,000 JD as a deposit and all the rest of the price at the time of registering the contract, and since the vendor has not formally registered the promise of sale, the contract would be void by virtue to article 168 of Jordanian Civil Law. This fact justifies the claim of the purchaser to have his deposit back on the ground that the rule laid down in article 107 of Civil Law does apply where the contract is invalid. This is what the Court of Cassation has settled on in many decisions, for example 1198/98 and 2367/90.<sup>952</sup>”

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<sup>951</sup> Aserhan, Adnan and khatir, Nori. “Sources of personal rights”. 1997. P 104.

<sup>952</sup> Civil Cassation No. 2247/1999 Bar Association Journal, 2000, p 178. See also Civil Cassation No. 1184/1997, Bar Association Journal, 1997, p 197.

### 5.2.3 Should words used by the parties be of decisive effect?

It can be asserted<sup>953</sup> that the use of the word deposit by the parties in the contract regarding the money paid in advance is of decisive effect. In a contract of sale the purchaser has agreed with a vendor to buy some trucks for his business. They agreed that the purchaser should immediately pay 7% of the price at the time of making the contract whilst the remaining amount would be due on receiving the subject matter. Article 7 of the contract provided that the rules of the deposit laid down in article 107 of Jordanian civil law would be applied to the first payment of the price. The purchaser withdrew from the contract before even paying the 7% deposit, which he had to pay on entering into the contract. The purchaser having used his contractual right to withdraw meant the vendor sued him for the deposit agreed upon. The Court of Appeal decided that since no payment has been made at the time of making the contract the amount agreed upon (7%) was in fact part of the price and the rules of deposit does not apply to this amount. On appeal the Court of Cassation overruled this decision by stating that:

“The decision of the Court of Appeal is illegal and baseless as the parties agreed in the contract to call the first payment “deposit” and apply the rules of deposit in the event of any default by either party”<sup>954</sup>.

However, it should be noted that the judgment of the Court of Cassation in this case would not be preferable to be applied to all cases. The deposit should always aim to create motivation to the payer and payee to perform their contractual obligations with each party understanding that certain consequences would follow in the event of default or withdrawal from the contract. Thus the deposit should not be used to avoid the application of the rules of another system. In other words, parties to the contract might use the word “deposit” or language appropriate to deposit to hide the real nature of the advance payment. The Court of Cassation was, with all respect, incorrect when it based its judgment on the fact that the parties described in their contract the payment, which should have been paid at the time of making the contract as a deposit. Parties to a contract may attach the label “deposit” to the payment of a sum of money in order to escape from

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<sup>953</sup> Civil Cassation No. 722/1997, Bar Association Journal, 1997, p 1116.

<sup>954</sup> Ibid.

the general rule which causes the payment as penalty. As a result the injured party cannot receive any compensation other than for the damage he has sustained.

The position of English law confirms that the language used by the parties does not conclude the nature of the sum paid in advance as a deposit. The courts via two authorities confirmed that the parties cannot escape the penalty clause jurisdiction by affixing the label “deposit” to a disproportionately great sum. The case of *Stockloser v. Johnson*<sup>955</sup> clearly clarifies that the vendor cannot forestall the court’s power to relieve against forfeiture by describing an extravagant sum as a deposit. Accordingly, as was given by Denning L.J, if the vendor has stipulated of an initial payment of 50% instead of the usual 10% of the price to be paid as a deposit, he will face the penalty clause. This is especially the case if it was provided for in the same contract that on purchaser’s default the vendor resells the subject matter and sues for the 50% deposit. “Surely the court will relieve against the forfeiture. The vendor cannot forestall this equity by describing an extravagant sum as deposit, any more than he can recover a penalty by calling it liquidated damages”<sup>956</sup>.

In *Linggi Plantations v Jagatheesan*<sup>957</sup> Lord Hailsham concluded that:

“...The parties may use language normally appropriate to deposits properly so – called and even to forfeiture which turn out on investigation to be purely colourable and that in such a case the real nature of the transaction might turn out to be the imposition of a penalty, by purporting to render forfeit something which is in truth part payment”<sup>958</sup>.

However this does not mean that the word (deposit) or language used by parties should not be considered. Rather it should be one of the most important factors to be taken into consideration in determining the real nature of the sum paid in advance. It has been clearly verified in *Gallagher v. Shilcock*<sup>959</sup> that in every case some factors should be considered in deciding whether parties to a contract have intended the sum, which has

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<sup>955</sup> *Stockloser v. Johanson* [1954] 1 QB 476.

<sup>956</sup> *Ibid.* At 491 per lord Denning L.J.

<sup>957</sup> *Linggi Plantations v. Jagatheesan* [1972] 1 Malayan LJ 89; available also on <web.lexis-nexis.com/professional/document?\_m.>

<sup>958</sup> *Ibid.*

<sup>959</sup> [1949] 2 KB 765.

been paid by way of advance payment, to be a deposit or not. These factors have been pointed out by Finnemore J. when he declared that: "...Regard may be had to the circumstances of the case, to the actual words of the contract, and to the evidence of what was said"<sup>960</sup>.

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<sup>960</sup> Ibid. At 768 per Finnemore J.

## Conclusion

So far the research examined and investigated the law relating to penalty clauses, together with its relationships with similar contractual provisions concerning forfeiture of money already paid. It was noted that the power of the parties to a contract to agree on damages in advance is controlled by the penalty rule. This rule, contrary to the generally accepted doctrine of freedom of contract, sets aside express stipulations on damages agreed upon by the parties. For this reason this research has tentatively suggested a New Approach which, if implemented correctly, would lead to greater respect for the principle of freedom of contract and the agreement on damages in advance. This New Approach<sup>961</sup>, while not denying courts' power over penalty clauses, operates from the presumption that such clauses should be given effect and that any intervention by the court to reduce their amount should be seen as exceptional in a very limited case<sup>962</sup>. The support for a New Approach could be found in the following statement of Lord Woolf: "The court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld"<sup>963</sup>

Therefore this section will deal with the following issues

- 1- Presenting summary and conclusions of the subject matter
- 2- The New Approach and why it would be more preferable than the existing law
- 3- Outline of the suggestions

### 1- Summary and conclusions

The original penalty rule had a simple beginning and complex subsequent history. The first chapter showed that the penalty jurisdiction grew from the practice in equity to amend what were perceived to be inequitable effects of the strict enforcement of penal bonds. The current penalty rule<sup>964</sup> was not advanced, either in the common law courts or in the courts of chancery until the late seventeenth century and then the development

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<sup>961</sup> The whole approach is based on the idea of fairness. See footnote 983.

<sup>962</sup> Where the stipulated sum is manifestly disproportionate to the actual loss.

<sup>963</sup> *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, at 59.

<sup>964</sup> Which makes all penalty clauses unenforceable.

culminated at the beginning of the twentieth century in the landmark case of *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd*<sup>965</sup>. The courts over the time have affirmed that the law of penalties as stated in *Dunlop* case still stands, and therefore it may be summarised as follows:

**\*How do the courts decide whether an agreed damages clause is unenforceable penalty clause?**

English law courts had, until the reception of the current regime, applied the intention test. However the juridical dependence on the parties' own words had obviously been undermined since *Kemble v. Farren*<sup>966</sup>. This case was a strong call that the terms of the parties to the contract should not be of decisive effect in determining the nature of agreed damages clauses. The courts subsequently developed a new approach focusing on a comparison between the sum stipulated and the pre-estimated loss judged at the time of contracting. This comparison forms the basis for the differentiation between unenforceable penalties and valid liquidated damages clauses. An agreed sum, which represents a genuine pre-estimate of the anticipated actual loss should be paid as valid liquidated damages. However where the sum stipulated is extravagant and unconscionable in comparison with the anticipated actual loss that will sustain as a result of breach it should be struck down as a penalty. In spite of the various arguments<sup>967</sup> put forward before it the Court of Appeal in the 2003 case of *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited*<sup>968</sup> reaffirmed the law on penalty clauses. The court confirmed that the classic statement of the law as laid down in *Dunlop* case still stands, and that the sum stipulated should be a genuine pre-estimate of damage to avoid being a penalty. The investigation of the main test for the assessment of the agreed sum, i.e whether it is a genuine pre-estimate or not, revealed that the existing law<sup>969</sup> states that:

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<sup>965</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79.

<sup>966</sup> *Kemble v. Farren* (1829) 6 Bing 141; 130 ER 1234.

<sup>967</sup> In this case *Jeancharm* argued that following the decision of *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41, the principles set out in *Dunlop* case had been virtually abandoned. And argued that the correct test now is the one that looks at the contract as a whole and the risks being undertaken by both parties and ask whether the clause was an appropriate clause valid or not depended on the risk also undertaken by the party seeking to rely on it. *Supra*. P 56.

<sup>968</sup> *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), Westlaw 116995. [2003] EWCA Civ 58.

<sup>969</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79. *Philips Hong Kong v. The Attorney General of Hong Kong* (1993) 61 BLR 41. See also *Robophone Facilities Ltd v. Blank* [1966]

- 1- Despite the fact that the equality of bargaining power of the parties is not a conclusive sign of whether a clause is an invalid penalty, it was acknowledged that the courts should take care before striking down as a penalty a provision which is negotiated at arm's length<sup>970</sup>. However where a provision is not negotiated between willing parties with similar bargaining powers the courts should scrutinise the clause with great care to remove the risk of oppression and abuse of autonomy.
- 2- In assessing whether a clause is a penalty clause or a liquidated damages clause the courts should not be concerned with what the parties wrote but rather the courts should examine the matter objectively. However though the term used by parties to a contract is not decisive in determining the nature of stipulated damages, it is not, however, disregarded. The expression inserted in the contract by the parties raises a presumption in favour of it. A clause is assumed to be as the parties have called it until the opposite is proved.
- 3- The clause should not be struck down as a penalty merely because in hypothetical situations (which have not in fact occurred) the agreed sum may exceed the injured party's actual loss.
- 4- The court in applying the test considers the disproportion between agreed sum and likely actual loss as of the time of contracting. This does not mean that subsequent events should be disregarded. In fact what actually happened after the formation of contract might provide evidence helpful in determining what was within the contemplation of the parties at the time of contracting. All these issues were dealt with in chapter two.

**\*The "penalty" rule only relevant where there is a breach of contract**

What was noted after investigating the existing law of penalty clause is that its application is capable of causing many theoretical inconsistencies. Chapter three reveals that it is only where there is a sum of money payable or a property to be transferred in the

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3 All ER 128. *Jeancharm Limited T/A Beaver International v. Barnet Football Club Limited* [2003] 16<sup>th</sup> January Court of Appeal (Civil Division), Westlaw 116995. [2003] EWCA Civ 58.

<sup>970</sup> It is nonetheless still open for a court to find, when the parties are of equal bargaining strengths, that a clause is a penalty after applying the rules as stated in *Dunlop* case.

event of breach of contract the penalty jurisdiction is relevant. Therefore when a sum is payable upon an event other than on breach it simply does not matter whether the promisor can convince a court that the penalty jurisdiction applies or that equity has a role in order to prevent an “absurd paradox”. In both cases it seems that what the parties have agreed upon should be fulfilled. As a result it should be acknowledged that this rule produces some exceptional consequences by excluding from the scope of the penalty rule a condition for the payment of what might be an extravagant and unconscionable sum of money upon the occurrence of some event other than breach. This is particularly the case in termination clauses in hire purchase contracts. It is unacceptable that the hirer who honestly terminates the contract early will be worse off than the one who defaults, as the former will have no relief under the current law.

Beside the fact that the law is only applicable on breach, the ability of the stronger party to evade the penalty jurisdiction was criticised in chapter three. He, with the assistance of draftsman, may use his adeptness to avoid the penalty rule in classifying a term into a condition. Such a difference in form and not substance was capable of giving the injured party the chance to evade the application of penalty jurisdiction. As a result it was said that:

“If, in the light of such a clause, any sum specified as damages for breach must be tested on the basis that it is a pre-estimate of “the loss to the promisee resulting from the loss of his bargain” as a whole<sup>971</sup>, the law as to penalties is subverted to such an extent that it is not worth preserving as a separate body of rules”<sup>972</sup>.

This is also the case in the event of acceleration clauses which stipulate that the whole principal should be paid forthwith on default of any one instalment. Such a clause should be subject to the penalty clause jurisdiction at least where it provides for the payment of undue interest or a financing charge to be paid immediately with the principal.

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<sup>971</sup> *Dunlop Pneumatic Tyre Co Ltd v. New Garage & Motor Co Ltd* [1915] AC 79

<sup>972</sup> Chitty on Contract. 29<sup>th</sup> ed. Vol. General Principles. Sweet & Maxwell. 2004. P 1498.

**\*Penalty clauses: Factors to help determine whether a particular clause is a penalty clause**

The power that the courts may have over penalty clauses was the subject of chapter four. The principle is that once a provision is held to be an invalid penalty clause, the court has no general jurisdiction to re-form the terms of the contract. A penalty clause in a contract is always in this sense regarded as a dead letter. The courts have no power of reduction. Rather the law permits the courts to completely eliminate the penalty clause and the injured party is remitted to the ordinary rules of damages however unsatisfactory they may be under the circumstances<sup>973</sup>. Once a provision is, on the other hand, held to be a valid liquidated damages clause, the injured party seeking compensation will recover the stipulated amount regardless of whether this sum is less than the actual loss sustained or even nil.

To distinguish an unenforceable penalty clause from a valid liquidated damages clause a series of rules were laid down in *Dunlop* case. Three situations were examined where clauses are more likely to be unenforceable penalty:

1-Where it is easy to calculate likely actual loss: The greater the difficulty of assessing damages the more likely it is that the sum stipulated will appear a genuine pre-estimate of loss. If from the nature of the terms of the contract and the particular facts of the case, it appears that the actual losses are readily ascertainable and that they may be trivial, any stipulation for an extravagant and unconscionable sum of money will not appear to constitute a genuine pre-estimate of loss and so would be regarded as a penalty.

2-Where a single lump sum is made payable on one of different events: this factor states that there is a presumption in favour of penalty when a single lump sum is made payable in the event of breach of one or several or all obligations, some of which are of trifling and others are of serious damages. However courts have over time decided that a variety of different possible losses does not preclude an enforceable provision for liquidated

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<sup>973</sup> As the injured party may be denied damages for some losses he has sustained. He may not fully be compensated especially where the actual loss is not recoverable.

damages. As a result this presumption raised in favour of penalty can be displaced and so the single lump sum could be regarded as liquidated damages in the following instances:

A-Where the losses are difficult to assess: the difficulty of estimating or proving damages was always regarded as a factor favouring the clause being considered valid liquidated damages clause.

B-Where the stipulated sum is a sort of averaging out subject to the caveat that there should not be too a great difference between the lowest possible loss and the largest possible loss. A danger arises where the difference between the losses is Broad. In this situation two solutions were put forward to avoid upsetting freely made bargains and court's time being wasted. Firstly the court should ascertain the true construction of the agreed damages clause, i.e. the court would make every possible effort to construe that the sum stipulated was only intended to be payable on the occurrence of the most serious damage. Secondly the parties should stipulate for different sums payable according to the size of breach because failure to stipulate for a sum payable on the occurrence of the lowest possible loss might result in liquidated damages not being recovered.

3-Where a graduated sum slides to the wrong direction: The court would observe to which direction the scale is sliding to hold the validity of an agreed damages clause. If the scale is sliding in the right direction, i.e. the estimated sum increases so long as there is a continuing breach, the sum may be regarded as a genuine pre-estimate of the actual loss likely to be suffered as a result of breach and so valid liquidated damages. However, if the sum payable slides in the wrong direction, i.e. the sum decreases over the time, it will not constitute a genuine pre-estimate of the likely actual loss and so will be an invalid and unenforceable penalty.

Jordanian law permits a moderation of a penalty clause, not its complete elimination. In deciding whether to intervene in order to modify the agreed penalty clause a Jordanian court should look at the disproportion between the amount agreed upon and the actual loss suffered. If the disproportion is either excessive or extravagant the amount may be

reduced to be equal to actual loss. This position was criticised on the ground that agreed damages should be upheld despite the actual damages incurred being lower than the agreed damages clause. This will however be subject to the agreed damages being merely excessive and not extravagant and unconscionable. However it is well established that where there is no actual loss suffered then an action to sue for a penalty will not be allowed. In contrast the English court considers the disproportion between pre-estimated damages and the likely actual loss to decide whether the agreed damages clause is a penalty. An action for agreed damages may therefore be allowed where the clause is held to constitute a liquidated damages clause even though there is no actual loss sustained.

**\*Can more than the “penalty” be recovered?**

A problem arises when actual loss turns out to be more than agreed sum. This situation may come up in two cases: Firstly where a single lump sum is made payable on the occurrence of one or several breaches of different significance and secondly where the environment at the time of contracting was different from what prevailed at the time of breach. As a result it was asked: can more than the penalty be claimed? The following conclusions were reached:

- 1- Where an agreed sum of this kind is held to constitute a valid liquidated damages clause there is no doubt that the injured party can not recover more than was agreed.
- 2- It should also be noted that sometimes liquidated damages are deliberately set at a too low figure in comparison with the likely loss as a method of limiting liability. In English law such a clause does not cease to be a valid liquidated damages clause under the penalty rules<sup>974</sup>. Therefore courts can not simply increase the agreed sum as is the case in Jordanian law, which allows the court to increase the sum fixed in a penalty clause in all cases in which the sum is less than actual loss<sup>975</sup>.

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<sup>974</sup> *Cellulose Acetate Silk Co Ltd v. Widnes Foundry (1925) Ltd* [1933] AC 20.

<sup>975</sup> This position of Jordanian law was criticised as the law should determine the limitation under which courts can increase agreed penalty. Supra. P 156.

- 3- If the clause is invalid as a penalty and actual loss is larger than penalty, does the sum fixed in a penalty clause act as an upper limit? There is some doubt whether the injured party can claim the full amount or is limited to the amount of penalty. This instance is only illustrated in charterparty cases where the law gives the injured party the right to ignore penalty and claim his full damages. This position was fully examined and criticised on the ground that the party imposing a penalty should not be given the opportunity to benefit from the intimidating force the penalty clause may have and then ignore it when it turns to be to his benefit to do so, i.e it becomes less than actual loss sustained. All these issues were discussed in chapter five.

#### **\*Forfeiture of money already paid**

Perhaps the most anomalous rule in the law of penalties, which was dealt with in chapter six, concerns forfeiture clauses of money already paid (deposit and instalments). As a general rule a part payment can be recovered from the payee on the default of the payer. However the parties might insert a clause to the effect that the part payment already paid will be forfeited upon breach. Where there is such an express forfeiture clause, the payee, upon the payer's breach, becomes entitled to terminate the contract and forfeit the payment already paid. In such a case can the payer, who is the party in breach, recover the pre-paid instalments? It was noted that under English law two kinds of relief may be granted: Firstly, the court has the jurisdiction to grant a defaulting payer an extra time to proceed with the contract. Secondly: Sometimes the court may grant a defaulting party, who is not ready and able to pay within the extension period, a relief by way of an order of the repayment of instalments already paid. In contrast as far as Jordanian civil law is concerned its judgment is clear in this situation as it regards the instalments paid under hire purchaser contracts as rent payments. As a result if the purchaser fails to complete the instalments, all previous instalments would be considered as "non refundable" rent payments<sup>976</sup>.

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<sup>976</sup> Article 487 of Jordanian Civil Law.

Since the decision of *Howe v. Smith*<sup>977</sup> the position regarding the forfeiture of a deposit has settled in English law. In this case it was held that the deposit, though it might be taken as a part payment in the event of performing the contract, is also a guarantee for performance. Therefore, when the claimant fails to perform his contract within a reasonable time, he has no right to demand the return of the amount he pays by way of a deposit. Lord Cotton confirmed the nature and the forfeiture of deposit by stating:

“What is the deposit? The deposit as I understand it... is a guarantee that the contract shall be performed... if [the purchaser] repudiates the contract, then...he can have no right to recover the deposit”<sup>978</sup>.

It seems odd that clauses providing for the forfeiture of deposit and the instalments paid by the party who has subsequently broken his contractual obligations, should not be subject to the penalty clause jurisdiction. There is no apparent theoretical reason why forfeiture clauses should be treated differently from agreed damages clauses. Each may be equally intimidating from the perspective of the person subject to them. They are the same in substance and have the same function.

The penalty jurisdiction has been indeed applied to clauses exacting the forfeiture of deposit<sup>979</sup>. But in the *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd*<sup>980</sup> suggested that this is not the case particularly where the deposit is 10% of the price in sale of land transactions. Where the deposit does not exceed the customary deposit it will be subject to forfeiture. But if it is greater than the customary deposit it will be invalid and should be returned in full. In other words, in these transactions if the purchaser defaults the vendor has a right to retain a 10% deposit regardless of actual loss, i.e. it does not matter whether this percentage is a genuine pre-estimate of the loss suffered by the vendor<sup>981</sup>. It should be acknowledged that a deposit in such a situation is of coercive nature and that constitutes a policy of implicitly upholding penalties in this area of the law, while expressly prohibiting them in the area of agreed damages clauses. On the other

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<sup>977</sup> *Howe v. Smith* (1884) 27 Ch.D 89. See also *Sprague v. Booth* [1909] AC 576.

<sup>978</sup> *Howe v. Smith* (1884) 27 Ch.D 89, at 95 per Lord Cotton.

<sup>979</sup> *Commissioner of Public Works v. Hills* [1906] AC 368.

<sup>980</sup> *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573.

<sup>981</sup> *Ibid.*

hand, and, surprisingly, if the sum paid by way of deposit is less than the actual loss suffered by the vendor he has the right to recover damages for the “uncovered” losses<sup>982</sup>.

There is no “customary” deposit in transactions other than those for the sale of lands. In these cases the situation remained unclear after the *Workers Trust* case. However when Lord Browne-Wilkinson stated the law of deposit in this case he clarified the position with regard to deposits paid in sale of land transactions. As a result it might be possible to infer that there is a requirement that the forfeited deposit is to be a genuine pre-estimate of the loss in other transactions.

It is tentatively suggested that penalty clause rules should apply to a clause that requires money to be paid by way of deposit or instalment. Forfeiture clauses should be for the benefit of both parties and not a privilege for the stronger.

## **2-The New Approach<sup>983</sup>: How would the New Approach operate differently from the existing law?**

This research has come to the conclusion that it would be preferable for the law of penalties to uphold and enforce all penalty clauses subject to the court’s power of modification in limited cases. It should be emphasized that there will no longer be a distinction between penalty clause and liquidated damages clauses. Rather, under the new approach, all agreed damages provisions are treated as enforceable penalty clauses<sup>984</sup>. A presumption is raised in favour of an agreed damages clause that it is the proper recovery unless it is rebutted. The burden of proof or rebuttal of the presumption is cast upon the party, who seeks to avoid paying the amount of penalty. Where he is unable to displace the presumption, i.e unable to persuade court that the amount selected is manifestly disproportionate to actual loss, the court should award the amount agreed upon. Where he is able to furnish proof that the pre-estimated damages are manifestly disproportionate to

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<sup>982</sup> *Lock v. Bell* [1931] 1 Ch 35.

<sup>983</sup> It should be emphasised that the basis for this approach is the idea of fairness. It would be unfair to refer the injured party to claim unliquidated damages in which the providing proof of damage might be extremely complex, difficult and expensive. This might at the end result in undercompensating him. For the meaning of unfairness please see footnote 357 of page 91.

<sup>984</sup> Or whatever the term used to indicate the agreement on damages in advance.

actual loss the presumption is displaced and the court would reduce the amount recoverable in line with the injured party's actual loss.

**\*Comparing the sum stipulated with actual loss does not mean ignoring the circumstances, which exist at the time of contracting?**

In pages (28-33) the New Approach provides separate guidance for instances suggesting that a manifestly disproportionate penalty clause<sup>985</sup> may still be enforceable. Courts will not have a power of reduction over such a clause in some instances. The circumstances will include the case where one party has paid a higher price to buy an excessive penalty clause or this clause has been inserted by the parties, as they knew that in the event of non-performance the promisee would not be properly or satisfactorily compensated via an unliquidated damages action or the usual practice of a certain trade adopts a policy of inserting such penalty clauses negotiated at arm's length<sup>986</sup>. In such cases<sup>987</sup> the penalty clause is regarded as a result of a fair and free agreement between the parties, especially when the market is competitive and/ or the contracting parties are experienced, which is often the case in commercial contracts. The non enforcement of such agreed damages clauses, which are freely accepted by the parties, is inefficient and it "hurts the very people it wishes to protect by offering them an alternative they do not want to retain (possibility of efficient breach) and expropriating from them an alternative they wish to have (adding an enforceable penalty clause to their contract)"<sup>988</sup>. Efficient breach is not really an issue when a penalty clause plays an important economic role (risk sharing, reputation signaling, protecting against losses that are irrecoverable under the current law) and the agreed damages plays a compensatory function for the injured party's actual losses<sup>989</sup>. However, though in these cases a higher agreed penalty<sup>990</sup> is justified as a way

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<sup>985</sup> This clause is efficient and sound at the time of making the contract, but seems quite excessive at the time of breach and trial when compared with the recoverable loss. It is enforceable though it is regarded as a manifestly disproportionate in comparison with amount recoverable in the event of the absence of agreed penalty clause.

<sup>986</sup> As it is the case in charterparty cases in the event of the improper detention by the charterer.

<sup>987</sup> These three situations were fully examined under the New Approach suggested in this work. *Supra*. P 27-33.

<sup>988</sup> Hatzis, Aristides. "Having the Cake and Eating it Too: Efficient Penalty Clauses in Common and Civil Contract Law". *International Review of Law and Economics*. (2003) 22 381, at 394.

<sup>989</sup> *Ibid*. However efficient breach is not completely deterred as the third party's offer could exceed even the higher agreed penalty.

to compensate for actual losses it should never exceed a just compensation. This could be gauged by looking at the role that a higher agreed penalty plays, i.e. to take into account the situations pointed out above. If the injured party can feel secure that a contractual penalty will be enforced he will benefit from the certainty and adequacy of compensation.

**\*Where penalty is less than actual loss**

With regard to the situation where the court has the power to increase the stipulated sum it was suggested that this power may be used in the event that the amount turns out to be substantially less than actual loss. Such a situation will not be a frequent occurrence and therefore the court is given a discretionary power to increase only in a restricted circumstance<sup>991</sup>.

**\* Why would the New Approach be fairer than the existing law**

The New Approach, which has been tentatively proposed in this work may constitute the first step in looking at the penalty clauses in a different way in English (and Jordanian) law. Throughout the thesis the New Approach has been compared with the current penalty rule. It was concluded that the New Approach offers the following advantages.

1- Under the New Approach many transaction costs can be avoided. Under the existing law of penalties in the event that a clause is unenforceable as a penalty, it is treated as having no legal effect, and the costs of including it are wasted. In addition the injured party must bear the costs of bringing an action for unliquidated damages<sup>992</sup>. The New Approach helps reduce these costs.

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<sup>990</sup> Even though it is regarded as, given that the compensatory damages means damages for the recoverable loss and not actual losses, overcompensatory at the current legal rules. But under the new approach suggested in this research the damages allowed for actual losses should be regarded as compensatory since they do not over compensate but compensate the injured party for his actual losses. Of course this applies to the three cases, in which a higher agreed penalty would be preferable to be justified. See for this comment Posner, Richard. "Economic Analysis of Law". 5<sup>th</sup> ed. Aspen Law & Business. 1998. P 144.

<sup>991</sup> Supra. P 178.

<sup>992</sup> These costs are liable to be very high and are greatly increased by the current uncertainty over what is required for the agreed damages clause to be enforceable and that will not be subject to the rule against penalties.

2- Avoidance of the absurdity of the existing position of English law as to a single lump sum being payable on the occurrence of one or more of several breaches some of which are of trifling importance and others of serious importance. The absurdity concerned is that the court may reject the award of the agreed sum to the promisee in spite of the fact that it is a genuine estimate of the loss suffered as a result of the actual breach. The justification of this under the present law is that the agreed sum might be disproportionately high in comparison with loss that might be suffered in the event of occurrence of another breach, which has not even occurred. In this way the rule may invalidate a perfectly fair bargain. This outcome will no longer be there under the New Approach, as the court will look at the actual loss suffered, i.e the penal sum will be compared with the actual loss suffered as a result of breach that actually has occurred. Therefore, the court will not refuse to uphold the stipulated sum if it is in line with the loss sustained from the actual breach irrespective of the fact that the sum might be manifestly disproportionate to loss which may result from another breach which has not even occurred. However, the court will have the jurisdiction to exercise its power to reduce the amount of penalty if it is manifestly disproportionate in relation to the actual loss sustained as a result of the breach that occurred.

3-The court has the opportunity to examine the situation at the time of breach rather than limiting itself to the time of making the contract. A thorough investigation requires consideration of all circumstances including those at the time of breach. The actual loss suffered may be a genuine pre-estimate at the time of making the contract, but may nonetheless turn out to be less or even non-existent at the time of breach. The existing law may be criticised when it upholds the entitlement of the injured party to the agreed sum in such circumstances. Under the new approach the court will allow the recovery of the amount payable under penalty clause and should not intervene to reduce that amount unless it is manifestly disproportionate to the actual loss as opposed to being compared with the pre-estimate of the likely loss under the current law as to penalties.

4- The new approach will create more certainty for the injured party. It should be noted that the agreement on damages in advance allows parties to determine their rights and liabilities in the event of breach. In making such agreement the parties avoid the uncertainties that arise when the matter comes to the court in order to determine the consequences of breach. It avoids any difficulties of proof inherent in judicial assessment of the loss arising out of breach by providing for a sum of money to be payable in that event. This goal is effectively achieved when applying the New Approach. In contrast the current rule against penalties renders futile any certainty that the agreement on damages beforehand may create.

In application of the current penalty rule the defaulting party can readily escape from performing his contractual obligations by resorting to the court where it is likely that the court will strike the penalty clause down when its amount is disproportionately high leaving the injured party to prove the loss he has suffered. This is to say that despite its very long history there remains considerable uncertainty in the law sufficient to make it worthwhile for the defaulting party to challenge the agreement in order to avoid his contractual obligations. However, in the New Approach the defaulting party knows that he may not get rid of his liability if the matter comes before the court as the best he can hope for is to reduce the amount of penalty<sup>993</sup> should he be able to prove that it is manifestly disproportionate to actual loss. In other words, if the defaulting party envisages that he still has the opportunity to escape from the penal sum by resorting to the courts, in the event of reduction, the injured party is sure that the court will hold that he is entitled of that sum<sup>994</sup>. In contrast the current penalty rule gives the defaulting party assurance that the agreed damages clause will be held as invalid when it is a penalty, leaving the position of the injured party full of uncertainties, in proving the loss sustained and going through a judicial process to receive his unliquidated damages. This costs both money and time.

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<sup>993</sup> To be in line with actual loss suffered.

<sup>994</sup> This position would be fairer as the agreed damages clause is always inserted in the contract in favour of the injured party as a protection against the losses he might suffer on breach.

5- Under the current English law treating a penalty clause as unenforceable may serve as a penalty in reverse. This is particularly illustrated in the situation where the injured party has paid a higher price to insert an extravagant penalty. Such a penalty is unenforceable according to the current English law. This means that the defaulting party will have profited from gaining a higher price for providing illusive insurance in the shape of an unenforceable agreed damages clause. This result will be avoided under the New Approach as the court will have the power to enforce the agreed damages clause if it is satisfied that in the circumstances of the case it is reasonable to award the amount agreed upon. (for details please see page 29-31)

6- The existing the distinction between termination upon breach and the hirer using his option, is illogical and unjust. The whole debate in chapter three showed the need to extend the application of penalty jurisdiction to the case where the hirer himself rescinds the hiring agreement. Under the New Approach the penalty jurisdiction will be applicable in case of breach, liquidation or death of the hirer and where he uses his option to terminate the contract.

7- The enforcement of stipulated damages simplifies efficient breach since the promisor, knows more precisely the amount of damages that he has to pay to the promisee in case of breach and so more easily determine if he would be better off after breach<sup>995</sup>.

8 Upholding the New Approach will like the present law deter a promisee from trying to induce a breach of the contract by a promisor. This is because he understands that he will not obtain the whole agreed amount when it is manifestly higher than his actual loss sustained as a result of breach. Rather he will be confined to his actual loss.

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<sup>995</sup> Hatzis, Aristides. "Having the Cake and Eating it Too: Efficient Penalty Clauses in Common and Civil Contract Law". *International Review of Law and Economics*. (2003) 22 381, at 391.

### 3- Outline of the suggestions

It would be preferable that the law in relation to penalty clause should be amended as follows:

- 1- Contracting parties may provide in their contract for the amount of damages to be payable by a party who fails to perform.
- 2- It is presumed that this clause should be enforceable by the court and therefore no larger or smaller amount of money may be awarded to the injured party.
- 3- The courts should continue to have a control over the penalty clause to modify its amount to be compatible to actual loss according to the following:
  - (a) Courts may, upon the request of defaulting party, reduce the amount recoverable under the clause when it is manifestly disproportionate to the loss that he has actually suffered. Thus there should not be judicial control over a penalty clause when its amount is merely more than and not manifestly disproportionate to the actual loss.
  - (b) Courts may, upon the request of injured party, increase the amount of penalty in a narrowly limited case<sup>996</sup>, i.e when it is manifestly less than actual loss sustained provided that the clause was not freely negotiated.
  - (c) Any agreement to the contrary should be void.
- 4- The courts power over penalty clauses should not be confined to cases where there has been a breach of contract. It should be extended to the cases where the contract is terminated early as a result of exercising an option under a contract and in the event of liquidation or death of the promisor (the hirer).
- 5- The above rules should be applied to the money already paid either by way of deposit or instalment.
- 6- The above rules should be applied to an acceleration clause if the sum payable is more than the principal sum and interest earned to date, i.e where there is no proper discount for undue interest or financing charge.

The law relating to penalties and liquidated damages is both complex and controversial. It is hoped that if the above suggestions are adopted that the law would be simplified, made more coherent and transparent and thereby improved.

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<sup>996</sup> And according to the limitations pointed out when this case was discussed in this research. Supra. P 187.

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