

## Rule against penalties: State of the law in Singapore

It has been just over two years since the UK Supreme Court reformulated the penalty rule in *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Limited v Beavis* [2015] UKSC 67. This alert looks at the application of *Cavendish Square* in practice and considers the state of the law in Singapore after the recent Singapore High Court decision of *Hon Chin Kong v Yip Fook Mun* [2017] SGHC 286.

### ***Cavendish Square* – a recap**

After a comprehensive review of the contractual penalty rule, the UK Supreme Court in *Cavendish Square* reformulated the approach to penalty clauses as follows:

- > The penalty rule applies only to secondary obligations, i.e. obligations triggered by a breach of contract. The rule does not apply to primary obligations.
- > If the penalty rule applies, we have to then consider whether the consequence of a breach is out of all proportion or “unconscionable” or “extravagant” having regard to the legitimate interests of the innocent party.

The reformulated rule is a departure from the traditional test in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 which focused on a narrow assessment of whether the impugned provision was a genuine pre-estimate of loss.

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## Cavendish Square – in practice

Three Singapore High Court decisions have considered the *Cavendish Square* test:

- > *iTronic Holdings Pte Ltd v Tan Swee Leon* [2016] SGHC 77. Please refer to our [client alert](#) on *iTronic*.
- > *Allplus Holdings Pte Ltd v Phoon Wui Nyen* [2016] SGHC 144. This case concerned a settlement agreement entered into in relation to legal proceedings where the Plaintiffs sued the Defendant for repayment of a loan of S\$2.5 million. The court had to consider the following key provisions of the settlement agreement:

Clause 1: *The Defendant shall pay the sum of S\$1 million (the "Settlement Sum") to the Plaintiffs as follows: (a) S\$500,000 by way of a cheque dated 23 June 2014; and (b) S\$500,000 by way of a cheque dated 5 June 2015.*

Clause 4: *In the event the Settlement Sum or any part thereof is not paid on or before the date stipulated in clause 1, the Settlement Sum shall be increased to the sum of S\$2.5 million along with interest accrued thereon at 12% per annum from 20 August 2008 to date of full payment.*

The court decided as follows:

- > Applying *Cavendish Square*, the court held that clause 1 was a primary obligation and clause 4, which stipulated the consequence of breach of clause 1, was in a substance a secondary obligation. Therefore, the penalty rule kicked in and the court had to consider whether clause 4 was a legitimate liquidated damages clause.
- > The court found that the genuine pre-estimate of loss test in *Dunlop* was still applicable in a straightforward damages clause such as clause 4. A genuine pre-estimate of the Plaintiffs' loss for breach of clause 1 would be interest at the prevailing rate on the sum that was not paid on time and not the sum claimed on the action which was settled.
- > The court held that it would have also struck down clause 4 on the basis that the increase in the settlement sum from S\$1 million to S\$2.5 million with backdated interest at 12% pa was simply out of all proportion to the Plaintiffs' legitimate interest in the enforcement of the primary obligation of timely payment in clause 1. The sum was exorbitant and unconscionable.
- > The Plaintiffs tried to argue that the settlement agreement was heavily negotiated and that the Defendant had legal representation. The court held that while such facts can rise to a strong initial presumption that the parties are the best judges of what is legitimate in a provision dealing with the consequences of breach, such a presumption was rebutted on the facts.

- > *CIFG Special Assets Capital I Ltd v Polimet Pte Ltd* [2017] SGHC 22. The court considered whether a default interest provision was unenforceable as a penalty. The judge referred to *Cavendish Square* and *iTronic* and upheld the provision. The judge found that the provision was not extravagant or unconscionable. There is a strong initial presumption that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach in a negotiated contract between properly advised parties of comparable bargaining power.

The three cases, although not expressly rejecting the genuine pre-estimate of loss test as set out in *Dunlop*, have applied the *Cavendish Square* test.

### ***Hon Chin Kong* – back to square one?**

In *Hon Chin Kong*, the Singapore High Court, without referring to any of the three cases above, took the position that the *Dunlop* test continues to be law in Singapore and that the *Cavendish Square* reformulation of the penalty rule is not part of the law in Singapore.

Notwithstanding *Hon Chin Kong*, we submit that while the *Dunlop* test is useful when considering the validity of a straightforward liquidated damages clause, there is no reason why the *Cavendish Square* test should not be used in Singapore in more complex cases where the clause aims to protect interests of the innocent party that are not confined to financial compensation. Three Singapore High Court decisions, for some reason not alluded to in *Hon Chin Kong*, have already taken this sensible and pragmatic approach.

We submit that the decision in *Hon Chin Kong* should be limited to the question whether the penalty rule applies to the forfeiture of true deposits. The court held that it did not. The penalty rule only applies to a liquidated damages clause as such a clause is compensatory and remedial in the sense that it seeks to predetermine the damages to be paid in the event of breach. On the other hand, a true deposit is not to compensate for breach but serves to sieve out frivolous or fickle counterparties. There is nothing unconscionable about forfeiting a true deposit upon breach, notwithstanding its disproportion to the innocent party's loss. The depositor's only remedy is to invoke the court's equitable jurisdiction to provide relief against forfeiture (a remedy not easily obtained).

## State of the law

While we await a Singapore Court of Appeal decision which addresses the above issues, here is our reflection on the state of the law in Singapore:

- > Three Singapore High Court decisions have already applied the *Cavendish Square* test. They support the view that it may not be appropriate in all cases to just focus on whether a clause gives a genuine pre-estimate of the loss suffered by the innocent party. In the context of M&A and joint venture transactions, where investments are typically long term and complex, such an assessment is often difficult to make. The *Cavendish Square* test reflects the new reality of commercial transactions.
- > *Hon Chin Kong* can be distinguished from the earlier High Court decisions as it was concerned with a deposit provision. Its authority is limited to the proposition that the penalty rule does not apply to the forfeiture of true deposits.
- > According to *Hon Chin Kong*, whether a sum is a true deposit depends on whether the sum is reasonable as an earnest or is customary or moderate. The focus is on whether the deposit is so large that it cannot be objectively justified by reference to the functions which such a deposit properly serves. In the *Cavendish Square* test, a sum which is out of all proportion to the legitimate interest served by a payment would constitute a penalty. In practice, the two tests may ultimately give rise to the same outcome.

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