

# P. ● ● Penalty Clauses

Broadly, a penalty clause is a clause in a contract which seeks to penalise a defaulting party for a contractual breach, where the penalty applied is significantly in excess of the actual loss caused as a result of the breach. Penalties are usually (although not always) financial in nature.

Penalty clauses are unenforceable beyond the actual loss suffered by the non-defaulting party, and are therefore to be avoided when drafting a contract. This can be a challenge as pre-agreed remedies for breach of contract (e.g. clauses which set out a monetary sum as damages for breach of contract) are a popular means by which contracting parties manage risk. Care needs to be taken that any such pre-agreed remedy is not, in fact, a penalty.

The law on penalty clauses has recently been clarified. A court will generally presume that in a contract which has been negotiated between two properly advised parties, the parties themselves are best placed to decide what constitutes a legitimate pre-agreed remedy for a contractual breach. However, just because the parties agree to a clause in a contract does not automatically mean the clause is not penal. Instead, a clause may be viewed by a court as an unenforceable penalty clause if, despite the parties agreeing to its inclusion in a contract, the clause is not justified. This may be where the relevant clause does not seek to protect a legitimate interest of the party relying upon it and/or provides a remedy which is out of proportion to the breach it seeks to protect.

It is easiest to view what this means in practice through the use of an example. The following is a basic liquidated damages provision from a contract for the supply of goods:

*"In the event of late delivery of the Goods, the Supplier shall pay, by way of liquidated damages, a sum equal to 5% of the total value of the relevant purchase order under which the Goods have been ordered for each week that delivery of the Goods is delayed beyond the agreed delivery date."*

To avoid this clause being considered a penalty, English law requires that the liquidated damages sum should be justified as a means of protecting the legitimate interests of the party seeking to rely on it – in this instance, this could be that the damages sum represents a genuine pre-estimate of the loss that the procuring party would suffer as a result of a delay in delivery, or it might be that there is some other commercial reason as to why such sums are relevant (e.g. perhaps the goods form a crucial part of a wider business-critical process and the procuring party needs to protect against late delivery as a result). In addition, the damages sum should not be out of proportion to the actual loss of the procuring party – this will depend on the circumstances, but in a situation where the goods supplied are business critical, it may be that a higher percentage is perfectly justified as the loss from late delivery might be particularly high.

Whether a clause is a penalty clause will depend on the facts and there are a number of nuances to the rule which mean that care should be taken when drafting any pre-agreed remedies for breach of a contract.

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