MEMORANDUM

From: Alexandros Economou, Chryso Antoniou

Date: February 2016 (updated March 2019)

Subject: The law against penalties in Cyprus as against the UK's revised law

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Introduction

The Contract Law, Cap. 149 (the "**Law**"), regulates the contract relations between parties in Cyprus since 1960 and it is identical to the Indian Contract Act 1872; essentially it reproduces the English applicable contract law principles as at 1960. While Cyprus in other aspects has begun to introduce its own legal principles (largely based on English law), the Law, including the law against penalties, remains almost unchanged since its adoption in 1960. The little development occurred in respect of penalties is limited to case law, where the Cypriot courts invoked relevant English case law.

Penalty and Liquidated Damages Clauses under Cyprus law

Under the Law

Section 74 (1) of the Law states that:

"when a contract has been broken, if a sum named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for. A stipulation for increased interest from the date of default may be a stipulation by way of penalty".

Under Case Law

Cyprus case law defined penalty clauses as a contractual term which seeks to intimidate through a stipulated amount of compensation which has to be paid in case of non-compliance with contractual obligations. It may take the form of a promise made by one contractual party to the other that in case that it does not fulfil or does not fulfil properly their contractual obligations will then be required to pay to the other (innocent) party, a particular amount of money, in the form of punishment.

Otherwise, a clause is held to be liquidated damages if it provides for a predetermined amount of damages that can be awarded to the innocent party upon breach of the contract and constitutes a genuine pre-estimate of loss. These clauses are absolutely valid and enforceable. The rule only

applies where there has been an actual breach of contract and will not be relevant if the trigger event is not a breach.

It is settled case law that although sometimes the word 'penalty' is used in an agreement, the court may decide that the amount constitutes damages instead. The same is the case when an agreement contains the word 'damages' but the court may rule that in essence it is penalty. Consequently, the language is not the decisive factor but rather the intention of the parties is.

The following rules were applied by Cypriot courts by invoking the well-established English case *Dunlop* (below) in order to provide the test between the distinction of the penalty and the liquidated damages clauses:

(a) If the amount is regarded as too excessive and irrational in relation to the maximum amount of damage that may result this will amount into a penalty.

(b) If the amount specified in an agreement is related to the non-payment of a specified amount and the agreed amount is greater than the amount which was supposed to be paid, then that amount is a penalty.

(c) If there is the same agreed amount which will be payable in the case of a violation of one and/ or more and/or all violations occur of which some are substantial and some minor, this amount will be regarded as penalty.

(d) When a contract contains more than one term and the amount of damages that may result from the violation of each term cannot be estimated, then the amount which is decided will be regarded as special damages. Still, it will be a penalty if it is too excessive and irrational.

(e) The question whether a stipulated sum is penalty or liquidated damages is a question of construction of the clause and is 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 and not as the time of the breach.

It follows from the above that the pre-estimate of the loss in case of breach of contract is not binding. It only delimitates the amount of the compensation that can be awarded. Whether a clause is liquidated damages or penalty, the court in either case is precluded from awarding damages beyond and in excess of the amount named in the contract. In Cyprus the distinction between the two types of clauses has no essential value as the court maintains in both circumstances its discretion to award reasonable compensation which can be lowered but in any case cannot exceed the amount designated in the contract. The above constitutes the substantial difference between (the previous) English and Cyprus law. In this way, Cyprus law gets rid of the tendency and confusion that (previous) English case law brought, by treating the penalty and liquidated damages clauses equally.

Penalty and Liquidated Damages Clauses under English law

Previous Position - the Dunlop test

The general understanding on the law against penalties derived from the English case *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79. The main principles of

the Dunlop Case are as illustrated above without considerable changes in both English and Cyprus law.

However, as stated above, English and Cyprus law differentiated in terms of damages. If an English court concluded that a clause in question was not a penalty clause and therefore valid it would give full effect to the provisions of the clause which meant that the innocent party would be relieved from the burden to prove its actual loss in order to recover any damages and it would simply recover the amount provided by the clause irrespective of the fact that its actual loss was less or more.

The *Dunlop* principles brought about much uncertainty when the courts started emphasising on the overall commercial purpose of a clause. Especially in respect of complex commercial contracts stipulated between sophisticated parties, the classification of a clause could not be easily appreciated by the commercial parties. The risk involved in such contracts led the drafters to carry out great efforts to balance the strong remedies against defaulting parties and the need to ensure provisions are enforceable. The then upcoming decision of the Supreme Court of the UK brought some hope to these parties that the law against penalties may be revoked.

Current Position under Cavendish test

The Supreme Court of the UK in *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 refused to abolish the rule against penalties and instead provided clarifications as to the circumstances in which the law on penalties will apply, and thus in which cases a clause will be unenforceable. The true test was held to be:

> "whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance".

As an illustration, the following points were applied by the court in order to determine whether a clause is a penalty:

(a) The penalty rule applies only to secondary obligations, which seek solely to define the measure of compensation payable by a party in the event of breach of a primary obligation. Simply because a term only becomes effective upon breach of another obligation does not mean that it is a secondary obligation. A clause might be a "conditional primary obligation" which it simply provides that if a party does not perform, he will pay the other party a specified sum. In this case, there is no obligation to perform the act. For instance, in *Cavendish* case, the relevant clauses were held to be primary obligations and thus the rule against penalties did not apply.

(b) The test whether a stipulated remedy represents a "genuine pre-estimate of damage" is not enough. Simply punishing the defaulting party is not to be regarded as a legitimate commercial purpose. The court must assess whether the innocent party's legitimate interest in performance of the contract goes beyond payment of damages. For instance, in *ParkingEye Limited v Beavis* [2015] UKSC 67, a charge of £85 in case of exceeding the time limit of two hours in the car park was not extravagant and justified a legitimate interest by ParkingEye Limited. They had to ensure the efficient use of parking spaces in the car park, the respect of

parking rights by customers and to ensure a good turnover of customers in the retail outlets. The approach taken of charging those who overstayed was common practice in the UK.

(c) If the clause is exorbitant or unconscionable in comparison with the legitimate interest pursued, then it will be held to be unenforceable as a penalty clause.

(d) There is a strong presumption that where a contract is negotiated between properly advised parties of comparable bargaining power, 'the parties themselves are the best judges of what is a legitimate provision dealing with the consequences of breach'.

This judgment gives more discretion to commercial parties negotiating contracts to decide what the consequence of the breach should be and more certainty in terms of enforceability. The flexibility of this test gives more freedom to the parties to set out the consequences of a breach without the need to adjust the remedy in order to be a genuine pre-estimate of the loss. In addition, the parties are in a much more comforting position when structuring a clause which stipulates compliance as a condition which must be met in order for a payment to be made (primary obligation) rather than withholding of the payment being a consequence of a breach of an obligation (secondary obligation). Henceforth, it will be more difficult for the parties to argue that a clause is penalty.

Impact of UK changes in Cyprus

In December 2018, a decision was issued by the District Court of Nicosia in respect of the law on penalties based on the rules of *Cavendish.* Specifically, the Court, citing *Cavendish*, held that the essential criterion is that the liquidated damages clause must not be disproportionate to the purpose of protecting the rights of the innocent party. It would be regarded as disproportionate if it is extravagant, unconscionable or incommensurate to the purpose of protecting the legitimate interests of the innocent party. As a result, it was concluded that the clause of the loan agreement in question imposing 10% default interest was a penalty since it was disproportionate to the purpose of protecting the legitimate interests of the bank.

Unless and until the Supreme Court of Cyprus repeals the said judgement or another one in the same point, we may safely assume that Cyprus law now applies the rules of *Cavendish* instead those of *Dunlop*.

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