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Published in:
European Review of Private Law

Publication status and date:
Published: 01/01/2017

Document Version
Publisher's PDF, also known as Version of record

Citation for the published version (APA):
Schelhaas, H. (2017). The UK Supreme Court Cases on Penalty Clause Cases from a Dutch Perspective. *European Review of Private Law*, *2017*(1), 209-218. http://hdl.handle.net/1765/106668

European Review of Private Law 1-2017 [209–218] © 2017 Kluwer Law International BV, The Netherlands.

The UK Supreme Court Cases on Penalty Clause Cases from a Dutch Perspective

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1. Introduction

The two recent UK Supreme Court decisions on penalty clauses attracted a great deal of attention in both the English and international legal press. This is understandable given the fact that the UK Supreme Court introduced a new test that made the law on penalties simpler and less controversial than it had been in the past. These decisions are remarkable given that Lord Dunedin's old and controversial penalty test seems to have been abandoned. It is no longer necessary to assess whether the agreed amount is a genuine pre-estimate of the loss but it must be determined whether the clause is out of all proportion to any legitimate interest of the innocent party. These two decisions made it clear that freedom of contract has become more important with regard to the control of penalty clauses under UK law.

If it had been the Dutch Supreme Court that had to decide on the legal issues of both cases, Dutch legal doctrine would not have regarded the outcomes of both cases as remarkable. This is due to the fact that Dutch law takes a different approach to the definition of a penalty clause and to the legal consequences of unfair penalty or liquidated damages clauses. Before discussing both cases from a Dutch perspective, I will provide a brief overview of the Dutch law on penalty clauses.

2. The Dutch Approach to Penalty Clauses

Historically, agreed payments for non-performance have two functions: to assess in advance the likely loss suffered as a consequence of non-performance; and/or to serve, by way of contractual punishment, to coerce the non-performing party to perform his obligations by imposing a very high payment obligation in case of non-performance.[1] However, Dutch law generally accepts penalty clauses irrespective of its function. A distinction between penalty clauses and liquidated damages clauses is legally irrelevant and is therefore not being made; the concept of penalty clauses ('*boetebeding*') refers to both.[2] See Article 6:91 Dutch Civil Code ('DCC'):

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1 See for instance R. Zimmermann, *The Law of Obligations – Roman Foundations of the Civilian Tradition* (Oxford: OUP, 2nd edn 1996), p 95.

2 Herein, the common term 'penalty clause' or 'contractual penalty' refers in relation to Dutch law to agreed payment clauses in general; that is, the English legal concepts penalty clauses *and* liquidated damages clauses.

> *Any stipulation which provides that a debtor, should he fail in the performance of his obligation, must pay a sum of money or perform another prestation, is considered to be a penalty clause, irrespective of whether this is to repair damage or only to induce performance.*

By generally acknowledging the validity of both functions of the penalty clause, Dutch law essentially observes the principle of freedom of contract. However, Dutch law also acknowledges that penalty clauses may have unfair consequences. However, in contrast to English law, the unfairness of a penalty clause is no obstacle to its enforcement, but the agreed payment may be modified by the court if equity clearly requires it to do so. The court may not reduce or supplement the contractual penalty *ex officio* but only upon demand of the debtor. This judicial authority to modify penalty and liquidated damages clauses is formulated as follows (Art. 6:94 DCC):

> *1. The court may reduce the stipulated penalty upon demand of the debtor if it is evident that equity so requires; the court, however, may not award the creditor less than the reparation of damage due by law for failure in the performance of the obligation.*
> *2. The court may award supplementary compensation upon the demand of the creditor if it is evident that equity so requires, this compensation is in addition to the stipulated penalty intended to replace reparation due by law.*
> *3. Stipulations derogating from paragraph 1 are null.*

According to the explanatory notes to this article, a court should be reluctant to exercise its authority to modify a contractual penalty; the judicial authority to reduce or supplement contractual penalties should only be used in exceptional circumstances.[3] In deciding whether or not to reduce or supplement contractual penalties, all relevant circumstances may be taken into account, including the amount of actual damages. The time of reference is *ex post*, which means that a court may consider circumstances that occur after the non-performance. Article 6:94 DCC makes it clear that the court is not only authorized to reduce contractual penalties, but is also allowed to supplement them. This is a consequence of the provision that, as a starting point, the contractual penalty replaces the statutory

3 A.S. Hartkamp & C.H. Sieburgh, *Mr. C. Asser's Handleiding tot de beoefening van het Nederlands burgerlijk recht. 6. Verbintenissenrecht - deel I, De verbintenis in het algemeen, eerste gedeelte* (Deventer: Kluwer, 15th edn 2016), no. 423; H.N. Schelhaas, *Het boetebeding in het Europese contractenrecht* (Deventer: Kluwer 2004), p 80 ff and also Dutch Supreme Court 27 April 2007, ECLI:NL:HR:2007:AZ6638, *NJ* ('*Nederlandse Jurisprudentie*') 2007, 262 (Intrahof/Bart Smit).

damages unless parties agree otherwise (Art. 6:92 (2) DCC).[4] This may result in a contractual penalty that is lower than the amount of damages to which a party would normally be entitled. In exceptional circumstances ('if equity so requires'), the court may award supplementary damages.

Under Dutch law, the contractual penalty not only replaces statutory damages unless parties agree otherwise, but also provides that a claimant may not generally demand both specific performance and payment of the contractual penalty. Article 6:92 (1) DCC stipulates that a party must choose between claiming specific performance of the primary obligation and the penalty. The provisions on the relation of penalty clauses and other remedies are supplementary and only apply if parties do not agree otherwise. Therefore, parties may agree that a party only relates to a delay in which case specific performance may be claimed, or that the claimant is entitled to both the penalty and statutory damages.[5]

Furthermore, Article 6:92 (3) DCC makes it clear that a contractual penalty may only be claimed if the non-performance can be imputed to the debtor. Article 6:93 DCC lays down that generally a default notice is necessary in order to demand payment. Again, both provisions contain supplementary law, so parties can make their own arrangements in this respect.[6]

In sum, the Dutch approach to penalty clauses can be summarized as follows. Under Dutch law, any stipulation as to agreed payment for non-performance is binding, irrespective of whether the penalty clause is intended to assess damages or to induce performance. The creditor is not obliged to prove that it has suffered any loss. The contractual penalty can be claimed when the amount of agreed damages exceeds the actual loss, or even when the creditor has not suffered any loss at all. However, in exceptional circumstances, the court has the power to modify contractual penalties.

In addition, if a penalty clause forms part of the general conditions and the debtor is a small-scale company or a consumer, the validity of a penalty clause has to be determined by virtue of Article 6:233 (a) DCC and can be annulled if it is unreasonably onerous to the other party. In a B2B transaction, both legal grounds (reduction of a penalty clause under Art. 6:94 DCC and the invalidity under 6:233 (a) DCC) can be invoked. However, if the non-performing party is a consumer and the transaction falls within the scope of the European Directive on Unfair Terms in

4 However, parties may derogate from this general rule and, for instance, provide that the contractual penalty is only a minimum or can be claimed irrespective of a claim for statutory damages: see Art. 6:92 (1) DCC. See A.S. Hartkamp & C.H. Sieburgh, *De verbintenis in het algemeen (6-I),* no. 423.

5 A.S. Hartkamp & C.H. Sieburgh, *De verbintenis in het algemeen (6-I),* no. 420–423.

6 H.N. Schelhaas, *Het boetebeding in het Europese contractenrecht (2004)*, pp 264–273.

Consumer Transactions, the court may not resort to the reduction of a penalty clause, but must first test whether the clause is unfair.[7]

It is against this background that both UK Supreme Court cases will be discussed from a Dutch perspective.

3. The Scope of the Rules on Penalty Clauses

In *Cavendish* v. *Makdessi*, the Supreme Court defined the rule on penalty clauses. Makdessi sold a controlling stake in his company to Cavendish. The sale contract included a restrictive duty against competing activities. Breach of that duty entitled Cavendish to (1) withhold the final two instalments of the purchase price, and (2) acquire Makdessi's remaining stake in the company at a reduced price. The first question that arose was whether these clauses had to be regarded as penalty clauses. The Supreme Court decided that the true test for a penalty clause is:

> *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.*[8]

Therefore, the penalty rule only applies to secondary obligations triggered by breach of contract.

Under Dutch law, a clause qualifies as a penalty clause as soon as it provides that a debtor must pay a sum of money or deliver another kind of performance in case of breach of contract (see the definition in Art. 6:91 DCC). This definition has two consequences in relation to the *Cavendish* v. *Makdessi* case.

First, it is not relevant whether a clause obliges one party to pay a sum of money or deliver something else in case of non-performance: both clauses qualify as penalty clauses. However, a clause that results in the withholding of sums that already have been paid does not qualify as a penalty clause in the sense of Article 6:91 DCC because it does not oblige a party to actively deliver a new performance. Dutch legal literature has criticized the fact that a penalty clause must result in a new performance rather than a forfeiture of money that has already been paid. It has been argued that if a non-performance triggers the payment or forfeiture of the sum of money, both clauses essentially have the same result: the debtor loses a sum of money that is fixed in advance.[9] However, the parliamentary explanatory notes to

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7 ECJ 30 May 2013, C-488/11, ECLI:EU:C:2013:341 (*Asbeek Brusse* v. *Johani*). See in more detail: para. 4 below.

8 UKSC 4 November 2015, *Cavendish Square Holdings BV* v. *Makdessi; ParkingEye Ltd* v. *Beavis* http://www.bailii.org/uk/cases/UKSC/2015/67.html at para. 32.

9 A.S. Hartkamp & C.H. Sieburgh, *De verbintenis in het algemeen (6-I)*, no. 416; H.N. Schelhaas, *Het boetebeding in het Europese contractenrecht (2004)*, pp 356-358.

Article 6:91 DCC are clear on this issue[10] and the Dutch Supreme court did not decide otherwise. This means that in Dutch law the clause in the *Cavendish* v. *Makdessi* case, as far as this entitled Cavendish to withhold the final two instalments of the purchase price, does not qualify as a penalty clause. However, this does not mean that the court is prevented from control on these kind of clauses. If applying the clause would be unacceptable according to standards of reasonableness and fairness, the clause cannot be invoked (Art. 6:248 (2) DCC) either in whole or in part. This may result in a reduction of the forfeited sum of money. Therefore, the qualification of a clause as a penalty clause is not as important as it is under English law.

The second consequence is that Makdessi's obligation to sell the remaining stake in the company at a reduced price is most likely regarded as a penalty clause under Dutch law. It obliges the debtor to do something other than pay a sum of money in case of a non-performance, and therefore falls within the scope of the definition of Article 6:91 DCC. The requested performance is detrimental to the debtor: the price to be paid for the remaining stocks is reduced and does not contain a compensation for goodwill and is therefore not 'at arm's length'. The fact that this performance does not consist of performing a sum of money is irrelevant; therefore, this detrimental performance qualifies as a penalty clause.[11] However, it should be noted that the trigger for defining a clause as a penalty clause is the non-performance. If parties draft their contractual duties differently and, for instance, stipulate that the debtor has an option to pay a sum of money or do something other than perform the duty not to compete, so that the creditor cannot force the debtor to comply with its obligations, the clause will not be regarded as a true penalty clause, However, analogous application of the provisions on penalty clauses is possible.[12] Likewise, if the contract is drafted in a way that the obligation not to compete is not a legal enforceable obligation (for instance, 'if the debtor competes, the price will be adjusted'), the clause is not a penalty since it is not triggered by a non-performance.

4. How to Control Penalty Clauses?

4.1 General

In *Beavis* v. *ParkingEye*, regarding a parking fee of approximately EUR 100 charged by ParkingEye to Beavis, it was beyond doubt that the law on penalties was applicable. The same conclusion would have been drawn under Dutch law.

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10 Parliamentary History of Book 6 DCC, p 321.

11 See also comment 7 (Dutch Law) to Art. 9:509 PECL, in: D. Busch, E.H. Hondius, H.J van Kooten, H.N. Schelhaas & W.M. Schrama (eds), *The Principles of European Contract Law and Dutch Law – A Commentary* (Nijmegen: Ars Aequi Libri 2002), p 431.

12 Parliamentary History Book 6 DCC, p 321.

Payment of a fee for non-compliance with an obligation to remove your vehicle within two hours after entrance of a car park undoubtedly falls within the scope of Article 6:91 DCC. More interesting was the question of whether the clause amounted to a penalty. According to the UK Supreme Court, it did not; among the reasons for this decision were that (1) the charge was prominently displayed in large letters at the entrance to the car park and at frequent intervals within it, (2) ParkingEye had a legitimate interest to charge the fee, (3) the fee was not exorbitant and unconscionable given the objectives of the charge (that is, facilitating the efficient use of parking spaces and providing an income stream to meet the costs and make a profit). Therefore, the penalty clause was enforceable in full. Furthermore, the clause was not regarded as unfair under the Unfair Terms in Consumer Contracts Regulations 1999.

Dutch law recognizes two specific possibilities to control penalty clauses in general conditions.[13] If the non-performing party is a consumer, it must be assessed whether the penalty clause was unreasonable onerous at the time of contracting. As will be discussed later, the possibility to reduce a penalty clause (Art. 6:94 DCC: see above) only applies here if circumstances arising after concluding the contract trigger the unfairness of the penalty clause. In B2B relations the non-performing party may choose the legal ground for attacking penalty clauses, unless the non-performing party is a large-sized company: in this case only Article 6:94 DCC applies.

I will first discuss the test for unfair general conditions, and then discuss the specific possibility to reduce penalty clauses.

4.2 Unfair General Term Against Consumers

Under influence of the Directive 93/12 on Unfair Terms in Consumer Transactions, the Dutch court may not resort the specific mechanism to reduce contractual penalties, but must first assess whether a penalty clause is unfair. This follows from ECJ 30 May 2013, C-488/11, ECLI:EU:C:2013:341 (*Asbeek Brusse* v. *Johani*) where the Court of Appeal in Arnhem asked the European Court of Justice:

> *whether Article 6 of the directive can be interpreted as meaning that it allows a national court, in the case where it has established that a penalty clause is unfair, instead of disapplying that clause, merely to mitigate the amount of the penalty provided for by that clause, as it is authorised to do by the national law and as the consumer has requested.*

13 In addition, in all cases the general principle of reasonableness and fairness of Art. 6:248 (2) DCC serves as a last resort. This general control mechanism, which applies to all contracts, will not be discussed here.

The European Court of Justice answered in the negative:

> *It follows that Article 6(1) of the directive cannot be interpreted as allowing the national court, in the case where it establishes that a penalty clause in a contract concluded between a seller or supplier and a consumer is unfair, to reduce the amount of the penalty imposed on the consumer instead of excluding the application of that clause in its entirety with regard to that consumer.*

The European Court of Justice's underlying reasoning is that reducing the penalty clause rather than excluding the application of the clause altogether undermines the *effet utile* of the directive. Moreover, the fact that a reduction of penalty clauses under Article 6:94 DCC requires a request by the non-performing party is not compatible with the European principle that national courts have to assess *ex officio* whether a clause is unfair or not.[14]

A decision on the question whether a clause is onerous depends on the circumstances of the case, which makes it difficult to predict with certainty what a court would decide in the Beavis v ParkingEye case. However, there are good reasons to believe that a Dutch court would decide that the parking fee was *not* onerous. First, the text of Article 6:233 sub a DCC accepts that based on facts and circumstances at the time of contracting the following factors should be taken into consideration: (1) the nature and the further content of the contract, (2) the manner in which the conditions have arisen, (3) the mutually apparent interests of the parties, and (4) other circumstances of the case. Like the UK Supreme Court, a Dutch court would also take into consideration the legitimate interest of ParkingEye, the fact that the charge was prominently displayed in large letters and the fact that EUR 100 does not seem to be exorbitant. Case law of the European Court of Justice makes it clear that it is the national court and not the European court that must decide whether a clause is onerous or not.[15]

4.3 Enforceable Penalty Clause v. Moderation by a Court

If the Directive on Unfair Terms in Consumer Transaction is not applicable, or if the non-performing party relies on facts and circumstances *ex post* instead of at the

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14 See, for instance: ECJ 26 October 2006, C-168/05, ECLI:EU:C:2006:675 (Mostazo Claro); ECJ 4 June 2009, C-243/08, C-243/08, ECLI:EU:C:2009:350 (Pannon); ECJ 9 November 2010, C-137/08, ECLI:EU:C:2010:659 (VB Pénzügyi Lízing).

15 See the Pannon-case, ECJ 4 June 2009, C-243/08, ECLI:EU:C:2009:350: 'It is for the national court to determine whether a contractual term, such as that which is the subject-matter of the dispute in the main proceedings, satisfies the criteria to be categorized as unfair within the meaning of Article 3(1) of Directive 93/13.' See, however, the directions in the Aziz-case, ECJ 14 March 2013, Case C-415/11, ECLI:EU:C:2013:164. It falls beyond the scope of this case note to analyse whether this clause would have been declared unfair under the Aziz viewpoints.

conclusion of the contract[16] or if it is a large-sized company that attacks the penalty clause,[17] then Article 6:94 DCC is applicable and the penalty can be reduced on request of the debtor 'if it is evident that equity so requires'. The Dutch Supreme Court made it clear that this is a severe test that must be exercised with constraint also in relation to consumers.[18] Several relevant circumstance can be derived from case law, such as the degree of fault, the nature and seriousness of the foreseeable loss, the interests of the parties, and whether the clause was clear and explicitly brought to the attention of the parties.[19] Moreover, the difference between the actual loss and the fixed amount is relevant, but only if the penalty is extravagant and there is an enormous discrepancy with the actual damages.[20] Against this background, I consider it unlikely that a Dutch court would decide that the parking fee has to be reduced since 'equity requires so'. Again, it is relevant that ParkingEye has a legitimate interest to charge the fee, the charge was prominently displayed, and the charge is not excessive compared to a public parking fee (which amounts to approximately EUR 50 or more than EUR 300 in case of a wheel clamp).

However, if the Dutch court would decide that the criterion of Article 6:94 DCC has been met, the consequence is different than under English law: the penalty is still valid and enforceable, but the fee will only be reduced to a level that is still well above the damages (if any) ParkingEye suffered.[21]

5. Conclusions

As follows from the above, a Dutch court would have qualified the Cavendish payment obligations as a penalty clause. Moreover, a Dutch court would presumably have reached the same result as the English court in relation to Mr. Beavis' parking fee. This this leaves the question about the extent to which the English and Dutch method still differ. There are indeed some important differences.

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16 According to Art. 4 of the European directive, the 'the unfairness of a contractual term shall be assessed, taking into account the nature of the goods or services for which the contract was concluded and by referring, at the time of conclusion of the contract, to all the circumstances attending the conclusion of the contract and to all the other terms of the contract or of another contract on which it is dependent.' This leaves national mechanisms where facts and circumstances *ex post* are relevant fully applicable.

17 Art. 6:235 DCC excludes the control of onerous general conditions for legal persons who have published annual accounts or where 50 or more persons are employed.

18 Dutch Supreme Court 13 July 2012, ECLI:NL:HR:2012:BW4986, *NJ* ('*Nederlandse Jurisprudentie*') 2012/459.

19 See in more detail: H.N. Schelhaas, *Het boetebeding in het Europese contractenrecht (2004)*, p 85-102.

20 Dutch Supreme Court 11 February 2000, *NJ* ('*Nederlandse Jurisprudentie*') 2000, 277 (Kok/Schoor); Dutch Supreme Court 27 April 2007, ECLI:NL:HR:2007:AZ6638, *NJ* ('*Nederlandse Jurisprudentie*') 2007, 262 (Intrahof/Bart Smit).

21 See Art. 6:94 (1) DCC: the minimum is an amount that equals the damages due by law for non-performance.

First, if a penalty clause is included in general conditions and falls within the scope of the European Directive, Dutch law does not apply specific penalty clause rules but only assesses whether the clause is unfair and therefore invalid in the sense of the directive.

Second, the scope of the rules on penalty clauses differ. Under Dutch law, detrimental 'secondary' obligations that are triggered by non-performance are classified as penalty clauses, which means that they fall within the scope of Article 6:91 DCC and can therefore be modified by a court.

Third, Dutch law accepts, as a matter of principle, that penalties may have a deterrent and 'penalizing' character, and therefore probably accepts penalty clauses more easily than English law. This is demonstrated by the fact that Dutch courts must explicitly exercise restraint in applying the power to modify penalty clauses. Moreover, a *pure* penalty that allows the creditor to claim both the contractual penalty and statutory damages is perfectly valid under Dutch law.

Fourth, even though the criterion used by the UK Supreme Court ('out of all proportion to any legitimate interest of the innocent party') is now less strict than the Dunlop rules ('a genuine pre-estimate of loss'), it is still different than under Dutch law ('if equity requires so'). Even more importantly, the validity of the clause under English law has to be assessed as of the time when the parties agreed on the clause. Dutch law, by contrast, considers all facts and circumstances until the day of the judgment relevant. This means, for instance, that subsequent behaviour and the actual amount of damages are relevant factors under Dutch law.

Fifth, Dutch law is more flexible than the (new) English rules on penalty clauses. Under English law, it is decisive whether a clause is a penalty clause or not. If it is, it will be unenforceable in full. A Dutch court would only reduce a penalty and leaves the essence of the clause alive. Therefore, the English law still accepts the all-or-nothing approach under the old Dunlop case.

Put briefly, even though the UK Supreme court in the words of Giliker 'marks an important turning point in the treatment of penalty clauses in England and Wales',[22] there are still major differences between UK law and Dutch law.

22 See P. Giliker, in her case note on English law in this issue.