Published on *The National Law Review* https://natlawreview.com

Coronavirus and Contractual Penalties

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We recently considered the issue that the Coronavirus outbreak may result in an upsurge of force majeure related claims under commercial contracts.

A further risk now coming to light is customers seeking to enforce contractual fines, penalties, “service credits” or “liquidated damages” (collectively referred to for ease of reference as “Penalties” although all slightly different things from a strict legal perspective) in connection with supplier failure or delays arising from Coronavirus related issues.

As such, a reminder of the law in that area now also feels appropriate:

Enforceability of Penalties: where a contract provides that Party A will pay Party B £x if Party A commits a breach of a particular obligation, that payment will ultimately only be enforced by an English court if the amount in question bears some realistic resemblance to the actual loss and damage Party B might actually suffer as a result of that breach.

In plain English that means if a contract provides Party A will pay Party B £1m for any delay in delivery or performance (no matter how minor) then ultimately an English court would only enforce that payment if Party B could demonstrate it really has or would suffer loss or damage to that level; if in reality the actual loss or damage resulting from Party A’s breach would be significantly lower or nil then the £1m payment wouldn’t be enforceable.

This is because English contract law is primarily concerned with putting Party B in the position it would have been in but for the breach by Party A – unlike some other jurisdictions English contract law is not though concerned with punishing Party A simply for having committed a breach, particularly if the actual impact of that breach is minimal.

As such, whilst the temptation for a customer may be to specify high-value Penalties those should ultimately be considered a deterrent against poor performance rather than a guaranteed right (unless the risk really is that great). For a customer wanting a Penalty to stand the best chance of success if tested it should be set at a reasonable level which could be substantiated by the customer if required by examples of the sort of loss and damage the customer has actually incurred as a result of the breach in question.

That said, there is an increasing line of case law to suggest that where any Penalty has been

negotiated between two businesses and isn't manifestly excessive or unreasonable then the English courts will be minded to hold the Penalty enforceable. As such suppliers also need to exercise caution before accepting Penalties on the assumption that those would not be enforced if tested, particularly if the Penalty in question is on the face of it reasonable and/or in-line with any market norms (such as in the construction industry where such provisions are common in many standard form agreements).

Limiting liability by the back door: it is common in many industries such as IT for pro-supplier contracts to provide that any Penalty is the customer's only right/remedy should the breach in question occur.

In this case the Penalty shouldn't be viewed as means to compensate the customer for poor performance – in reality the Penalty is a way for that supplier to limit its liability by the back door, particularly if the value of the Penalty is low.

The sensible middle ground is often that any such Penalty is the customer's only right/remedy for minor "day to day" breaches but that the customer has the option to bring an additional damages claim and/or exercise termination rights for more serious incidents.

Alternatively, in such circumstances a customer may wish to consider removing the Penalty all together so that if a serious issue were to occur it has a full range of legal options available to it rather than those having been compromised by accepting the right to receive an occasional low value Penalty following a minor service issue.

Follow the process (1): related to the above issue is that many pro-supplier contracts will require customers to pro-actively submit claims for a Penalty within a very limited period following a breach, often following a specific process.

For customers wishing to claim a Penalty it is therefore important that any such process is followed. In any event it is good practice to submit claims as soon as possible as the longer those are left the greater the risk of a supplier then arguing the customer has left it too late to claim, particularly if there is evidence the customer was aware of its entitlement to that Penalty.

Follow the process (2): suppliers exposed to the risk of Penalties may be able to avoid liability by relying on any "force majeure" protection available under the terms of the relevant contract.

As noted in the previous post, whether such protection is available will very much depend on the precise detail of the contract in question and the supplier following any prescribed process or procedure for claiming relief.

Suppliers concerned about exposure to liability for Penalties should therefore be reviewing any relevant contracts sooner rather than later, following any prescribed process and should not wait until a claim for a Penalty is made before claiming force majeure relief.

The difference between a breach and a right: the above rules apply only where payment of a Penalty is triggered by a party committing a breach of its obligations, not where a party is simply exercising a contractual right.

By way of example, if a contract does not provide Party A with a right to terminate early for convenience but goes on to provide that if Party A nevertheless purports to do so a Penalty will be

due then the above rules will apply – payment of the Penalty is triggered by Party A doing something which it shouldn't or doesn't have the right to do under its contract.

However, if that contract grants Party A the right to terminate early for convenience subject to a payment of £x the above rules will not apply – in this scenario there is no breach or Penalty rather Party A is simply being required to pay an amount in order to exercise a contractual right in the same way it is obliged to pay the contractual price for the right to receive goods or services under its contract.

So dependent on which side of the table you are sat, when structuring a contract it should always be considered whether a Penalty really is required or whether a contractual right and payment approach may be a better option in the circumstances.

National Law Review, Volume X, Number 48