PENALTY CLAUSES

Overview

Freedom of contract is a fundamental principle of Singapore contract law. The Singapore courts generally uphold the freedom of parties to determine their respective contractual obligations. However, contractual freedom is not absolute and the courts will not enforce a contractual provision which is found to be a penalty clause pursuant to the rule against penalties. This is seen most recently in the Court of Appeal decision in *Ethoz Capital Ltd v Im8ex Pte Ltd and others* [2023] SGCA 3.

Briefly, in *Ethoz*, Ethoz Capital Ltd ("**Ethoz**") extended loan facilities to Im8ex Pte Ltd ("**Im8ex**") of a principal amount of $6.3 million at an interest rate of 3.75% per annum, with instalment payments to be made monthly over 180 months. Im8ex defaulted on payment and was subject to the payment of default interest of 0.0650% per day with monthly rests (the **"Default Interest**"), as well as the full and immediate payment of total interest due on the principal amount (that would otherwise have been payable only on instalment) (the "**Total Interest**").

Rule Against Penalties

What is a Penalty Clause?

The Court of Appeal reaffirmed the prevailing test in Singapore to determine if a provision is a penalty clause as set out in *Dunlop Pneumatic Tyre Co, Ltd v New Garage and Motor Co, Ltd* [1915] AC 79. Under the *Dunlop* test, a provision that requires the payment of money *in terrorem* of the defaulting party an unenforceable penalty clause. However, if it is a genuine pre-estimate of loss by the non-defaulting party at the time of contracting, it would be an enforceable liquidated damages clause.

In determining whether a clause is a penalty, the courts will consider the following:

(a) whether "the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach" (the "**Greatest Loss Test**");

(b) whether "the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid" (the "**Greater Sum Test**"); and

(c) whether "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage" (the "**Single Lump Sum Test**").

The approach by the Singapore courts in this regard departs from the English approach, under which a provision is a penalty if it imposes a detriment on the defaulting party "out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation". Such a "legitimate interest" may extend beyond compensation for breach of contract.[1]

Primary and Secondary Obligations

In applying the rule against penalties, a distinction is drawn between primary and secondary obligations. The penalty doctrine only applies where the defaulting party is subject to a secondary obligation to pay damages upon a breach of a primary obligation.[2] A primary obligation is the "essential purpose" of the contract, whereas a secondary obligation is "incidental" to the primary obligation. In this regard, the Court of Appeal in *Ethoz* stated that a "substance over form" approach will be adopted to determine if the true nature of a clause is obscured by "clever drafting" in order to circumvent the application of the rule against penalties. If such a clause is in substance a penalty, it would be struck down if it is found to be a penalty.

Under a "substance over form" approach, the courts will construe the clause in accordance with the parties' intentions in light of the following:

(a) the overall context in which the clause was agreed to;

(b) the reasons for the inclusion of the clause; and

(c) if the clause was entered into as part of the parties' primary obligations to secure an "independent commercial purpose or end", or if it was to hold the defaulting party *in terrorem* to secure his performance of its primary obligations.[3]

[1] *Cavendish Square Holding BV v Makdessi* [2016] AC 1172
[2] *Denka Advantech Pte Ltd v Seraya Energy Pte Ltd* [2021] 1 SLR 631
[3] *Leiman, Ricardo v Noble Resources Ltd* [2020] 2 SLR 386

Full and Immediate Payment of Interest

Notably, the Court in *Ethoz* stated that a primary obligation may become a secondary obligation where the performance of the primary obligation is "accelerated", depending on the nature and extent of the acceleration. On this basis, the Court held that the requirement to make full and immediate payment of the Total Interest was a secondary obligation as it was triggered only upon Im8ex's breach of its primary obligation to make due payment under the loan facilities. It found the relevant clause to be a penalty in accordance with the Single Lump Sum Test and the Greater Sum Test. Under the former, the Total Interest was found to be payable as a single lump sum upon 25 different events of default that varied in the degree of severity of losses to the non-defaulting party. Under the latter, the payment of Total Interest was found to be disproportionate to the amount of the potential defaults on the instalment payments. In contrast with the full and immediate payment of interest upon an event of default, payment of prepayment fees would fall outside the rule against penalties as it would not be triggered upon a breach of a primary obligation.

Default Interest

In accordance with the Greatest Loss Test, the Court also found the payment of Default Interest to be a penalty on the basis that there was an "extravagant increase" of almost 20% above the loan interest rate. Such an increase was not found to be a genuine pre-estimate of Ethoz's losses. It rejected Ethoz's argument that the Default Interest was in accordance with the maximum interest chargeable under the Moneylenders Rules 2009, which was irrelevant in the application of the rule against penalties.

Conclusion

Several observations may be made of the decision in *Ethoz*. Importantly, as the Court held, the freedom of parties to enter into contracts also entails the freedom of parties to "change their mind and break their contractual undertakings if they so wish albeit at a price".[4] On this basis, any clause that "forces" parties to comply with their contractual obligations, thereby interfering with their freedom to breach the contract, will be held to be an unenforceable penalty. The implication for creditors is that the risk of a clause in a typical financing transaction being struck down as an unenforceable penalty by the courts appears to have increased. In particular, to reduce the risk of default interest clauses being regarded as penalties, it would be opportune for creditors to ensure that the difference between the default interest rate and the regular loan interest rate is not markedly disproportionate.[5] What is more tricky is the issue of acceleration clauses which require borrowers to pay the outstanding balance and interest accrued upon the occurrence of any event of default, which may range from a technical breach of a representation and warranty to a breach of an information covenant, neither of which would necessary cause a loss to the creditor under the Single Lump Sum Test. In this regard, there is much to be said of the English approach which is more sensitive to market practice and provides greater flexibility for parties to structure their contractual obligations. Factors such as the relative bargaining power of the contracting parties as well as the commercial purpose of the contract appear to be less material in the determination of whether the

[4] *Leiman, Ricardo v Noble Resources Ltd* [2020] 2 SLR 386
[5] *Alternative Advisors Investments Pte Ltd v Asidokona Mining Resources Pte Ltd* [2022] SGHC 41

clauses in *Ethoz* were penalties despite their relevance to the inquiry, as the Court of Appeal had stated previously.[6]

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[6] *Denka Advantech Pte Ltd v Seraya Energy Pte Ltd* [2021] 1 SLR 631