# International Arbitration Alert

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## Take or Pay: Does the Law of Penalties Apply?

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Q2 2020 saw a tangible increase in the number of queries from clients asking about the enforceability of take or pay clauses common in supply agreements. Intermingled with questions around *force majeure*, the key issue appears to be whether take or pay clauses can be an unenforceable penalty, thus opening up questions about the delta between the supplier's loss relative to the amount payable under the take or pay provision. Take or pay agreements dealing with the supply of workers, project management, materials or gas (the paradigm) are all affected. English law often governs international supply agreements, and so one typically looks at the English case law on take or pay clauses. However, the question whether the law of penalties applies to such provisions also opens up a wider generic debate in other jurisdictions, including whether the sums payable can be reduced commensurate with the actual harm to the supplier. Put shortly:

- *M&J Polymers Ltd. v. Imerys Minerals Ltd.*[1], *E-Nik Ltd v. Department for Communities and Local Government*[2] and *Cavendish Square Holdings BV & Anor v. El Makdessi*[3] tend to the conclusion that a failure by the buyer to "take or pay" is a breach giving rise to damages such that the law on penalties is activated.
- There is also English law authority that concludes that a failure to "take or pay" is a debt claim (not a claim in damages) and so not subject to the rule on penalties, for example *White & Carter (Councils) Ltd. v. McGregor*[4] and *Euro London Appointments v. Claessens International*[5].
- The jurisprudence indicates that take or pay clauses ought not fall into the law on penalties but even if a Tribunal found otherwise, the U.K. Supreme Court in *Cavendish Square Holdings BV v. Makdessi and Parking Eye*[6] has reinforced the point that English Courts will be reluctant to disturb the parties' agreement. Internationally, buyers keen to assert that the harm to the supplier is lower than that set in the agreement may attempt to seize upon Civil Codes such as the UAE Civil Code Article 390 (2) or Article 1231-5 of the French Civil Code.
- Application of the penalty rule can still turn on questions of drafting and so care and caution is essential when drafting "take or pay" provisions.


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## Take or Pay

Take or pay clauses usually operate to the benefit of both buyer and supplier. There is a well-understood commercial justification for including such a provision in a supply contract: a buyer may require the flexibility to take delivery or not to take delivery of workers, materials or gas commensurate with needs; a seller could give the buyer an option on whether or not to take delivery or call-off the services, on condition that the seller would still require the buyer to make payment to the seller of a certain value for the quantities of gas, resource or services not delivered. Such a payment is in essence an option fee which is payable for the buyer's election not to take delivery. It is widely understood that this take or pay payment creates an obligation in debt in the seller's favor. This is different to a liability in damages (typically found in a take and pay clause) because under a take and pay clause, the buyer's "nonofftake" is a breach of contract, whereas under a take or pay provision the buyer's "nonofftake" is an exercise of a contractual right to do so. The distinction is an important pleading point. Whether the supplier runs a damages claim or a claim in debt affects not only procedure but also can open up wider debates about the enforceability of pre-agreed amounts and, in particular, if the law of penalties applies or if such amounts can be reduced.

## Does the Law of Penalties Apply?

*M&J Polymers Ltd. v. Imerys Minerals Ltd.*[7] and *E-Nik Ltd. v. Department for Communities and Local Government*[8] are two English High Court Judgements decided by Mr. Justice Burton. The same judge in a third case of *Cavendish Square Holdings BV & Anor v. El Makdessi* made clear that he considered that "take or pay" clauses despite creating a debt claim could nevertheless qualify as a penalty clause. This clarification was important. Mr. Justice Burton stated:

> "Thus I concluded in *M&J Polymers Ltd. v. Imerys Minerals Ltd.* [2008] 1 AER (Comm) 893 that a "take or pay clause" might qualify as a penalty clause, i.e., that the concept of penalty could apply to a debt claim as much as to a damages claim (contrary to the previous understanding in *Jervis v. Harris* [1996] Ch. 195). My conclusion (at paragraph 46) was that the clauses in question plainly had commercial justification and (as I summarize in paragraph 25 of my later judgment in *E-Nik Ltd. v. Department for Communities and Local Government* [2012] EWHC 3027 (Comm)) "did not amount to oppression, were negotiated and freely entered into between parties of comparable bargaining power and did not amount to a provision in terrorem" (see also *Lancore Services Ltd. v. Barclays Bank Plc* [2008] EWHC 1264 (Ch) [2008] 1 CLC 1039 at para 98 per HHJ Hodge QC).

The provenance of Mr. Justice Burton's "expansion" of the concept of penalty has been questioned. The learned judge stated "… the way in which in more modern times the concept of penalty, while remaining a *rara avis*, has, at least in principle, moved outside the original province of a clause providing for an extravagant assessment of (liquidated) damages. One development, to which I have referred, was to expand its operation, although in the event unsuccessfully, into what was otherwise a claim in debt[9]…" In *M&J Polymers* the learned judge considered that the House of Lords approach in *White & Carter (Councils) Ltd. v. McGregor*[10] and its citation in Chitty on Contracts – "The law on penalties ... is not relevant where the claimant claims an agreed sum (a debt) which is due from the defendant in return for the claimant's performance of his obligations" was "too simplistic". Burton relied on Lord Roskill's

speech in *Export Credits Guarantee Dept. v. Universal Oil Products Co.* where it was said "the clause was not a penalty clause because it provided for payment of money upon the happening of a specified event other than a breach of a contractual duty owed by the contemplated payor to the contemplated payee."[11] However, Lord Roskill was summarizing Slade LJ's judgment in the Court of Appeal which in turn relied on Diplock LJ's judgment in the Court of Appeal *in Philip Bernstein (Successors) Ltd. v. Lydiate Textiles Ltd.*[12] In that case, Diplock LJ (as he then was) confirmed that the "penalty area" is restricted to the "narrow field" where there has been "a prior agreement by the parties to the contract as to an amount to be paid by a party in breach to the other party in respect of that breach." Such is the beauty of the common law and jurisprudence that a supplier could argue that the law of penalties does not apply and cite back to the House of Lords in *White & Carter (Councils) Ltd.* Should a tribunal find otherwise, then one needs to look at how liquidated damages are treated.

## Nature of Penalties Under English Law

The Supreme Court reviewed comprehensively the nature of penalties in *Cavendish Square Holdings BV v. Makdessi* and *ParkingEye Ltd. v. Beavis*[13]. In their joint judgment, Lord Neuberger and Lord Sumption pointed to the distinction between a primary contractual obligation and a secondary obligation which arises only on breach of a primary obligation. They continued:[14]

> "The true test 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. 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. In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach. ... But compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations."

The comments of Lord Mance add further weight to the proposition that the Courts are unlikely to set aside the pre-agreed or liquidated amounts. Supply agreements that invoke "take or pay" provisions are complex and negotiated at arm's length based on legal advice. Lord Mance said:[15]

> "What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable. In judging what is extravagant, exorbitant or unconscionable, I consider (despite contrary expressions of view) that the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor."

## Liquidated Damages Under Civil Codes

Should a tribunal find that take or pay relates to breach and damages, then the international debate will focus on whether the sums claimed can be reduced. By way of example, pursuant to Article 390(2) of the UAE Civil Code the court holds a

discretion to adjust the pre-agreed amount of compensation to ensure the damages are equal to the loss suffered. Article 390(2) provides as follows:

- The contracting parties may fix the compensation in advance by providing for it in the contract or by later agreement under the law.
- The court may, on the application of either party, adjust the agreed amount of compensation so it is equal to the loss. Any agreement to the contrary shall be void.

Similar provisions are found in the Civil Code of the Republic of Uzbekistan at Article 326 which may allow a penalty to be reduced in case where it is manifestly incommensurate to the consequences of breach of obligation. Article 1231-5 of the French Civil Code (since the reform dated 2016, combining the former Article 1152 and Article 1231) may also be relevant. It provides:

- When an agreement provides that the party who fails to perform it will pay a certain sum as damages, the other party may not be awarded a greater or lesser amount.
- Nevertheless, the judge may, even on his own motion, moderate or increase the penalty agreed upon when it is manifestly excessive or ridiculously low.
- Where the obligation has been performed in part, the agreed penalty may be reduced by the judge, even ex officio, in proportion to the interest that the partial performance has provided the creditor, without prejudice to the application of the preceding paragraph.
- Any stipulation contrary to the two preceding paragraphs shall be deemed unwritten.
- Except in the case of final nonperformance, the penalty shall only be incurred when the debtor is given notice.

[1] [2008] EWHC 344 (Comm); [2008] 1 All E.R. (Comm) 893.

[2] [2012] EWHC 3027 (Comm); [2013] 2 All E.R. (Comm) 868.

[3] [2012] EWHC 3582 (Comm); [2013] 1 All E.R. (Comm) 787.

[4] [1962] AC 413.

[5] [2006] EWCA Civ 385; [2006] 2 Lloyd's Rep. 436.

[6] [2015] UKSC 67; [2016] A.C. 1172.

[7] [2008] EWHC 344 (Comm); [2008] 1 All E.R. (Comm) 893.

[8] [2012] EWHC 3027 (Comm); [2013] 2 All E.R. (Comm) 868.

[9] *Cavendish Square Holdings BV & Anor v El Makdessi* [2012] EWHC 3582 (Comm) at paragraph 29.

[10] [1962] AC 413.

[11] [1983] 1 W.L.R. 399.

[12] Unreported, June 26, 1962; Court of Appeal (Civil Division).

[13] [2015] UKSC 67; [2016] A.C. 1172.

[14] [2016] A.C. 1172 at para. 32.

[15] [2016] A.C. 1172 at para. 152.