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SGCA Struck Down Unenforceable Penalty: Key Takeaways for Singapore Construction Contracts

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EXECUTIVE SUMMARY

On 20 January 2023, the Singapore Court of Appeal ("**SGCA**" or the "**Court**") in *Ethoz Capital Ltd v Im8ex Pte Ltd* ("***Ethoz Capital***") held that a clause demanding borrower to pay the entire remaining interest of a loan upon default constitutes an unenforceable penalty. In doing so, the Court affirmed its continued application of the common law test for penalties as established in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 (the "***Dunlop***" test). The Court focused on the substance of the default clause, concluding its effect was to compel performance rather than genuinely compensate for loss.

FACTS

Ethoz Capital Ltd ("**Lender**" or "**Ethoz**") extended a S$ 6.3 million loan to Im8ex Pte Ltd ("**Borrower**" or "**Im8ex**") for a 15-year term, charged with a flat interest rate of 3.75% per annum totaling to S$ 3.5 million ("**Total Interest**"). Repayment was structured through 180 equal monthly instalments covering principal and this Total Interest, detailed in a schedule.

Crucially, the agreement included:

- Clause 7(B): Deeming the Total Interest "earned and accrued in full upon the drawdown."
- Clause 14(B): Borrower to immediately repay the outstanding principal, the entire remaining balance of the Total Interest, and default interest, upon an Event of Default (such as non-payment).
- Clause 15: A default interest rate of 0.065% per day (effectively 26.08% p.a., compared to the calculated contractual rate of 6.444% p.a.).

Im8ex defaulted within the first year. Ethoz subsequently demanded from Im8ex immediate payment of the outstanding principal, the *full remaining* Total Interest (most relating to future years), and the default interest.

ISSUES

The central questions before the SGCA were:

- Did the obligation under Clause 14(B) to pay the entire remaining "Total Interest" immediately upon default amount to an unenforceable penalty?
- Was the interest pursuant to the Default Interest rate under Clause 15 also an unenforceable penalty?
- What was the correct sum payable by the borrower to redeem the loan facilities if these clauses were deemed penal?

HOLDING

The SGCA found both the accelerated Total Interest clause and the Default Interest rate to be unenforceable penalties.

a. On the Accelerated Total Interest

The Court determined that Im8ex's primary obligation was to repay the loan and interest via 180 instalments over 15 years. The requirement in Clause 14(B) to pay all remaining Total Interest immediately upon default was a secondary obligation triggered by breach.
While acknowledging Clause 7(B) deemed the interest "earned," the Court looked past the drafting to the clause's substance and effect. Requiring immediate payment of interest meant to compensate for 15 years of fund usage, especially upon an early default, was disproportionate.

The Court applied the "genuine pre-estimate of interest" test (the *Dunlop* test) to determine whether the above amounts to a penalty under Singapore law.
It held that the interest under the Total Interest clause served not as a genuine pre-estimate of the lender's loss from the breach, but would function to force compliance with the primary payment obligation, thereby undermining the purpose of the penalty doctrine. The Court rejected the notion that merely accelerating an existing debt automatically bypasses penalty scrutiny.

b. On the Default Interest

The Court agreed with the High Court's calculation showing the default interest rate (26.08% p.a.) was nearly four times the effective contractual rate (6.444% p.a.). This significant uplift was deemed "extravagant" on its face.

Ethoz failed to provide evidence justifying this premium as a genuine pre-estimate of additional loss specifically caused by the default itself. Comparisons to statutory limits were considered irrelevant to the contractual penalty analysis.

c. On the remedy

Since the penalty clauses were unenforceable, Im8ex was allowed to exercise its equitable right to pay back the outstanding principal plus accrued interest calculated according to the original instalment schedule (Schedule 3), excluding the accelerated future interest and the penal default interest. Im8ex was granted three months to make this payment. Failure to make such payment would entitle Ethoz to pursue the available remedies, including (but not limited to) exercising the power of foreclosure and sale of the property.

THE PENALTY DOCTRINE UNDER COMMON LAW

The Traditional Framework: *Dunlop*

For nearly a century, common law jurisdictions applied a consistent test for penalty clauses based on the House of Lords' decision in *Dunlop*. Under Lord Dunedin's principles, a clause would be struck down as an unenforceable penalty if it was "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach," or if "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 *Dunlop* test focused on whether the stipulated sum represented a genuine pre-estimate of the loss likely to be suffered from the breach. Courts examined the mathematical relationship between the breach and the anticipated consequences, emphasizing compensation rather than deterrence.

The *Cavendish* Reformulation at the UK Supreme Court

In 2015, the UK Supreme Court in *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 ("***Cavendish***") fundamentally reformulated the test for penalty clauses. The *Cavendish* test asks whether the impugned provision is a secondary obligation that 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."

This shifted the focus from solely whether the clause was a "genuine pre-estimate of loss" to a broader consideration of the innocent party's "legitimate interests," which could include wider commercial interests beyond direct compensation. The *Cavendish* approach allows for justification of clauses that might not strictly represent a pre-estimate of direct financial loss but serve broader commercial purposes.

Singapore's Retention of *Dunlop*: Explicit Rejection of *Cavendish*

The Singapore Court of Appeal, in cases like *Denka Advantech Pte Ltd v Seraya Energy Pte Ltd* [2019] 1 SLR 631 and reaffirmed in *Ethoz Capital*, explicitly declined to adopt the *Cavendish* "legitimate interest" test. Instead, Singapore maintains its adherence to the *Dunlop* test.

What does that mean? The primary determinant of whether a clause is an unenforceable penalty in Singapore remains whether it is a genuine pre-estimate of the loss likely to be suffered from the breach, rather than whether it protects a broader "legitimate interest" of the innocent party. Singaporean courts have expressed concerns that the "legitimate interest" concept is too general and could lead to uncertainty for contracting parties. The focus in Singapore remains on the compensatory nature of such clauses, aligning with the principle that punitive damages are generally not awarded for breach of contract.

IMPLICATIONS ON CONSTRUCTION DISPUTES: CONTRASTING APPROACHES TO LDS FOLLOWING PARTIAL TAKE-OVER

Historical Context

The case of *Bramall & Ogden v Sheffield City Council* (1983) 29 BLR 73 ("***Bramall***") predates *Cavendish* and demonstrates the traditional approach under *Dunlop* principles. The English court found that Liquidated Damages ("**LD**") expressed as "£20 per week for each uncompleted dwelling" could not be enforced where partial possession of a housing estate was taken in phases and the contract did not provide for sectional completion or a proportionate reduction in LDs. This outcome aligns closely with traditional *Dunlop* principles, where the lack of apportionment for partial completion could render the clause penal. The shift in English law is evident when comparing *Bramall* with *Eco World*—the latter's reliance on the broader "legitimate interest" concept under *Cavendish* allowed the LD clause to be upheld despite lacking a reduction mechanism for partial possession.

English courts – post-Cavendish

In the case of *Eco World – Ballymore Embassy Gardens Co Ltd v Dobler UK Ltd* [2018] EWHC 2207 (TCC) ("***Eco World***"), the English court considered an LD clause that stipulated a single rate for delayed completion of the entire works, even though the employer had taken early possession of significant portions of the works and the contract lacked a mechanism to reduce LDs proportionately. Applying the *Cavendish* test, the English court held that the LD clause was valid and not an unenforceable penalty. The court reasoned that the parties were sophisticated and legally advised, the employer had a legitimate interest in the timely completion of the whole project (as delay to any part could impact the overall project and cause wider losses), quantifying general damages would be difficult, and the LD rate itself was not argued to be unreasonable.

Under Singapore Law

LD clauses in construction contracts will continue to be assessed based on the *Dunlop* test. In other words, they must represent a genuine pre-estimate of the loss anticipated from the breach (e.g., delay) at the time the contract was made.

Consequently, LDs are more susceptible to being struck down by a Singaporean court if they are deemed excessive under the *Dunlop* criteria, particularly if:

- The sum is "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach"
- A single lump sum is payable for various events of differing severity, some of which may cause only trifling damage

Because Singapore still adheres to the narrower "genuine pre-estimate of loss" standard of *Dunlop* rather than the broader "legitimate interest" approach of *Cavendish*, LD clauses that might be justifiable under English law based on wider commercial interests could face a higher risk of being invalidated as penalties in Singapore if they appear disproportionate to the foreseeable loss.

Accordingly, a Singaporean court, applying the *Dunlop* test, may potentially approach this issue differently from an English court. One of Lord Dunedin's key principles in *Dunlop* establishes a rebuttable presumption that a clause is penal if "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." If an employer takes over a substantial part of the works, the actual loss suffered from a delay to the small remaining part is likely to be significantly less than the loss from a delay to the entire project. A single, unreduced LD rate in such a situation could easily be seen as "extravagant and unconscionable" in relation to the potential loss from delaying only the remainder, and not a genuine pre-estimate of that reduced loss. The "legitimate interest" in overall project completion, while a commercial reality, might not save the clause in Singapore if the stipulated sum is deemed disproportionate to the actual loss anticipated from the specific breach.

PRACTICAL TAKEAWAY

This analysis highlights the divergence between two common law jurisdictions. English law, post-*Cavendish*, allows for a wider range of commercial justifications for LD clauses, focusing on whether the detriment is "out of all proportion" to a "legitimate interest." Singapore law, by retaining the *Dunlop* test, maintains a stricter focus on whether the LD sum is a "genuine pre-estimate of loss" for the specific breach.

Therefore, for construction contracts governed by Singaporean law:

- An LD clause that does not provide for a reduction in the event of partial possession is more susceptible to being held a penalty in Singapore than it might be under English law. That is because that clause may fail the "genuine pre-estimate of loss" test for the remaining works and be deemed "extravagant and unconscionable" in that context.
- Singapore law is generally considered stricter in its scrutiny of LD clauses compared to the more flexible *Cavendish* approach.

Because Singapore adheres to the narrower "genuine pre-estimate of loss" standard of Dunlop rather than the broader "legitimate interest" approach of *Cavendish*, LD clauses that might be justifiable under English law based on wider commercial interests (but which are not a direct pre-estimate of loss) could face a higher risk of being invalidated as penalties in Singapore if they appear disproportionate to the foreseeable loss.

The emphasis in Singapore remains on compensation for anticipated loss rather than determining the legitimate interest holistically. A careful legal analysis is therefore required when choosing Singapore law as the governing law of a construction contract containing an unconventional LD clause.

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Peter & Kim is a specialist arbitration firm with offices in Geneva, Zurich, Sydney, Seoul and Singapore. We support clients globally through a cohesive cross-border team structure offering a depth of common and civil law expertise that is grounded in decades of combined experience at partner level in international arbitration proceedings (including ISDS cases) and in advising and representing commercial and government clients in arbitration-related proceedings before State Courts.

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