

ARE PENALTY CLAUSES ENFORCEABLE IN CONTRACTS UNDER NIGERIAN LAW?

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INTRODUCTION

According to the Black's Law Dictionary, a penalty clause is "a contractual provision that assesses against a defaulting party an excessive monetary charge unrelated to actual harm"¹. It is usually disproportionate to the actual breach suffered and often used as a form of punishment against a party who defaults or fails to comply their obligations under a contract. For example, in a contract where there is a clause mandating a party to pay N50,000,000 (Fifty Million Naira) to the other party upon failure to pay N500,000 (Five Hundred Thousand Naira) within 45 (Forty – Five) days; the said clause no doubt is meant to punish one of the parties for failing to pay N500,000 to the other party is a penalty clause.

Before now, there has not been much controversy surrounding penalty clauses in contracts in Nigeria, however, ever-changing landscape in business dealings involving multinational corporations and the ever-evolving legal jurisprudence in the country has made it necessary to discuss the issue in this writeup.

DISTINCTION BETWEEN DAMAGES AND PENALTY



It is easy to assume that damages and penalty are the same, however, they are not. In the case of *UBN Plc v. Chimaeze*² the Supreme Court of Nigeria explained that:

"Damages are money claimed by or ordered to be paid to, a person as compensation for loss or injury. In other words, damages are the sum of money which a person wronged is entitled to

receive from the wrongdoer as compensation for the wrong."

Meanwhile, penalty has been defined as 'a sum of money imposed as punishment for a civil wrong. It is an extra charge against a party who violates the terms or provisions of a contract'³. It is usually fixed, not as a pre-estimate of probable damages, but as a punishment whose threat is aimed at preventing the breach.

Perhaps the best distinction between damages and penalty can be found in the case of *Chevron Nigeria Limited v. Titan Energy Limited*⁴ In that case, the Court of Appeal in distinguishing between damages and penalty held as follows:

"Damages are the sum of money which a person wronged is entitled to receive from the wrongdoer as compensation for wrong...Penalty is a sum of money extracted as punishment for a civil wrong, as distinguished from compensation for the injured party's loss. It is an extra charge against a party who violates the terms or provisions of a contract...Penalty is therefore a sum which a party undertakes to pay or forfeit in the event of a breach of contract. Penalty is fixed, not as a pre-estimate of probable damages, but as a punishment whose threat is aimed at preventing the breach. See Charles T. McCormick, Handbook on the Law of damages page 146 at 699 (1935). Consequential damages refer to losses that do not flow directly and immediately from an injurious act but that result indirectly from the act. See Black's Law dictionary, 9th Ed. From the meanings of the terms examined above, it will be correct to say that damages and penalties are not the same."

It is crystal clear from the foregoing judicial pronouncements that penalty is distinct from damages. A penalty clause is an aggressive step to ensure that a party to a contract is deterred from breaking the terms of contract at will. While damages in a breach of contract seeks to restore an injured party to a position, he would have been had the contract been performed, a penalty is meant to punish the defaulting party for the breach. It has been opined that the award of

¹ Blacks' Law Dictionary, Eight Edition

² [2014] LPELR-22699 (SC)

³ Blacks' Law Dictionary, Nineth Edition

⁴ [2013] LPELR-21202 (CA)

penalty where necessary does not in any way stop the Court from awarding damages that naturally flow from the breach. The presence of penalty clause in a contract is not a bar to the award of damages in deserving cases.

POSITION OF NIGERIAN LAW ON PENALTY CLAUSE

The position of English law on penalty clause is clear and straight to the point. Penalty clauses are unenforceable under English law. Since the 1720's it has been position in English Contract Law that if a position in a contract constitutes a penalty, then that provision will become unenforceable against the parties to the contract. Recently, the English Supreme Court in the case of *Cavendish Square Holding BV v. Talal El Makdessi*⁵ confirmed the position that penalty clauses are still unenforceable.

In Nigeria, the Supreme Court had the opportunity to confirm the current position of the law as it relates to question of whether penalty clause is enforceable under the law. And in the case of *Oyeneyin & Anor. v Akinkugbe & Anor*⁶. (supra) the apex court held that:

"Penalty clauses are generally unenforceable, particularly when clauses of the nature are designed to terrorize or frighten the party into performance. For example, a contract may provide that the promissory is to pay N5 on a certain event but if he fails to do so, he must then pay N500. A clause of that kind is called a penalty clause by lawyers. For several years, it has been the law that such promises cannot be enforced on the ground that it is unfair and unconscionable to enforce clauses which are designed to terrorize.

In the peculiar circumstance of Exh. H – where the penalty clause demands for the payment of N100 per day for occupation of land where the usual rent is N100 annually is morally unjustifiable. The trial court cannot salvage an unenforceable transaction by applying the landlord and tenant law neither has the trial court the vires to formulate cases for the parties."

The lower courts in Nigeria have also followed the lead of the Supreme Court and have held that penalty clause in contracts is unenforceable. In the recent case of *Awutolo (W/A) Limited & Anor. v Okolo*⁷ the Court of Appeal in affirming the law that penalty clause is unenforceable held that:

"...For example, a contract may provide that the promissory is to pay N5 on a certain event but if he fails to do so, he must then pay N500. A clause of that kind is called a penalty clause by lawyers. For several years, it has been the law that such promises cannot be enforced on the ground that it is unfair and unconscionable to enforce clauses which are designed to terrorize." See also the case of ALLINGFORD vs. MUTUAL SOCIETY (Supra) where the mortgage agreement stipulated for payment of interest by the mortgagor if he fails to repay the loan punctually. The Court held that such clause was void and unenforceable as constituting a penalty. This Court therefore, finds it unable to disagree with learned Appellant's Counsel that Clause 2 of the testatum is not a "penalty clause" which is void and unenforceable against the Appellants."

It is pertinent to point out that the test in determining whether a clause amounts to penalty is whether the clause in question imposes an obligation on the defaulting party that is not proportionate to the interest of the victim of any alleged breach in the contract. Once the clause imposes an obligation on the defaulting party that is disproportionate to the breach suffered or if the import of the clause is to punish/deter the defaulting party from and/or for the breach, then the clause is a penalty clause and therefore not unenforceable. In such circumstance, the courts will intervene and strike down such clause for being a penalty clause.

CONCLUSION

There is a distinction between a clause setting out defined liquidated damages and a penalty clause. Liquidated damages are usually monetary compensation paid to a person for injury or loss suffered. The sum payable as liquidated damages

⁵ [2016] AC 1172

⁶ [2010] LPELR-2875 (SC)

⁷ [2023] LPELR-59808 (CA)

is usually reasonable, commensurate with the breach/injury suffered and is aimed at putting an aggrieved person in a comfortable position as money can. Unlike a penalty clause that is disproportionate to the breach suffered. in order to draft an effective damages clause in contracts, it is important to ensure that the amount payable as damages is reasonable and proportionate to the losses suffered by the victim of a breach as anything contrary risks being dubbed a 'penalty clause'.

Consequently, it is therefore recommended therefore that drafters of commercial agreements should ensure that the wordings in their contracts are drafted in such a way that the clauses are not to be interpreted as penalty because the current position of the law in Nigeria is that penalty clauses are void and unenforceable in contracts.

It also goes without saying that it is extremely important for individuals, corporate and multinational entities to consult a lawyer with legal expertise in commercial contracts when looking to enter into commercial transactions to provide adequate legal advisory services in order to ensure that their commercial agreements are not declared null and void by virtue of containing penalty clauses which are unenforceable under the current legal regime in Nigeria.

CONTACTS



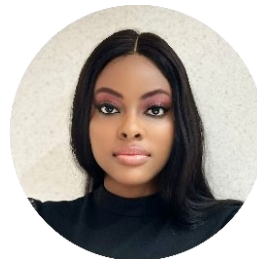
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