

**THE EASTERN CARIBBEAN SUPREME COURT  
IN THE COURT OF APPEAL**

**TERRITORY OF THE VIRGIN ISLANDS**

**BVIHCMAP2020/0016**

**BETWEEN:**

**RENISTON LIMITED**

Appellant

and

**NEDLANDS OVERSEAS INC.**

Respondent

**Before:**

The Hon. Dame Janice M. Pereira, DBE  
The Hon. Mr. Paul Webster  
The Hon. Mde. Vicki-Ann Ellis

Chief Justice  
Justice of Appeal [Ag.]  
Justice of Appeal [Ag.]

**Appearances:**

Mr. Michael Adkins and Ms. Daisy Bovingdon for the Appellant  
No appearance by or for the Respondent

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2020: November 26;  
2021: February 3;  
**Re-issued: February 19.**

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*Commercial appeal — Contractual Interpretation — Decision of learned judge refusing to give effect to contractual interest clause contained in guarantee agreement — Whether learned judge erred in concluding that rate of interest imposed by contractual interest clause was an unenforceable penalty — Whether contractual interest clause constituted a secondary obligation under guarantee agreement — Costs — Whether fixed costs regime applies in proceedings before the Commercial Division of the High Court — Rule 69B.10 of the Civil Procedure Rules 2000 — Whether learned judge required to make costs award giving effect to indemnity costs clause in guarantee agreement*

SZAG Ltd (“SZAG”) entered into a loan agreement with Daferson Development Limited (“Daferson”) by which SZAG borrowed monies from Daferson. The loan agreement was guaranteed by the respondent, Nedlands Overseas Inc. (“Nedlands”) by way of a

Guarantee Agreement (the "Guarantee") with Daferson, under which Nedlands agreed to stand as guarantor and indemnifier for SZAG's loan. Under the Guarantee, in the event that SZAG defaulted on the loan, Nedlands was obligated to pay Daferson on demand. Clause 4 of the Guarantee stipulated that, in the event of SZAG's default, Nedlands was also obligated to pay interest on the monies due on SZAG's behalf. Nedlands is not a party to the loan agreement and SZAG is not a party to the Guarantee.

Subsequently, Daferson assigned its rights under the loan agreement to the appellant, Reniston Limited ("Reniston"), up to a certain value plus interest and any other payments provided for in the loan agreement as well as its rights under the Guarantee. SZAG defaulted on the loan agreement. As a consequence, Reniston filed a claim against Nedlands for payment of the amount owed by SZAG under the loan agreement, as well as for interest pursuant to clause 4 of the Guarantee at a rate of 36.5% per annum, or a daily rate of US\$6,649.07, and costs pursuant to rules 12.12 and 69B.12 of the Civil Procedure Rules 2000 ("CPR"). Nedlands, although served with the claim, did not participate in the proceedings.

The learned judge entered judgment in favour of Reniston for a sum to be fixed. He, however concluded that Reniston was not entitled to interest at the rate provided under clause 4 of the Guarantee as it amounted to a penalty. The judge, in a subsequent order, fixed the judgment sum in favour of Reniston in the amount of US\$2,124,205.04 with interest. He also ordered fixed costs to be paid by Nedlands to Reniston on the basis that Reniston ought to have applied for entry of judgment in default.

Reniston, being dissatisfied, has appealed. Reniston contended that the judge erred in concluding that clause 4 was a secondary obligation under the Guarantee which amounted to an unenforceable penalty, and in consequently refusing to permit Reniston's recovery of interest pursuant to the clause. It was further contended that the judge erred in awarding fixed costs on the claim, rather than applying CPR 69B.10 to the commercial claim in respect of which the fixed costs regime is disappplied. Reniston on this appeal has also sought to be indemnified against Nedlands' costs of the proceedings in light of the indemnity costs clause 5(d) of the Guarantee. The issues arising for this Court's determination concern: (i) whether the judge erred in concluding that clause 4 was a secondary obligation which amounted to an unenforceable penalty; (ii) whether the judge erred in awarding fixed costs on the claim; and (iii) whether the learned judge was required to make a costs award giving effect to clause 5(d) of the Guarantee.

**Held:** allowing the appeal; finding that Reniston is entitled to contractual interest in accordance with the terms of clause 4.1 of the Guarantee; setting aside the costs order of the learned judge; and ordering that Reniston's costs in the court below and on appeal are to be assessed by the court below, with the costs on appeal not exceeding two-thirds of the costs below, that:

1. A contractual provision will only fall within the purview of the penalty rule if it is a secondary contractual obligation, being a contractual obligation liable to be performed only where a primary contractual obligation has been breached. In determining whether a clause amounts to a secondary obligation, the court must

examine the substance of the provision and determine its nature against the wider context of the contract. Once it is shown that a contractual obligation is a secondary obligation, the court must determine whether it imposes a detriment which is out of proportion to any legitimate interest of the innocent party in the enforcement of the primary obligations under the contract.

**Printing and Numerical Registering Company v Sampson** (1875) L.R. 19 Eq. 462 considered; **Philips Hong Kong Ltd. v Attorney General of Hong Kong** (1993) 61 BLR 41 considered; **Cavendish Square Holding BV v Talal El Makdessi** [2015] UKSC 67 applied; **Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Car Co. Ltd.** [1915] AC 79 applied; **Bridge v Campbell Discount Co. Ltd.** [1962] AC 600 considered.

2. In this case, the determination of whether clause 4 is a secondary obligation turns on the interpretation of the Guarantee Agreement, which ought to be construed without reference to the loan agreement. It is clear that clause 4 of the Guarantee Agreement is not a secondary obligation but a conditional primary obligation and thus does not fall within the scope of the penalty rule. This is because it merely requires the payment of interest to Daferson/Reniston by Nedlands following SZAG's breach of the loan agreement, circumstances which do not amount to a breach of the primary obligations as between the parties to the Guarantee, Daferson/Reniston and Nedlands. Accordingly, the learned judge erred in concluding that clause 4 was a secondary obligation and that the penalty rule was engaged.

**Export Credits Guarantee Department v Universal Oil Products Co and Others** [1983] 2 All ER 205 applied; **Philip Bernstein (Successors) Ltd v Lydiate Textiles Ltd** [1962] CA Transcript 238 considered; **Re B (children) (relocation to UAE: Enforceability of charge over property and issues of wardship)** [2017] 1 All ER 1099 considered; **Andrews v Australia and New Zealand Banking Group Ltd** (2012) 247 CLR 205 considered.

3. An appellate court ought not to interfere with a judge's costs order unless it is shown that the judge was plainly wrong in the exercise of his or her discretion. Under rule 69B.10 of the **Civil Procedure Rules 2000**, the fixed costs regime is disapplied from proceedings before the Commercial Division of the High Court. It was therefore not open to the learned judge to award costs utilising the fixed costs regime. Accordingly, the learned judge's costs award was plainly wrong and must be set aside.

Rules 69B.10 to 69B.14 of the **Civil Procedure Rules 2000** considered; **Michel Dufour et al v Helenair Corporation Ltd. et al** SLUHCVAP1995/0004 (delivered 12<sup>th</sup> February 1996) followed; **Friar Tuck Ltd et al v International Tax Authority** BVIHCVAP2017/0003 (delivered 12<sup>th</sup> March 2019) followed.

4. The learned judge was not required to make a costs award on the basis of clause 5(d) of the Guarantee. This is because no such claim for costs had been made in

Reniston's claim in the court below. Further, and in any event, clause 5(d) does not in any way purport to fetter or dictate the basis upon which the court, in its discretion, is entitled to award costs. The learned judge therefore retained the discretion to determine the incidence and quantum of costs in the proceedings.

## **JUDGMENT**

- [1] **PEREIRA CJ:** This is an appeal against the decision and order of a learned judge of the Commercial Division of the High Court in the Territory of the Virgin Islands, made on 31<sup>st</sup> July and 7<sup>th</sup> August 2020 by which the learned judge, upon entering judgment in favour of the appellant, Reniston Limited ("Reniston"), declined to give effect to a contractual interest clause contained in a guarantee agreement which formed the basis of Reniston's claim against the respondent, Nedlands Overseas Inc. ("Nedlands"), and by which the learned judge made an award of fixed costs in favour of Reniston. The appeal rests primarily on whether the learned judge erred in concluding that the rate of interest imposed by the contractual interest clause was *in terrorem*, exorbitant and therefore ultimately an unenforceable penalty under the English common law rules against penal contractual clauses.

### **Background**

- [2] The background to the appeal revolves, in the main, around a series of contracts, the first of which is an agreement entered into by Daferson Developments Limited ("Daferson"), as lender, and SZAG Ltd. ("SZAG"), as borrower, for a loan in the amount of US\$6,530,000.00 ("the Loan Agreement"). Daferson is a legal entity under the laws of Cyprus, while SZAG is an entity under the laws of the Russian Federation. The Loan Agreement is governed by the laws of the Russian Federation.
- [3] The Loan Agreement was guaranteed by Nedlands, by way of a Deed of Guarantee and Indemnity dated 22<sup>nd</sup> March 2013 ("the Guarantee Agreement"). Nedlands is a company incorporated in the Territory of the Virgin Islands. The Guarantee Agreement is between Nedlands, as guarantor and indemnifier, and Daferson as the lender, under the Loan Agreement. SZAG (the borrower under the Loan Agreement) is not a party

to the Guarantee Agreement. The Guarantee Agreement is governed by the law of England and Wales.

- [4] The two most relevant provisions of the Guarantee Agreement are clauses 2 and 4. Clause 2 is the foundational provision of the Guarantee Agreement and describes the legal relationship between Nedlands and Daferson under the agreement as follows:

“2.1 In consideration of [Daferson] entering into the Finance Documents, [Nedlands] guarantees to [Daferson], whenever [SZAG] does not pay any of the Guaranteed Obligations when due, to pay on demand the Guaranteed Obligations.

2.2 [Nedlands] as principal obligor and as a separate and independent obligation and liability from his obligations and liabilities under clause 2.1 agrees to indemnify and keep indemnified [Daferson] in full and on demand from and against all and any losses, costs, claims, liabilities, damages, demands and expenses suffered or incurred by [Daferson] arising out of, or in connection with, the Guaranteed Obligations not being recoverable for any reason or any failure of the [SZAG] to perform or discharge any of its obligations or liabilities in respect of the Guaranteed Obligations.”

- [5] In essence, according to sub-clause 2.1, the Guarantee Agreement represents ‘consideration’ for the entry into the Loan Agreement. The consideration referred to is the agreement of Nedlands to pay to Daferson, on demand, any of the Guaranteed Obligations owed under the Loan Agreement when SZAG fails to do so. Sub-clause 2.2 further speaks to the ‘separate and independent obligation and liability’ of Nedlands to indemnify Daferson according to the terms of the clause.

- [6] Clause 4 is the contractual interest clause. It provides that, in the event of default on the Loan Agreement by SZAG, Nedlands shall pay interest on the sums due, on SZAG’s behalf. Clause 4 reads as follows:

“4.1 The Guarantor shall pay interest to the Lender at the daily rate which is 0,1% on all sums of debts demanded under this guarantee from the due date of the repayment by the Borrower or, if earlier, the date on which the relevant damages, losses, costs or expenses arose in respect of which the demand has been made, until, but excluding the date of actual payment.

4.2 Interest under clause 4.1 shall accrue on a day-to-day basis calculated by the Lender upon such terms as the Lender may from time to time determine.”

- [7] On 16<sup>th</sup> August 2018, Daferson entered into two agreements with Reniston. Reniston is a company incorporated under the laws of Cyprus. The effect of the agreements was that Daferson assigned its rights under the Loan Agreement to Reniston, up to the value of \$5,847,979.00 plus any interest accrued on this amount, and any other payments provided for in the Loan Agreement, as well as its rights under the Guarantee Agreement.

### **The Claim and the Learned Judge's Decision and Order**

- [8] On the footing of the Guarantee and Assignment Agreements, Reniston filed a fixed date claim against Nedlands for payment of the sum of US\$5,847,979.00, being amounts owed by SZAG under the Loan Agreement, along with contractual interest pursuant to clause 4 of the Guarantee Agreement at 36.5% per annum, or a daily rate of USD\$6,649.07, and costs pursuant to rules 12.12 and 69B.12 of the **Civil Procedure Rules 2000** (the "CPR").
- [9] Nedlands was served with the claim but did not participate in the proceedings.
- [10] Following a number of amendments to the claim form and statement of claim made by Reniston consequent upon directions given by the learned judge, in a written judgment dated 31<sup>st</sup> July 2020, the learned judge found that Reniston's amended claim disclosed a viable claim in law, and accordingly agreed that judgment ought to be entered in favour of Reniston for a sum to be fixed in chambers. The learned judge, however, concluded that Reniston was not entitled to interest at the rate provided for under clause 4. The reasons advanced by the learned judge in support of his conclusion on clause 4 may be shortly summed up as follows:
- (i) A guarantee is a classic example of a secondary obligation thus, if the rate of interest payable by a guarantor on the breach by the principal debtor of its obligations is otherwise a penalty, the fact that the guarantor assumes its obligations as a primary obligor does not as a matter of substance change the true nature of the obligation under the guarantee as a secondary obligation.

- (ii) The law on contractual penalties is more concerned with the substance of a contractual provision as opposed to its form, and therefore one must look at the Guarantee Agreement in the broader commercial context in which it operates.
- (iii) In the absence of an attempt by Reniston to either show, by its pleadings or by adducing evidence, that the 36.5% per annum rate of interest imposed by clause 4 was commercially justifiable, and the interest rate was *in terrorem*, extravagant, exorbitant and unconscionable, and therefore unenforceable.

[11] In his subsequent order in chambers on 7<sup>th</sup> August 2020, the learned judge, *inter alia*, fixed judgment in favour of Reniston and ordered fixed costs to be paid by Nedlands to Reniston. The relevant terms of that order are as follows:

- “1. That judgement against the Defendant be fixed in the sum of two million, one hundred and twenty-four thousand, two hundred and five US dollars and four cents (\$2,124,205.04) with Judgement Act interest thereon from 1<sup>st</sup> August 2020;
- 2. That the Defendant do pay the Claimant's fixed costs, as would have been payable had a claim for the judgement debt been brought under a Part 8 claim form and a default judgment obtained;
- 3. ...
- 4. ...”.

### **The Appeal**

[12] Reniston has now appealed the learned judge's decision and order on two grounds. The grounds collectively argue that the learned judge erred in concluding that clause 4 amounted to a penalty, and in consequently refusing to permit Reniston's recovery of interest pursuant to the clause. There is also an issue raised as to the award of fixed costs made by the learned judge on Reniston's claim, which is addressed below. As in the court below, Nedlands, through its registered agents in the Territory of the Virgin Islands, was served by Reniston with the documents and notices of hearing in the

proceedings before this Court,<sup>1</sup> but has not appeared on any occasion either through a representative or through counsel to respond to the appeal.

- [13] As foreshadowed, the appeal revolves around the application of the common law rules on contractual penalties. It is therefore necessary to discuss those principles in brief prior to considering the challenge by Reniston to the learned judge's decision.

### **The Law on Contractual Penalties**

- [14] The law of contract has traditionally permitted contracting parties a great deal of autonomy as to the terms of their contractual arrangements. This is, in short form, the long-standing principle of freedom of contract. The policy considerations underpinning parties' freedom of contract were expressed as follows by Sir Jessel MR in **Printing and Numerical Registering Company v Sampson**:<sup>2</sup>

“...if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice.”<sup>3</sup>

The general rule is now well-established that the court will not interfere with the clear terms of a contract, or relieve a contracting party from the terms of its agreement, save in limited circumstances, such as where there is some element of illegality, incapacity on the part of a party to the contract, mistake, duress, misrepresentation and frustration.

- [15] The penalty rule is an admitted common law abrogation of freedom of contract. This is made clear by the Privy Council in **Philips Hong Kong Ltd v Attorney General of Hong Kong**<sup>4</sup> wherein the Board stated at paragraph 58, citing the view of Dickson J in the Supreme Court of Canada in **Elsey v J. G. Collins Insurance Agencies Ltd**,<sup>5</sup> that:

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<sup>1</sup> See the Affidavits of Service of Dwight Hutchinson Jr. filed by Reniston on 27<sup>th</sup> October 2020 and 3<sup>rd</sup> November 2020 produced at Tabs 24 and 25 of the Hearing Bundle filed on 13<sup>th</sup> November 2020.

<sup>2</sup> (1875) L.R. 19 Eq. 462.

<sup>3</sup> Ibid at page 465.

<sup>4</sup> (1993) 61 BLR 41.

<sup>5</sup> (1978) 83 DLR.



“It is now evident that the power to strike down a penalty clause is a blatant interference with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum.”

- [16] The policy of the courts of law and equity has been that while parties are generally permitted to determine the terms of their agreements, the court, as the ultimate enforcer of those obligations, supervises the agreed arrangements and gives or withholds its sanction on the basis of now established public policy considerations. As a matter of policy, the courts have consistently refrained from enforcing a contractual provision which operates as a punishment or which would entitle a party to recover, in an action, a sum greater than the measure of damages to which he would be entitled at common law. In the words of Lords Neuberger and Sumption at paragraph 29 of the United Kingdom Supreme Court decision in **Cavendish Square Holding BV v Talal El Makdessi**:

“The availability of remedies for a breach of duty is not simply a question of providing a financial substitute for performance. It engages broader social and economic considerations, one of which is that the law will not generally make a remedy available to a party, the adverse impact of which on the defaulter significantly exceeds any legitimate interest of the innocent party.”<sup>6</sup>

- [17] The rules undergirding the court’s jurisdiction not to enforce penal clauses, and the circumstances required to engage that jurisdiction, were recently restated in **Cavendish Square Holding BV v Talal El Makdessi**. The Supreme Court, in its 5 judgments which together comprise the decision of the court, considered a number of issues concerning the history, application and future of the penalty rule. I shall however only briefly discuss the two broad considerations espoused by the court pertaining to the application of the penalty rule.
- [18] Firstly, and importantly, a contractual provision will not fall within the purview of the penalty rule if it is a primary or core contractual obligation under a contract. This is because the court under the penalty rule is not concerned with examining the parties’ core obligations under the contract, but is only concerned with the remedies for breaches of those core or primary obligations, which remedies it is asked to enforce.

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<sup>6</sup> [2015] UKSC 67.

As Lords Neuberger and Sumption succinctly stated at paragraph 13 of **Cavendish**, 'the penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves'. Instead, the penalty rule is concerned with secondary contractual obligations – these are contractual obligations liable to be performed only where a primary or core contractual obligation has been breached.

- [19] At the heart of the secondary obligation is that they are triggered or subject to claims for performance only upon the occurrence of a breach of contract. In the words of the learned authors of **Lewison on Contracts**, 'it is the essence of a penalty that it is payable upon breach of contract'.<sup>7</sup> The law therefore differentiates between obligations which are conditional upon the happening of some event other than a breach of contract (referred to as conditional primary obligations) and secondary obligations which are engaged only by a breach of contract. The distinction between primary and secondary obligations is explained at paragraph 14 of **Cavendish** where Lords Neuberger and Sumption differentiated between conditional primary obligations and secondary obligations. Their Lordships explained as follows:

"Where a contract contains an obligation on one party to perform an act, and also provides that, if he does not perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which is capable of being a penalty; but if the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation and cannot be a penalty."

- [20] The effect of the distinction between conditional primary obligations and secondary obligations is clear – conditional primary obligations are not, in law, capable of falling within the purview of the penalty rule, whereas secondary obligations are those with which the rule concerns itself. In the case of penalty clauses, the secondary obligation will usually require the breaching party to take some steps or impose some burden on the breaching party with a view to remedying the breach, including the transfer of

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<sup>7</sup> The Interpretation on Contracts 6<sup>th</sup> Ed. page 483, at para. 16.03.

property,<sup>8</sup> the payment of a sum as liquidated damages,<sup>9</sup> the payment of interest on a sum owing under a contract,<sup>10</sup> and forfeiture clauses.<sup>11</sup>

- [21] Against this background, it is clear, that whether a clause amounts to a secondary obligation is usually a question of construction of the relevant obligation, which is ‘...[dependent] on how the relevant obligation is framed in the instrument’. Further, as the distinction between the primary and secondary obligations is often fine, but nonetheless consequential, the court must undertake to carefully construe the relevant provisions to determine their nature prior to engaging the penalty rule. In undertaking this exercise of construction, the court must be more concerned with the substance of the obligation rather than the form of it. In other words, it matters not what the parties to an agreement themselves consider the nature of the provision to be (whether a primary or secondary obligation), even if the parties communicate their view on the nature of a provision, in the express terms of the provision by referring to it as a primary or secondary obligation. The court must, despite the labels attached to a clause, or the *prima facie* effect of the clause, be nonetheless astute to examine the substance of the provision and determine its nature against the wider context of the contract. As Lord Dunedin in **Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Car Co. Ltd**,<sup>12</sup> opined:

“Though the parties to a contract who use the word ‘penalty’ or ‘liquidated damages’ may *prima facie* be supposed to mean what they say, the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages.”<sup>13</sup>

- [22] Similarly, in **Bridge v Campbell Discount Co Ltd**,<sup>14</sup> Lord Radcliffe stated:

“[t]he intention of the parties themselves is never inclusive and may be overruled or ignored if the court considers that even its clear expression does

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<sup>8</sup> Jobson v Jobson [1989] 1 WLR 1026, CA.

<sup>9</sup> Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd [1915] AC 79.

<sup>10</sup> Lordsvale Finance plc v Bank of Zambia [1996] QB 752.

<sup>11</sup> See Cavendish at paragraphs 170, 226 and 227.

<sup>12</sup> [1915] AC 79.

<sup>13</sup> Ibid at page 86.

<sup>14</sup> [1962] AC 600.

not represent 'the real nature of the transaction' or what 'in truth' it is taken to be."<sup>15</sup>

[23] Secondly, once it is shown that a contractual obligation is a secondary obligation capable of being engaged only upon a breach of contract, the court will then undertake a qualitative and contextual analysis of the obligations imposed by the impugned clause. In simple terms, the court examines the secondary obligation in the context of its operation as a remedy for the breach of contract to which it is pegged, and makes a determination on whether the remedy afforded by the clause is proportionate to the breach, justifiable and fair in the circumstances.

[24] This is an evaluative exercise to be carried out by the judge having regard to the circumstances of the case. Indeed, and as Lord Parker stated at paragraph 97 of **Dunlop** 'whether the sum agreed to be paid on the breach is really a penalty must depend on the circumstances of each particular case'.<sup>16</sup> Further, as Lord Hodge very succinctly stated at paragraph 243 of **Cavendish**, 'it is a question of construction of the parties' contract judged by reference to the circumstances at the time of contracting'.

[25] The threshold or test which is to apply to this evaluative exercise has been reformulated by the courts of England with varying degrees of inconsistency. What is clear notwithstanding, is that descriptors traditionally attached to penalty clauses like "in terrorem", "swinging" or "penal" are, of themselves, generally unhelpful in determining whether a clause will qualitatively amount to an unenforceable penalty.<sup>17</sup>

As Lord Roskill in **Bridge v Campbell Discount Co Ltd** stated, those labels:

"...add nothing of substance to the idea conveyed by the word 'penalty' itself, and it obscures that fact that penalties may be quite readily undertaken by parties who are not in the least terrorised by the prospect of having to pay them and yet are, as I understand it, entitled to claim the protection of the court when they are called upon to make good on their promises."<sup>18</sup>

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<sup>15</sup> Ibid at page 622.

<sup>16</sup> See para. 24 of Cavendish.

<sup>17</sup> Bridge v Campbell Discount Co Ltd [1962] AC 600 at 622.

<sup>18</sup> [1962] AC 600 at 622.

- [26] In my view, the learned authors of **Halsbury's Laws of England** have very helpfully and accurately summarised the Supreme Court's most recent reformulation of the test to be applied, as set out in **Cavendish**, in the following way:

"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. The correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract."<sup>19</sup> (Underlining supplied)

- [27] The learned authors of **Chitty on Contracts**,<sup>20</sup> in their discussion on freedom of contract at paragraph 1-032 similarly recite the test in the following terms:

"In view of the Supreme Court, the true test whether a contract term imposes a 'penalty' on the party in default is whether: '...it imposes a detriment on the contract breaker out of all proportions to any legitimate interest of the innocent party in the enforcement of the primary obligation'." (Underlining supplied)

- [28] Taking into account the relevant portions of **Cavendish**<sup>21</sup> and the principles as they have been distilled by the learned authors of **Halsbury's** and **Chitty**, the question under the second consideration is therefore, whether the secondary obligation imposes a detriment which is exorbitant or unconscionable in the sense that it is out of proportion to any legitimate interest of the innocent party in the enforcement of the primary obligations under the contract. Critically, the Supreme Court in **Cavendish**, and indeed the summary of the principles arising therefrom as summarised by **Halsbury's** and **Chitty**, speak to an evaluation of the interests of the innocent party in the performance by the breaching party of the secondary obligation. The effect of this reference, and indeed the several cases on this point which predate **Cavendish**, is that a secondary obligation will not be deemed an unenforceable penalty where its existence can be reasonably justified by the innocent party. An innocent party therefore has the opportunity to justify the imposition of a secondary obligation as a

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<sup>19</sup> Halsbury's Laws of England (Volume 29 (2019)), at para. 554: The rule against penalties: unconscionable and extravagant provisions penal.

<sup>20</sup> (2018) 33<sup>rd</sup> Edition, Volume 1.

<sup>21</sup> See paras. 32, 35, 75 and 287 of Cavendish.

remedy for a breach of contract with evidence of the proportionality of the consequence engaged by the relevant obligation, to the interests of the innocent party in receiving the benefit of that consequence.

- [29] Finally, the law is clear as to the effect of a conclusion that a contractual clause is a penalty. Once such a determination is made in keeping with the requirements of the penalty rule as outlined above, the clause is wholly unenforceable, and the court has no power to rewrite the clause with a view to avoiding the consequence of unenforceability.<sup>22</sup>

### **Discussion**

- [30] In keeping with the guidance offered by **Cavendish**, the two relevant questions to be asked in this appeal in relation to clause 4 of the Guarantee Agreement are: (i) was clause 4 a secondary obligation (as opposed to a primary obligation) under the Guarantee Agreement, and therefore, in law, capable of being classified as a penal contractual clause; and (ii) if clause 4 was a secondary obligation, did it impose a detriment on Nedlands which is out of all proportion to any legitimate interests of Reniston in the enforcement of its primary contractual obligations?

### **Is clause 4 a secondary obligation capable of amounting to a penalty?**

- [31] The crux of the learned judge's reasoning in relation to the nature of the Guarantee Agreement and by extension clause 4, is found at paragraph 16 of his judgment where he reasons as follows:

“A guarantee is a classic example of a secondary obligation. Thus, if the rate of interest payable by a guarantor on the breach by the principal debtor of its obligations is otherwise a penalty, the fact that the guarantor assumes its obligations as a primary obligor does not as a matter of substance change the true nature of the obligation.”

- [32] It is apparent from the paragraph quoted above, and from the remainder of the judgment, that the learned judge construed the Guarantee Agreement in the broader context of the Loan Agreement and in so doing, concluded that the entire agreement,

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<sup>22</sup> See paras. 9, 84, 85, 86, 283, 291 and 292 of *Cavendish*.

including clause 4, amounted to a secondary obligation relative to obligations under the Loan Agreement.

[33] Mr. Adkins argues that this approach by the learned judge was wrong as a matter of law. He argued that a clause can only be a penalty if it provides for the payment of a sum of money by the contract-breaker, upon the breach by him of the same contract that contains both the primary obligation and the potential penalty clause, and therefore that only obligations contained within a contract, can be primary or secondary. He contends further that a secondary obligation can only arise upon the breach of a primary obligation in the same contract and therefore that the learned judge's conclusion that the Guarantee Agreement, in the broader context of the Loan Agreement, was wrong. He contends that on a proper construction, a guarantor's obligations under a guarantee are conditional upon the default by a borrower, and are not in any way "secondary" to primary obligations owed by the guarantor under the contract of guarantee. He concluded therefore that, on that basis, that the interest payable under clause 4 of the Guarantee Agreement represented Nedlands' primary (and not its secondary) obligations to Reniston and could not therefore as a matter of law amount to an unenforceable penalty.

[34] Let me say, at the outset, that when one examines the Guarantee Agreement as a stand-alone contract, it can hardly be said that the interest rate imposed by clause 4 was capable of engaging the penalty rule, any at all. As stated earlier, the penalty rule is concerned with secondary obligations – these are obligations which arise from the non-fulfilment or breach of a primary obligation. Clause 4 requires the payment of interest to Daferson/Reniston on all sums demanded from Nedlands following a breach by SZAG of the Loan Agreement. It is clear that clause 4 is engaged solely in those circumstances, neither of which amounts to a breach of the contractual duties owed between Daferson/Reniston on the one hand, and Nedlands on the other. By definition, therefore, clause 4 is not a secondary obligation under the penalty rule as no breach of contract is required for Nedlands' obligation to pay interest thereunder to be engaged. Clause 4 is, in the true sense, a conditional primary obligation which is

brought into play on the occurrence of a mere event specified in the terms of the Guarantee Agreement.

- [35] Against that background, whether clause 4 may properly be a secondary obligation, hinges on the correctness of the judge's treatment of the Guarantee Agreement (and therefore clause 4) as a secondary obligation, consequent upon the breach of the Loan Agreement as between SZAG and Daferson/Reniston, and not as a primary obligation under the Guarantee Agreement as between Nedlands and Daferson/Reniston.
- [36] The question of whether a guarantee agreement and by extension the clauses contained therein may properly be considered a secondary obligation under the penalty rule is not, in my view, frontally addressed by the decision in **Cavendish**. Mr. Adkins submitted that the answer to this question may be gleaned from the decision of the English Court of Appeal in **Export Credits Guarantee Department v Universal Oil Products Co and others**.<sup>23</sup> I agree.
- [37] The background to **Export Credits** is described by the House of Lords and Court of Appeal as 'extremely complicated' and 'highly complex', but may be simply stated as follows. Procon (Great Britain) Ltd, a subsidiary of Universal Oil Products Limited, agreed to construct a refinery. Financing for the construction project was provided by a consortium of banks, led by Kleinwort Benson Ltd. The financing agreement was guaranteed by the Export Credits Guarantee Department ("ECGD"). By ECGD's guarantee, ECGD agreed to repay the banks, in the event that Procon defaulted on the terms of the finance agreement, and Procon undertook to reimburse ECGD for any payments made by ECGD to the banks. Procon, at some point, defaulted to the terms of the finance agreement, and consequently ECGD's guarantee was called upon. Following payment by ECGD to the banks, ECGD sought reimbursement from Procon as they had agreed. Procon however claimed before the court that the terms of its agreement to reimburse ECGD were penal in nature, and sought to be relieved by the

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<sup>23</sup> [1983] 2 All ER 205.



High Court from the obligations under the guarantee. In essence, Procon's argument was that its indemnity under the guarantee agreement with ECGD was penal in nature, being engaged as a consequence of the breach of the finance agreement between Procon and the banks.

- [38] Procon's argument was rejected by the High Court, Court of Appeal and House of Lords. At the Court of Appeal, Waller LJ in his judgment in essence considered that the obligations under the guarantee were conditional primary obligations. Waller LJ considered that the provisions were only liable to be engaged on the condition that there was default by Procon under the terms of its agreement with the banks, as opposed to upon a breach of the agreement between Procon and ECGD. At page 216, he reasoned as follows:

"The situation in this case is entirely different from any of the cases dealing with penalty clauses which are clauses put into a contract to cover breach of that contract. This was quite different, this was a clause in a contract by which the ECGD had undertaken to guarantee against certain risks but they had specifically excluded from the guarantee liability for those risks when there was the additional risk created by the fact that Procon were in default. It was a clause providing for the payment (in fact the repayment) of certain sums of money on the happening of an event, namely default of the Newfoundland companies causing payment by the ECGD to the banks at the time when Procon were in default."

- [39] As the obligations under ECGD's guarantee were conditional obligations, Waller LJ concluded that, though the terms of guarantee turned out to give rise to an expensive risk, there was no sufficient basis upon which to award relief to Procon from the terms of its guarantee with ECGD.
- [40] Similarly, Slade LJ in the Court of Appeal relied heavily on dicta from the decision of Diplock LJ in **Philip Bernstein (Successors) Ltd v Lydiate Textiles Ltd**<sup>24</sup> and later rejected the arguments by counsel that the penalty rule could apply to relieve the breaching party from contractual obligations other than those owed between some entity who was not a party to the contract. He stated:

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<sup>24</sup> [1962] CA Transcript 238 (sub nom *Sterling Industrial Facilities Ltd v Lydiate Textiles Ltd* 106 SJ 669).

“In my judgment, however, neither the Gilbert-Ash decision nor any other decision subsequent to the Bernstein case which has been cited to this court lends any support whatever to the proposition that it should or can extend the penalty area so as to cover cases where the breach of contract which is expressed to give rise to the obligation to pay the alleged penalty is the breach of a contractual duty owed to a third party other than the person who is to receive it.”

[41] Slade LJ concluded as follows:

“Staughton J, as I read his judgment, rejected the Procon companies' submission essentially on the grounds that a provision cannot amount to a penalty if it provides for the payment of money on a specified event other than a breach of a contractual duty owed by the contemplated payer to the contemplated payee. For the reasons which I have given, I agree with this conclusion.”

[42] Lord Roskill, delivering the unanimous decision of the House of Lords, upheld the decision of the Court of Appeal on the same grounds articulated by Slade LJ; that the provisions of the Guarantee were not an unenforceable penalty as they provided for payment of money on the happening of a specified event other than a breach of a contractual duty owed by the contemplated payer to the contemplated payee.

[43] Both the instant appeal and **Export Credits** concern an amalgam of interlocking and interdependent contracts, one of which is a guarantee contract for the provision of a loan, where the guarantor is not itself a party to the loan agreement or any of the other related agreements. In my view, the circumstances of this appeal are materially identical to **Export Credits** and there is no basis upon which to materially distinguish one case from the other. Applying **Export Credits** to the instant appeal, it is clear that the learned judge erred in considering that the Guarantee Agreement itself was a penalty. As the penalty rule is concerned with the court's jurisdiction over the enforcement of contractual provisions consequent upon breach of contract, the rule is necessarily concerned only with the nature of obligations under a contract and the provisions contemplated by the parties to remedy a breach of that contract.

[44] The approach of the Court of Appeal and House of Lords makes it clear that whether the terms of the Guarantee Agreement are to be construed as a penalty or not will

depend on whether the contract imposes an obligation upon the breach of contractual duty as between the contemplated payer (in this case, Nedlands) and the contemplated payee (Reniston). Such an approach necessarily excludes the approach taken by the learned judge as, in this case, the contractual duties as between the payer and the payee are set out exclusively in the Guarantee Agreement. Following the approach of the courts in **Export Credits**, the Guarantee Agreement must be construed without having regard to the Loan Agreement to which it relates. As I reasoned earlier, the unavoidable conclusion arising from such a construction is that clause 4 is a conditional primary obligation under the Guarantee Agreement, engaged only upon the requirement for payment by Nedlands under the Agreement, which requirement for payment cannot, on any view, be regarded as a breach of the Guarantee Agreement. As the obligation to pay interest under clause 4 is not triggered by a breach of the Guarantee Agreement as between the parties to the Guarantee, there is simply no scope to argue that clause 4 amounts to a penalty. Neither can any such breach be imported from the broader context of the Loan Agreement to which Nedlands is not a party. Against the principles stated in **Export Credits** therefore, I am satisfied that the learned judge erred in concluding that the Guarantee Agreement and by extension, clause 4, was a secondary obligation, as that term is understood in the context of the law pertaining to penalty clauses. Clause 4 is not, in law, capable of falling within the purview of the penalty rule as it is not a secondary obligation.

- [45] It is worth mentioning that **Export Credits**, is a case of some (albeit relatively recent) vintage. Notwithstanding its vintage, and the fast-paced developments in statutory regimes governing contracts including the increased prevalence of complex interlocking commercial contracts, it remains good law in the United Kingdom. Indeed, the approach taken by **Export Credits** has been followed recently by the unanimous decision of the English Court of Appeal in **Re B (children) (relocation to UAE: Enforceability of charge over property and issues of wardship)**.<sup>25</sup> Importantly, McFarlane LJ opined that the principle espoused in **Export Credits** has been virtually

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<sup>25</sup> [2017] 1 All ER 1099.

unaffected by the **Cavendish** decision which is considered to have largely reformulated the substantive requirements for the engagement of the penalty. At paragraph 65, McFarlane LJ states:

“We would add that the law on this point does not appear to us to have been affected by the comprehensive review of the common law relating to penalty clauses recently performed by the Supreme Court in *Cavendish Square Holding BV v Talal El Makdessi, Parking Eye Ltd v Beavis* [2015] UKSC 67, [2016] 2 All ER 519,, [2015] 3 WLR 1373, in which judgment was given on 4 November 2015, a week after the conclusion of the hearing before us: see, in particular, the judgments at paras [12] to [18], [129] to [130], [239] to [241], [291] and [293].”

- [46] I would only add to McFarlane LJ’s statements in **Re B** by noting that in **Export Credits**, Lord Roskill made clear that were the penalty rule made to permit interference with the terms and obligations entered into under a contract, as a result of breaches committed in relation to contractual duties outside of those owed by the parties to an agreement, this would be ‘[extending] the law by relieving against an obligation in a contract entered into between two parties which does not fall within the well-defined limits in which the court has in the past shown itself willing to interfere’. Such an extension was made by the High Court in Australia and adopted as a part of the common law in decisions such as **Andrews v Australia and New Zealand Banking Group Ltd**.<sup>26</sup> The majority of the Supreme Court in **Cavendish** considered (albeit in different circumstances) whether it should undertake to extend the penalty rule to take account of developments in contract law occasioned by the modern legislative framework to which contracts are now subjected, and in light of common law developments outside the United Kingdom. In sum, the Supreme Court considered that any substantive changes to or extensions of the penalty rule, at this stage of its existence, ought properly to be a matter for Parliament by way of legislation given the rule’s firm and relatively consistent and traceable roots in the common law and in equity. With this in mind, it appears to me that unless reconsidered by the Supreme Court or abridged by legislation, the principle expressed in **Export Credits** remains good law.

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<sup>26</sup> (2012) 247 CLR 205.

[47] Lastly, I would observe for what it is worth, and in fairness to the learned judge, that contracts of guarantee have been classified as 'secondary obligations' relative to the principal obligations owed by a debtor under a separate agreement. As the learned authors of **The Modern Contract of Guarantee**<sup>27</sup> stated at pages 9 and 10 of the text:

"A contract of guarantee is predicated upon the existence of a principal obligation owed by the principal debtor. If there is no such principal obligation, generally the guarantee fails. Consequently, a valid guarantee depends upon the existence of a promise made to a person to whom a debtor is already answerable or is to become answerable.

...

The distinctive feature of a contract of guarantee is the secondary obligation which is assumed by the surety of guarantor.

...

The guarantor's liability is secondary in the sense that it is contingent upon the principal debtor's continuing liability and, ultimately, his default. This collateral obligation is totally dependent upon the primary obligation as it existed when the secondary liability arose." (Underlining supplied)

[48] It is clear that the terms 'principal obligation' and 'secondary obligation' as used above, take on a different meaning in the context of the law as to guarantees. In this context, these terms describe the dependence of a guarantee agreement on the co-existence of some other agreement at the time the guarantee is created and for the life of the guarantee. In this sense, a contract of guarantee is truly secondary to a primary agreement as the foundation of its existence depends on another agreement. Accordingly, while the learned judge's description of the Guarantee Agreement as a secondary obligation is technically correct in the context of the law as to guarantees, the term secondary obligation bears a different meaning under the penalty rule – an obligation consequent to a breach of a primary obligation in the same agreement.

[49] In view of the authorities cited above, clause 4 of the Guarantee Agreement was not, in law, a contractual penalty, and the learned judge therefore erred in so concluding and in refusing to give effect to it on that basis.

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<sup>27</sup> 1985, O'Donovan and Phillips, The Law Book Company Limited.

### **Costs Below**

- [50] As mentioned earlier, the learned judge made an award of fixed costs in the court below. The learned judge at paragraph 2 of his order stated: '[t]hat the Defendant do pay the Claimant's fixed costs, as would have been payable had a claim for the judgement debt been brought under a Part 8 claim form and a default judgement obtained'.
- [51] There was no ground of appeal in relation the judge's costs order. Reniston has however sought, in its notice of appeal, an order that: 'The respondent do fully indemnify the Appellant against all its costs of these proceedings pursuant to clause 5(d) of the Guarantee.' In its skeleton arguments and in the oral submissions by Mr. Adkins, it became clear that Reniston seeks to substantively challenge the judge's decision to order fixed costs in the court below on the basis that it was not open to him to so order in light of the relevant Civil Procedure Rules and in light of clause 5(d) of the Guarantee Agreement. I would remark in passing that such a frontal challenge to the learned judge's costs order, which is clearly independent of Reniston's challenge to the judge's treatment of clause 4 as a penalty, ought properly to have been reflected in Reniston's grounds of appeal. In the circumstances of this case however, Nedlands, having not participated at all in the proceedings, there can be no prejudice arising from Reniston's failure to have properly raised this issue in the notice of appeal.
- [52] Both the oral and written submissions on this point were very brief. Mr. Adkins argued that pursuant to CPR 69B.10, the fixed costs regime does not apply to matters before the Commercial Division of the High Court in the Territory of the Virgin Islands. He argued therefore that the learned judge accordingly erred in law in making an award of fixed costs.

- [53] It is undoubted that the question of costs is a matter which is generally within the discretion of the judge. This is a discretion which must be exercised judicially in the context of the relevant legal principles. As the question of costs is discretionary, an appellate court ought not to interfere with a judge's costs order unless it is shown that the judge was plainly wrong in the exercise of his or her discretion.<sup>28</sup>
- [54] In so far as the CPR prescribes the costs regimes applicable to the diverse type of proceedings commenced thereunder, the rules generally do not admit of much flexibility. It is for this reason that Michel JA at paragraph 22 of **Friar Tuck Ltd et al v International Tax Authority**<sup>29</sup> stated that: 'Whereas there is some overlap between the regimes for the quantification of costs under the CPR, it is not open to a judge to assimilate costs regimes where the CPR expressly requires that a particular regime be utilised'.
- [55] Costs in proceedings before the Commercial Division are primarily governed by CPR 69B.10 to 69B.14. Critically, CPR 69B.10 states: 'Rules 65.3 to 65.10 (inclusive) shall not apply in commercial matters.' Rules 65.3 to 65.10 respectively set out the bases upon which costs are to be quantified under the CPR including the fixed costs, prescribed costs, and budgeted costs regimes. In my view, CPR 69B.10 is clear and unambiguous. The fixed costs, prescribed costs and budgeted costs regimes under rules 65.3 to 65.10 are clearly disapplied from proceedings before the Commercial Division of the High Court. From the outset therefore, it is apparent that it was not open to the learned judge to award costs utilising the fixed costs regime set out under CPR 65.4. As a consequence, the learned judge's costs award was plainly wrong and must be set aside.
- [56] Mr. Adkins has invited this Court to exercise the discretion as to costs afresh. He argues that the learned judge was required to make a costs award which gives effect

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<sup>28</sup> Michel Dufour et al v Helenair Corporation Ltd et al [SLUHCVP1995/0004] (delivered 2<sup>nd</sup> & 12<sup>th</sup> February 1996).

<sup>29</sup> (BVIHCVAP2017/0003, delivered 12<sup>th</sup> March 2019).

to the indemnity costs clause of the Guarantee Agreement – clause 5(d) – which provides as follows:

“The Guarantor shall promptly on demand, pay to, or reimburse the Lender on a full indemnity basis, all costs, charges, expenses, taxes and liabilities of any kind (including, without limitation, legal, printing and out-of-pocket expenses) incurred by the Lender in connection with:

...

(d) the preservation, or exercise and enforcement, of any rights under or in connection with this guarantee or any attempt so to do.”

[57] This submission, in my view, is unsustainable. Firstly, I observe that Reniston, in its claim form, did not seek costs on the basis of clause 5(d). In fact, quite differently, the amended claim form upon which the learned judge entered judgment sought costs ‘pursuant to rules 12.12 and 69B.12 of the **Civil Procedure Rules 2000** or such other basis as the Court deems fit’ with the statement of claim at paragraph 24, simply requesting ‘Costs’. This fact alone is, in my view, fatal to an application for costs on the basis of clause 5(d). It behooved Reniston to plead the specific basis upon which it sought costs in the court below. Reniston was given several opportunities to amend its pleadings, yet did not amend its prayer for costs to include a claim for costs pursuant to the Guarantee Agreement. In those circumstances, it is not, in my view, appropriate for this Court simply to defer to clause 5(d) where no such claim for costs had been made in the court below.

[58] Furthermore, and in any event, clause 5(d) very clearly contemplates the liability of the Guarantor to the Lender on a ‘full indemnity basis’ for any and all costs incurred by the Lender in relation to the preservation, or exercise and enforcement, of any rights under or in connection with the guarantee. The clause does not in any way purport to fetter or dictate the manner or basis upon which the court, in its discretion, is entitled to award costs within the context of the CPR. It is simply a contractual arrangement between the parties to the Guarantee Agreement for the payment of costs, as between themselves, were such costs to be incurred as contemplated by the Agreement. Given the clear words of clause 5(d), even if Reniston’s claim included a claim for costs on the basis of the clause, the Court nonetheless retained its discretion to determine the incidence and quantum of costs in the proceedings. On any view



therefore, as a matter of law, the argument that the judge was, or this Court is required to make an award for costs on the basis of clause 5(d), is without merit.

- [59] In the circumstances, and having regard to the costs provisions for matters in the Commercial Division which are set out in CPR 69B.10 to 69B.14, it is appropriate, in my view, to remit the question of the quantum of costs to be awarded to Reniston for assessment by the court below.

### **Costs on Appeal**

- [60] Reniston having prevailed in its appeal is also entitled to its costs in accordance with CPR 65.13.

### **Order**

- [61] For all the above reasons, I would therefore make the following orders:
- (1) The appeal is allowed.
  - (2) Reniston is entitled to contractual interest in accordance with the terms of clause 4.1 of the Guarantee Agreement;
  - (3) The costs order of the learned judge is set aside; and
  - (4) Reniston's costs in the court below and on appeal are to be assessed by the court below, with the costs on appeal not exceeding two-thirds of the costs below.

I concur.  
**Paul Webster**  
Justice of Appeal [Ag.]

I concur.  
**Vicki-Ann Ellis**  
Justice of Appeal [Ag.]

**By the Court**

**Chief Registrar [Ag.]**