

# Client Update

## UK Supreme Court Provides Welcome Clarification to Rules on Penalty Clauses for First Time in a Century

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The UK Supreme Court has recently handed down its long-awaited judgment in the combined cases of *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis* [2015] UKSC 67. The decision, which concerns two disputes at different ends of the commercial spectrum, provides clarification as to the circumstances in which the law on penalties will apply, and when a clause will be seen as a penalty and therefore held to be unenforceable.

### THE PREVIOUS POSITION ON PENALTIES

Before the decision in *Cavendish*, the general understanding was that the law of penalties applied to any contractual provision that provided for a specified payment or transfer to be made by one party in the event that it committed a breach of contract. This transfer could take several forms, including a direct payment by the breaching party of a fixed sum, denial of a payment to the breaching party that would otherwise be made or a forced transfer by the breaching party of an asset.

The key test applied to such clauses was taken from the judgment of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] A.C. 79. Subsequent cases focused on whether the required payment or transfer constituted a “genuine pre-estimate of damage” likely to be suffered by the innocent party as a result of the breach, in which case the clause was generally enforceable, or whether the clause was out of proportion with the likely damage and was a punishment for the party breaching the contract, in which case the clause would be a penalty and unenforceable.

However, applying these principles, particularly to complex commercial contracts between sophisticated parties, was seldom easy. Tensions arose between the rules on penalties and the expectations of commercial parties that

their contractual terms would be upheld. More recent cases (*See, e.g., Lordsvale Finance plc v Bank of Zambia* [1996] QB 752 and *Murray v Leisureplay plc* [2005] EWCA Civ 963) saw courts placing increasing emphasis on the overall commercial purpose of a clause when considering its enforcement. While this was a welcome development in supporting parties' freedom of contract, it created uncertainty as to when exactly a clause would fall foul of the law on penalties.

### THE ISSUES IN *CAVENDISH* AND *PARKINGEYE*

Two cases arising at similar times provided an opportunity for the Supreme Court to provide a much-needed review of the law. The two cases arose in very different contexts.

*Cavendish* was a substantial commercial dispute over the sale of a controlling stake in a leading advertising and marketing company. The purchase price was payable by Cavendish in instalments. Later instalments were expressed to be subject to compliance by Mr. Makdessi with certain continuing obligations and non-compete covenants. On breach of those obligations, Cavendish ceased to be liable to pay any further instalments, and would have a right to buy out Mr. Makdessi's remaining shares in the company for a price that excluded the company's goodwill. Having breached his obligations, Mr. Makdessi claimed that the terms providing for loss of instalments and forced sale of shares were unenforceable penalties. He was successful on this argument in the Court of Appeal, and *Cavendish* brought the matter to the Supreme Court.

In *ParkingEye*, ParkingEye Ltd managed a car park. Notices were displayed at the entrance of the car park stating that parking was free for up to two hours, but a failure to vacate the car park within that time limit would "result in a Parking Charge of £85". Mr. Beavis used the car park and stayed beyond the two-hour period of free parking. When ParkingEye sought payment of the £85 charge, Mr. Beavis' defence was that the charge was unenforceable as a penalty or, alternatively, that it was unfair and unenforceable by virtue of the Unfair Terms in Consumer Contracts Regulations 1999. Both the High Court and Court of Appeal rejected those arguments, and Mr. Beavis appealed to the Supreme Court.

### THE "TRUE TEST" FOR ENFORCEABILITY

The appeals were heard jointly by a seven-member bench of the Supreme Court. The first judgment was given jointly by Lord Neuberger and Lord Sumption, with Lord Clarke and Lord Carnwarth agreeing. Their judgment criticized the creation in decisions since *Dunlop* of a dichotomy between "genuine pre-estimates of loss" and "penalties". Instead, they held that:

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. (paragraph 32)

This judgment clarifies two questions: (1) whether the rules on penalties are engaged at all by a particular clause; and (2) if they are, in what circumstances will the clause be held unenforceable.

On the first point, Lords Neuberger and Sumption drew a distinction between “primary” obligations and “secondary” obligations. The rules on penalties do not apply at all to primary obligations, as “it is not a proper function of the penalty rule to empower the courts to review the fairness of the parties’ primary obligations”. Instead, the penalty rule applies only to “secondary” obligations, which seek solely to define the measure of compensation (as an alternative to a standard claim in damages) payable by a party in the event of breach of a primary obligation.

However, simply because a term only becomes effective upon breach of another obligation does not mean that it is a secondary obligation. The Court will have particular regard to how the relevant obligation is framed in the contract, “i.e. whether as a conditional primary obligation or a secondary obligation providing a contractual alternative to damages at law”.

It is suggested that while this distinction may be clear in some cases, in other cases it may be more difficult to determine whether an obligation arising upon breach is primary or secondary.

On the second point, Lord Neuberger and Lord Sumption held that it is not appropriate to consider only whether a stipulated remedy represents a “genuine pre-estimate of damage” to determine if it is a penalty. The court must assess the clause against the innocent party’s legitimate interest in performance of the contract, which may go beyond payment of damages. Only if the clause is exorbitant or unconscionable in comparison with the legitimate interest pursued will it be held to be a penalty and unenforceable.

The judgment provided some guidance as to the circumstances in which a clause will be unconscionable. In particular, the judgment emphasised that where a contract is negotiated between properly advised parties of comparable bargaining power, a strong presumption will be that “the parties themselves are the best

judges of what is a legitimate provision dealing with the consequences of breach". This suggests that it will be difficult for parties in substantial commercial contracts to rely upon the rules on penalties in the future. However, the Supreme Court was asked by *Cavendish* to consider abolishing the law of penalties for commercial contracts completely, but it expressly declined to do so. The rules on penalties do therefore continue to apply even in the commercial context.

### THE DECISIONS ON THE FACTS OF THE APPEALS

Applying these principles to the particular appeals, the Supreme Court unanimously held that all clauses under consideration were enforceable.

In *Makdessi*, the relevant clauses were held to be primary obligations. The rule on penalties therefore was not engaged. The decision illustrates that parties are generally free to agree conditional primary obligations, such as obligations to pay certain sums upon the occurrence of a specified event that is not a breach, as long as they are carefully drafted.

In *ParkingEye*, the Court found that the obligation to pay a charge was secondary and so the penalty rule was engaged. However, *ParkingEye Ltd* had a legitimate interest in imposing a charge that went beyond the loss they could strictly recover as damages for breach of contract: they had to ensure that parking rights were not abused by customers and the car park could operate for the benefit of the public generally. The court found that a charge of £85 was not extravagant or unconscionable in the circumstances to protect that legitimate interest.

### CONCLUSION

This long-awaited case marks a departure from the principles previously applied to penalty clauses. Parties will no longer be primarily concerned with whether a contractual clause represents a genuine pre-estimate of loss, but will instead need to consider whether a clause is a primary or secondary obligation, what legitimate interests a party is seeking to protect in its contract, and whether a specified remedy is extravagant or unconscionable in that context. Particularly for commercial contracts, this may reduce the scope for parties to argue that certain clauses are unenforceable as penalties. However, it remains to be seen whether this new test will be any easier to apply than the one it replaces.

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Please do not hesitate to contact us with any questions.