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Supreme Court changes law relating to Liquidated Damages and Penalty Clauses

Cavendish Square Holding BV v Talal El Makdessi; Parkingeye LTD v Beavis [2015] UKSC 67

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1. Introduction

The Supreme Court yesterday (4th November 2015) launched its own fireworks a day early by changing the law relating to liquidated damages and penalty clauses. The judgment in *Cavendish Square Holdings BV v Talal El Makdessi* , *ParkingEye Ltd. v Beavis* [2015] UKSC 67 can be found at https://www.supremecourt.uk/cases/docs/uksc-2013-0280-judgment.pdf.

Liquidated damages clauses (LDs) require the contract breaker to pay the innocent party a specified sum of money on the occurrence of his breach. Other clauses deprive the wrongdoer of something he has already advanced (e.g. deposit) or his future entitlement under the contract (in which case the equitable jurisdiction to grant relief from forfeiture may also apply). Or it may confer additional rights on the innocent party (e.g. an increased remuneration rate) as a result of the wrongdoer's breach of contract. If the clause is effective the innocent party need not prove his loss or quantify it - his entitlement is automatic. These clauses are potentially subject to the penalties rule if the trigger is the wrongdoer's breach of contract.

Such clauses are often found in construction contracts, commercial agreements and design-and-build contracts. They are usually triggered by a delay in one/other party's performance but can also found where the work is done on time but does not meet certain stipulated criteria. The amounts involved are often very substantial and can sometimes force the contract breaker into insolvency/bankruptcy. Needless to say, he will often dispute his liability and one of the ways of doing so is to argue that the clause is a penalty and therefore unenforceable.

2. The law up to now

What is a penalty? The test which - until now - has usually been applied is Lord Dunedin's in *Dunlop Pneumatic Tyre Company Ltd. v New Garage and Motor Company Ltd.* [1915] AC 79, 86-87. He sets out a number of principles. The two most frequency cited are:

- first "*the essence of a[*n unenforceable*] penalty is a payment of money stipulated as in terrorem of the offending party [whereas] the essence of [*enforceable*] liquidated damages is a genuine covenanted pre-estimate of damage*".
- second, a clause "*will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.*"

So, in sum, if what the clause allows for is a genuine pre-estimate of the innocent party's loss, it is enforceable. But if it bears no relation to the maximum loss he could realistically have suffered and the purpose of the clause is rather to act as a deterrent, it is a penalty and unenforceable. These principles were well-established although they have come to be treated as a quasi-statutory code, to be interpreted, applied or distinguished.

3. The background to the appeals

Cavendish Square v Talal El Makdessi

Mr Makdessi agreed to sell Cavendish a controlling stake in a holding company of a Middle East communications group. The purchase price was payable in instalments. He covenanted not to compete with the group's business. If he did, the contract provided (cl.5.1) that he would forfeit the right to the

last two tranches and could be made to sell his remaining shares to Cavendish at a price based on asset value i.e. which excluded goodwill (cl.5.6). Mr Makdessi breached the covenants and when Cavendish sued he argued the clauses were penalties and therefore unenforceable. The Court of Appeal, overturning the decision at 1st instance, agreed.

ParkingEye Ltd v Beavis

Parking Eye were managers of a customer car park at the Riverside Retail Park. Displayed notices made clear that parking for more than the maximum time allowed (2hrs) would incur a £85 parking charge. Mr Beavis overstayed but contested his liability on the basis it was a penalty and/or was contrary to the Unfair Terms in Consumer Contracts Regulations 1999. The Court of Appeal, upholding the 1st instance decision, held it was not.

Cavendish and Mr Beavis appealed to the Supreme Court and the two appeals were heard together.

4. The Supreme Court decision

The Supreme Court allowed Cavendish's appeal and dismissed Mr Beavis', deciding in the first case that the clauses were not penalties and in the second that the charges were nevertheless enforceable. Lords Neuberger and Sumption gave a joint judgment. Lords Clarke and Carnwarth agreed. Lords Mance and Hodge gave concurring judgments. Lord Toulson agreed with the decision in *Cavendish* but dissented in *Beavis*.

However the importance of the case is not the result but what the Supreme Court has now said is the test to decide if a clause is a penalty.

5. The reasons for the judgment – what makes a contractual term penal?

Lords Neuberger and Sumption decried the over-literal application of the principles in Lord Dunedin's speech in *Dunlop Pneumatic Tyre* to all cases [**31**]. They were ancillary to the broader consideration of whether the clause was extravagant or unconscionable [**22**]. The court should take into account the wider interests of the innocent party, as identified in Lord Atkinson's speech in the *Dunlop* case at pp.91-3 [**24**].

Accordingly they re-cast the test relating to penalties by holding that the validity of this type of clause depended instead on whether the innocent party had a "legitimate interest" in its enforcement. If the clause has an adverse impact that significantly exceeds that interest it will be unenforceable as a penalty. But the fact a clause is not a pre-estimate of loss does not, without more, mean that it is penal [**31**]. The innocent party may have a legitimate interest above and beyond recovering compensation i.e. the performance of the other side's primary obligations.

Lords Neuberger and Sumption held that "[**t]he true test [of a penalty] is whether the [clause] 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"** [**32**]. In straightforward damages cases that interest will not extend beyond compensation. Then Lord Dunedin's test is enough of itself. But in other cases the innocent party's wider interests must be taken into account. Even so the court should be reluctant to interfere with a negotiated contract between properly advised parties of comparable bargaining power - the "strong initial presumption" is they are the best judges of what is legitimate [**35**].

They reaffirmed that the law relating to penalties only applies to secondary obligations which arise on the occurrence of a breach, not to primary ones. Whilst that gives rise to the possibility that clever drafting can be used avoid the rule, the court looks to the substance of the clause, not its form, to decide if the trigger is a breach.

Lord Mance agreed. An uplift resulting from another's breach is valid if it reflects the change in risk to the innocent party or his administration costs, but not if it is in the nature of punishment or pure deterrence [**148**]. However the innocent party has interests beyond the purely compensatory. So:-

"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" [**152**]

Lord Hodge also agreed, reaffirming that the test was whether the remedy was exorbitant or unconscionable, having regard to the innocent party's interest in performing the contract [**255**], not whether it was a genuine pre-estimate of loss or intended as deterrence [**246-8**]. When judging if a term is exorbitant or unconscionable one has regard the interests, commercial or otherwise, which the innocent party sought to protect. If it is the payment of money by a certain date, such payment plus interest and costs normally vindicates that interest. Where it is performance of some other term the task is more complex: the court looks to the interest in timely performance [**249**].

Lord Toulson agreed with Lord Hodge's formulation of the test at [**255**] and with Lord Mance and Lord Hodge on the relationship between penalty and forfeiture clauses **[294]**.

6. Application to the facts

Cavendish v El Makdessi

Clause 5.1. The Court was prepared to assume (without deciding) that a clause may be a penalty if it disentitled the wrongdoer from receiving what would otherwise have been due to him. But that was so only if it did not define the parties' primary obligations but merely their secondary ones that arise on a breach [**72**]. The law of penalties does not apply to pure price adjustment clauses or clauses which provide for stepped payments on the performer meeting certain criteria, unless he also promised to do so.

Clause 5.1 was a price adjustment clause. The seller earned the consideration for the transfer of the shares by (inter alia) observing the no-compete covenant. So whilst the failure to do so was a breach, it also meant he did not provide part of the consideration for the price [**74**]. Even if it was a penalty, whilst it was not a genuine pre-estimate of loss Cavendish had a legitimate commercial interest in enforcing the covenant since it preserved the value of the goodwill it was buying. Since the court could not know what the deal would have been had the covenant not been given it must defer to the parties, who were the best judges of their interests. [**75**].

Clause 5.6. A similar analysis applied here too. The price formula for the sale of the shares reflects the reduced price Cavendish was willing to pay if the seller was actively undermining the business he was selling. Whilst therefore it may not have been a precise estimate of *loss,* it reflected the *price* Cavendish was willing to pay to buy the business on the hypothesis that Mr Makdessi was not loyal **[79-83]**.

ParkingEye v Beavis

Unlike in *Makdessi* the penalty rule was engaged in *Beavis*. The £85 charge had two main objects: to manage the efficient use of the parking spaces, by deterring customers from staying too long, and to provide an income to meet the costs of parking services [**98**]. Whilst it was not a genuine pre-estimate of ParkingEye's loss (since it was merely a managing agent) it had a wider legitimate interest, including the interests of its employers/the landowners. Whilst it could not levy a fee out of all proportion to its interests, the sum here was not out of kilter with other parking providers' charges. The fact the car park was well used despite the clear warning was some evidence of its reasonableness.

Lord Toulson (dissenting) would have allowed the appeal in *Beavis* on the basis the charge fell foul of the 1999 Regulations.

Comment

The Supreme Court has significantly relaxed the law relating to penalties by weakening the criteria for whether a clause is truly penal. It has also added significant uncertainty, making it difficult now to be

confident whether/not a clause will be upheld. And by significantly widening the scope of the court's task (e.g. ascertaining the nature and extent of a party's interests and whether they are legitimate) it has made litigation on penalty clauses more expensive and lengthened the amount of court time which will be needed to decide them.

Until now, the test appeared to be whether the sum stipulated was a genuine pre-estimate of loss or was merely a deterrent against breach. Now you must first identify what the innocent party's legitimate interests are in *ensuring performance* (i.e. not necessarily recovering the sum). Charges *whose purpose is deterrence may be allowed if there is a commercial justification for them*. These interests are not necessarily financial. What they are and whether they are legitimate is likely to be the main forensic focus of future disputes.

Then you ask if the sum etc. stipulated is "extravagant" or "unconscionable" when measured against those interests. Quite what that means is not clear and is likely to prove a fertile source of future argument. The threshold is obviously meant to be very high. The test appears to be whether the penalty is wholly disproportionate compared to those interests. That is ultimately a value judgment, depending on the facts and circumstances of each case. Where there are industry comparables (e.g. other providers charges) the task may be relatively easy. But where the contract/circumstances are unique it will be all the harder.

Where a party's legitimate interest are purely financial *and* quantifiable the court's task is relatively clear. Where however they are not easily quantifiable the task is far more difficult. And where those interests are not commercial at all, courts must now compare apples and pears. In many cases the court is likely to allow the parties – at least ones who were at arms-length and had the benefit of legal advice - a significant "margin of appreciation". Even – it seems – where they contracted on one party's standard terms. In those cases, the court is likely to defer to the parties on the basis they must have thought that the penalty was fair. Whether that assumption is valid one is debatable. The fact it avoids the delay, uncertainty and expense in proving damages on the traditional, compensatory basis will be a further reason for upholding it (although the irony of the fact that you must litigate that to trial to see if it is true will not have been lost).

On a practical level it has made it all the harder for ordinary consumers faced with such charges (e.g. unauthorised overdraft fees, late payment penalties, etc) to successfully challenge them. The subtext appears to be that it is really for Parliament to regulate them rather than the courts.

Whether the uncertainty created by the Supreme Court will encourage more litigation on penalty clauses or dissuade litigants from fighting remains to be seen.

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