The Highest UK Court Reviews The Law On Penalties

Written by Steve Mangan

A penalty is now to be regarded as:

"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 UK Supreme Court has reviewed the English law of penalties and re-formulated the test in a landmark judgment on two unrelated appeals heard together: (1) *Cavendish Square Holding BV – v – Talal El Makdessi* ("Cavendish"); and (2) *ParkingEye Ltd – v – Beavis* ("Beavis")[1].

The two appeals did not involve construction matters. The judgment will nevertheless be of great interest to construction industry practitioners, including lawyers, when considering whether a liquidated damages clause is valid and so fixes the sum payable in the event of a breach of contract, or alternatively, is an unenforceable penalty. If it is a penalty, the innocent party will need to prove his damages at common law.

Practitioners should note that the distinction has just become rather more clouded. The test provided 100 years ago has been replaced by more subjective considerations on which more guidance will inevitably be required from the courts. It may transpire that certain types of construction employer, in seeking to protect a wide interest, may now seek greater sums in liquidated damages than previously.

Penalties are Secondary Obligations

The law regarding penalties is a rule of contract law based on public policy. A contract may not "punish" a contract-breaker. Penal provisions will therefore not be enforced by the courts. They have for a long time acknowledged that the law regarding penalties does not apply to primary contractual obligations. Save for circumstances involving illegality, duress or questions of consent and the like, primary obligations are matters for the parties alone. The courts will generally not interfere because to do so would run counter to the parties' freedom of contract.

Only secondary obligations that respond to a breach of contract may be subject to the law on penalties. The most obvious example of a secondary obligation is one whereby the contract-breaker must pay money in the form of liquidated damages to the innocent party. But as we shall see, other secondary obligations may be equally amenable to the test for a penalty. For example, the requirement to transfer property or shares may also qualify as a penalty in the appropriate context.

Former Distinction Between Liquidated Damages and Penalty

In 1915 the House of Lords decision in *Dunlop*[2] famously underlined the dichotomy between a penalty and a liquidated damages provision in a contract. It was said to be ultimately a question of construction. *Dunlop* held that the essence of a penalty was the payment of money stipulated as *in terrorem* of the offending party i.e. intended to deter a breach. In contrast, Dunlop also held that the essence of a valid liquidated damages provision was *"a genuine, covenanted, pre-estimate of damage"*. Anything that was not a genuine pre-estimate was at risk of being found penal after *Dunlop*. If the sum stipulated was *"extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach"*, it was definitely penal according to *Dunlop*.

Now, whilst the dichotomy between a penalty and a valid liquidated damages clause still exists as a matter of law, the boundary between the two has moved.

Cavendish v Makdessi

Tel: + 44 (0)20 8614 6200
Fax: + 44 (0)20 8614 6222
Email: info@corbett.co.uk
www.corbett.co.uk

The Supreme Court case of *Cavendish* concerned an agreement for the sale of a majority shareholding by Mr Makdessi to Cavendish at a price per share that reflected very valuable goodwill. The agreement provided for stage payments - an initial payment to Makdessi followed by further payments calculated to reflect company profits when they were known. There was an anti-competition covenant that was later broken by Makdessi. In such circumstances the agreement provided that Makdessi forfeited entitlement to the further payments and that he could also be required to transfer his remaining shareholding to Cavendish at a price per share stripped of the value of goodwill. Makdessi contended that the provisions, including that for the transfer of his remaining shareholding, were penalties and unenforceable.

The Supreme Court resisted a submission for the penalty rule's complete abolition. It however recognised many problems inherent in *Dunlop*. For example, secondary obligations following the breach of a primary obligation, particularly in modern commercial contexts, were said not always to be confined to the payment of money, contrary to the test set out in *Dunlop*. They might involve the forfeiture of a deposit in money or even the transfer of property e.g. in shares. It was said to depend on the nature of the right which the contract-breaker is being deprived of and the basis on which he is being deprived of it. The courts should be free to examine such secondary obligations to determine whether they are penal and therefore unenforceable, the Supreme Court said.

The Court was not unanimous in its categorisation of the provisions for the treatment of goodwill under Makdessi's agreement. A minority decided that the provisions regarding loss of entitlement to further payments were not secondary obligations by Makdessi but were in fact part of a conditional primary obligation to pay by Cavendish. They were no more than a price adjustment mechanism whereby Makdessi, as seller, effectively earned his future goodwill payments by not competing with the company he was selling. Goodwill was part of his consideration for the sale. If it was not provided Cavendish was not required to pay for it. Non-payment under the agreement did not therefore amount to damages for breach of the anti-competition covenant. The law regarding penalties could not therefore apply, according to the minority. A majority of the Court however considered the forfeited payments were indeed secondary obligations on the part of Makdessi but were not penal for other reasons.

The distinction between what is a primary and a secondary contractual obligation and the prospect of "disguising" the true position in complex arrangements is therefore a potential problem for the future. Equally problematic may be the potential overlap between the common law right of an innocent party to withhold something otherwise due under an agreement and the equitable remedy of relief against forfeiture available to a contract breaker.

The Law Lords in *Cavendish* also found the *Dunlop* concept of *in terrorem* or deterrence to be unhelpful. They said that an innocent party might have a legitimate interest in the performance of the contract by the other party which went well beyond the simple right to recover damages - financial compensation for breach – even if the damages could readily be calculated. There might be a wider purpose to the bargain and deterrence might be reasonable and appropriate to protect it. Particularly in cases where the parties have access to legal advice and can negotiate on equal terms (as was the case with Cavendish and Makdessi), the Court considered that they should have the freedom to agree terms that were a deterrent to breach. Here the Court found that Cavendish and Makdessi placed a very high value on Makdessi's accumulated goodwill. It was central to the bargain and Cavendish wanted to acquire it. Cavendish had a legitimate interest in protecting it. Once Makdessi had breached the anti-competition covenant, *"the wolf was in the fold"* as the lower court judge expressed it. The goodwill was effectively lost. Makdessi accordingly lost the entitlement to payment. Furthermore, once this had happened, Cavendish had a legitimate interest in severing the relationship between the parties as quickly as possible. It could not proceed with a disaffected minority shareholder in Mr Makdessi. It was entitled to acquire the balance of Makdessi's shareholding immediately and without the goodwill component, as provided for in the agreement. The requirement for the share transfer did not amount to a penalty.

For similar reasons the Supreme Court in *Cavendish* also thought unhelpful *Dunlop*'s requirement for a valid liquidated damages provision to be a genuine pre-estimate of loss that might flow from the breach. Circumstances might mean that the amount to be paid following breach or other secondary obligation could not satisfy that strict test. As stated above, *Dunlop* had referred to a penalty in terms of the sum paid being *"extravagant and unconscionable."* Similar phraseology is to be found in the review of more than 100 years of case law helpfully set out in Cavendish. One sees phrases such as *"exorbitant"*, *"wholly disproportionate"*, *"gross excessiveness"*, *"unreasonable"*, *"manifest excess"*, *"extravagant disproportion"* (and combinations of most of them!) all used to describe a penalty provision over the years.

From this raft of egregious terms, the Supreme Court has distilled down the essence of a penalty. It has now approved the following succinct re-statement of the test. The test for a penalty now 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.".

Beavis v ParkingEye

ParkingEye managed the car park of a retail centre containing many individual stores. Signs throughout the car park stated that the first two hours' parking by customers was free but those who parked for anything longer would incur an £85 single charge. The signs also stated that, by parking in the facility, motorists were agreeing to the above terms. Mr Beavis overstayed by almost one hour and was charged £85. In court proceedings brought by ParkingEye to recover the charge, Beavis alleged that it was unenforceable at common law because it was a penalty. He also alleged that it was unfair and unenforceable by virtue of the Unfair Terms in Consumer Contracts Regulations 1999 ("Regulations").

The Supreme Court heard the scheme described as a *"traffic space maximisation scheme"*. The £85 charge clearly had nothing to do with compensating ParkingEye for Beavis's breach. Its predominant purpose was *in terrorem* - to deter over-stayers – prohibited by *Dunlop*. The entire scheme benefitted the retailers who relied on the offer of two hours' free parking to attract potential customers to the retail centre and on the £85 charge then to repel them, so ensuring that there was a regular turnover of visitors. The subsidiary purpose of the charge was to fund the scheme. That benefitted ParkingEye by allowing it to make a reasonable profit. Even the car park's users benefitted from the scheme through having access to parking space that might otherwise be clogged up with vehicles not belonging to customers of the retail centre.

ParkingEye therefore was found to have a legitimate interest in the enforcement of the charge which was not out of line with those of other such schemes elsewhere in the UK. The charge was therefore not wholly disproportionate to that legitimate interest and not a penalty. Neither was it unfair under the Regulations.

Conclusion on the implications of *Cavendish* and *Beavis*

The concept of penalty remains. But the point at which it is reached has become more elastic. It would seem that with the disappearance of the emphasis on requiring a genuine pre-estimate of loss, there is now scope for liquidated damages to exceed previous levels. Some deterrence is in principle now acceptable. So long as there is a legitimate interest in enforcement of the original obligation and the sums stipulated are not "out of all proportion" and

Tel: + 44 (0)20 8614 6200
Fax: + 44 (0)20 8614 6222
Email: info@corbett.co.uk
www.corbett.co.uk

unconscionably so, the courts are likely to tolerate the level of damages agreed. Much uncertainty, however, remains:

- The distinction between primary and secondary obligations was unclear even to the seven-member bench assembled in *Cavendish*. For complex commercial matters further guidance will be required on this question and on how one may identify a penalty masquerading as a primary obligation. In the commercial arena one can now expect to see obligations framed as primary obligations so far as possible to render them immune from attack.
- In the field of construction, a simple obligation to pay liquidated damages for completion after an agreed date is unlikely to be regarded as primary in nature. However, where differences in performance of the final product attract liquidated damages, depending upon how the provisions are drafted when looked at overall, there might be greater scope for such a finding.
- A further problem lies in the identification of what a legitimate interest is, and on its distinction from an "illegitimate" one. May an employer, say, a high-profile authority with responsibilities towards the general public, now argue that its interests entitle it to enforce a contractor's obligation to pay liquidated damages for delay or under-performance that far exceed the "genuine pre-estimate of loss" that formerly it would have demanded?
- If so, the importance of an Employer's "legitimate interests" in performance and the potential effects of a breach on those interests are best declared at the outset and set out clearly within the contract documentation.
- Given the considerations of the Supreme Court in *Cavendish*, in those circumstances it would also be sensible to include a declaration that the parties are of comparable bargaining power and have had access to legal advice.
- A still further problem resides in determining what constitutes a detriment *"out of all proportion"* to a legitimate interest. Which, if any, of the superlatives may still be relied upon now for further guidance? Lord Mance considered them to be *"extravagant, exorbitant or unconscionable"*, at least in cases where the parties were not of equal bargaining power and properly advised.

[1] [2015] UKSC 67.

[2] *Dunlop Pneumatic Tyre Company Ltd – v – New Garage & Motor Company Ltd ("Dunlop").*

Article Author

Steve Mangan

Email: steve.mangan@corbett.co.uk

Tel: + 44 (0)20 8614 6200
Fax: + 44 (0)20 8614 6222
Email: info@corbett.co.uk
www.corbett.co.uk