Cordells Rompotis

Case Note – December 2015

Penalty Clauses Revisited by the UK Supreme Court

Executive Summary

As a risk allocation tool, penalty clauses are used across a broad range of commercial contracts. In a recent judgment handed down in the UK, the Supreme Court considered two appeals involving disputes on the validity of provisions contended to have contravened the traditional formulation of the penalty rule – that a clause in a contract would be considered a penalty and therefore unenforceable where the sum payable represents more than a genuine pre-estimate of loss. In a judgment likely to impact the future formulation of penalty clauses in many commercial contracts, the Court considered that the penalty rule was an "ancient haphazardly constructed edifice which has not weathered well", finding that the disputed clauses in both appeals were valid since they served a legitimate business interest and were not extravagant, exorbitant or unconscionable. The Court therefore allowed the appeal in Cavendish v El Makdessi and dismissed the appeal in ParkingEye v Beavis.

Facts

Cavendish v El Makdessi

The appellant ("Cavendish") was part of the world's leading marketing communications group and the respondent ("Makdessi") was one of the founders and owners of the Middle East's largest advertising and marketing communications group (the "Group").

Makdessi agreed to sell to Cavendish a controlling stake in the holding company of the Group. It was contractually provided that if Makdessi participate in any of the stipulated competitive or potentially competitive activities, he would not be entitled to receive the final two instalments of the purchase price from Cavendish and could be required to sell Cavendish the rest of his shares. Makdessi subsequently breached the non-compete covenants and argued that the relevant clauses were unenforceable penalties. Cavendish succeeded before the first instance judge. The Court of Appeal overturned the first instance decision, holding both clauses to be unenforceable penalty clauses.

ParkingEye v Beavis

The appellant ("Beavis") was the owner and driver of a vehicle which he parked in a retail shopping car park for 2 hours and 56 minutes on 15 April 2013. The respondent ("ParkingEye") was engaged by the owner of the retail site and carpark to provide "a traffic space maximisation scheme" under which it erected throughout the car park prominent notices, stating that failure to comply with a two-hour limit will result in a parking charge of GBP 85.

Beavis maintained that the GBP 85 charge demanded of him was an unenforceable penalty and/or it is unfair and invalid within the meaning of the Unfair Terms in Consumer Contracts Regulations 1999. Beavis failed at first instance as well as before the Court of Appeal.

The Penalty Rule

Prior to this judgment, it was generally accepted that the question of whether a damages clause was unenforceable as a penalty depended on whether the sum payable under it represented more than a "genuine pre-estimate of damages".

In a comprehensive judgment, the Supreme Court examined the development of the penalty rule in England from its equitable origins to its modern common law variants, observing that the underlying principle behind the rule was that the penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves. The Court recognised that payment of a sum of money was the classic obligation under a penalty clause, but also accepted that clauses requiring transfer of assets or payment of non-refundable deposits were also capable of constituting a penalty.

Contrary to conventional understanding, the Court found that the notions of "deterrence" and "genuine pre-estimate of loss" were unhelpful. Accordingly, the fact that a contractual provision was not a pre-estimate of loss or was described as a deterrent did not mean that it was necessarily penal. Put another way, the true test was whether the impugned provision was 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 Court considered that the key is to consider, first, whether any 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 extravagant, exorbitant or unconscionable, with "legitimate interest" not restricted to the recovery of financial compensation for a breach.

Application

Cavendish v El Makdessi

The Court considered that in the context of an acquisition of a marketing company in the Middle East where personal relationships with clients are especially important, the parties had accepted that the goodwill of the business was crucial to the deal. Both the impugned clauses were in reality price adjustment clauses which reflected the reduced purchase price that Cavendish was prepared to pay for the acquisition of the business in circumstances where it could no longer count on the loyalty of Makdessi.

The Court held that the relevant clauses in question provided for primary as opposed to secondary obligations. Moreover, Cavendish had a legitimate interest in the observance of the restrictive covenants which extended beyond the recovery of loss and punishment. Even though the clauses could act as a deterrent against competitive conduct, they could be justified by the legitimate function of achieving Cavendish's commercial objective in acquiring the business.

The Court took into account the fact that the relevant clauses were part of a carefully constructed contract negotiated over a long period between sophisticated parties, bargaining on equal terms with legal advice. It did not consider that the clauses can or should be regarded as extravagant, exorbitant or unconscionable. As such, neither clause was avoided by the application of the penalty rule.

ParkingEye v Beavis

The Court accepted that there was a contract between Beavis and ParkingEye under which Beavis undertook not to park for more than two hours and, upon any breach of that obligation, incurred a liability of GBP 85. The penalty rule was therefore plainly engaged.

The Court considered that ParkingEye had a legitimate interest in charging GBP 85, an amount which extended beyond the recovery of any loss as the charge allowed efficient use of parking space in the interests of retail outlets and of the users of those outlets who wished to find parking spaces. It also provided an income stream to enable ParkingEye to meet the costs of operating the scheme and make a profit from its services.

After considering the level of charges imposed by other UK car parks, the prominence of the notices and the fact that many motorists regularly use the car park despite the charge, the Court concluded that the charge was neither extravagant nor unconscionable. The Court therefore held that the charge imposed on Beavis was not a penalty.

Based on the same considerations, the Court also held that the charge was not unfair for the purpose of the Unfair Terms in Consumer Contracts Regulations 1999.

Conclusion

The decision reinforces the principles of freedom of contract and legal certainty, both of which are essential principles underlying English contract law. It is also notable that the Supreme Court adopted a flexible approach in applying the penalty rule, which is particularly desirable in an age where transactions are increasingly complex and damages clauses are far from straightforward.