

Supreme Court Ruling on Penalties: A Genuinely Commercial Approach

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The Supreme Court has clarified and restated the scope of the English law rule against penalties. This important decision will have a far-reaching impact on commercial parties' assessment of whether contract provisions dealing with the consequences of breach will be regarded as unenforceable penalties. In *Cavendish Square Holdings BV v El Makdessi*¹, the Supreme Court has replaced familiar formulations of the rule against penalties with a more flexible test based on whether the clause in question imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party. The decision also confirms the courts' reluctance to use the rule against penalties to interfere with parties' freedom of contract, especially where they are sophisticated commercial parties.

While the new focus on the innocent party's legitimate interest and the proportionality of the consequences imposed on breach is welcome, it remains to be seen how the courts will apply this in practice.

The rule against penalties – the historical position

The English law rule against penalties limits parties' freedom to agree terms requiring a party to make payment (or forgo an entitlement) to another party upon a breach of contract. Where such provisions provide for an extravagant or unconscionable remedy, the English courts will not enforce them. Typically, provisions that stipulate remedies on a breach of contract aim to give parties certainty about the consequences of breach, as well as minimising time and effort spent quantifying and proving loss. But, as *Makdessi* shows, such provisions may be (and often are) driven by other commercial factors.

The rule against penalties has long been a source of potential difficulty for commercial parties and their advisers. As the Supreme Court acknowledged:

"The penalty rule is an interference with freedom of contract. It undermines the certainty which parties are entitled to expect of the law." [33]

The basis for the modern law on penalties stems from the judgment in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*, a case decided by the House of Lords over a century ago. Following *Dunlop*, the rule against penalties has typically been held to apply where (i) a clause was intended primarily to deter

¹ *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Limited v Beavis* [2015] UKSC 67.

breach and (ii) where the amount stipulated to be paid on the breach was not a genuine pre-estimate of loss at the time the contract was made. Such a clause would be deemed penal, and so unenforceable.

Practical application of the rule

The rule against penalties frequently arises as a consideration when drafting commercial contracts. *Makdessi* itself concerned the applicability of the rule to a post-closing price adjustment and call option mechanism triggered by a seller's breach under a share purchase agreement (as discussed further below). More generally, the rule against penalties is often a consideration when drafting compulsory buy-out provisions arising upon breach of shareholders' agreements; provisions providing for break fees payable when a transaction fails to complete; in default interest provisions in finance documents; and in take-or-pay clauses in supply contracts (particularly in the energy sector) – to give some examples. Such provisions operate with cumulative and varied effects within complex contractual structures and are aimed at various commercial purposes. This is a far cry from the self-contained liquidated damages clauses on which the traditional case law was typically decided.

Evolution of the historical case law

Perhaps reflecting the more complex circumstances in which the rule against penalties may be engaged in commercial contracts, the courts have recently moved towards a more pragmatic and commercial approach, and have focused on whether the provision in question could be said to be commercially justified. However, until Wednesday's decision, the courts generally continued to take the view that a provision whose purpose was predominantly to deter breach rather than to compensate any actual loss that may be suffered would not be justifiable and would be liable to be an unenforceable penalty.

Factual background to the appeal

The decision concerns two joined cases on penalties arising from very different facts.

In the first case, *El Makdessi v Cavendish Square Holdings BV*, Mr Makdessi and another shareholder agreed to sell shares in the holding company of their marketing and advertising group to Cavendish. After the sale, Mr Makdessi breached restrictive covenants in the sale and purchase agreement (the "SPA"). Where a seller breached restrictive covenants in the SPA, the SPA provided:

- (i) at Clause 5.1, that the seller would not be entitled to receive any further instalments of the purchase price, meaning that (depending on the timing of the breach) the seller might forfeit a large proportion of the consideration to which it would otherwise be entitled; and
- (ii) at Clause 5.6, that Cavendish acquired an option to purchase that seller's retained shareholding at a price excluding the goodwill value in the business. This call option also had the effect of depriving the seller of a put option to sell his retained shares for a price that included goodwill value, and therefore could provide for substantially greater compensation for the seller.

The question arose as to whether Clauses 5.1 and 5.6 were unenforceable penalties.

The second case, *ParkingEye Ltd v Beavis*, was brought by the operator of a car park against a motorist (Mr Beavis) who had overstayed a two-hour free parking time limit. The car park prominently displayed signs stating that failure to comply with the two-hour limit would "result in a Parking Charge of £85". Mr Beavis argued that the charge was an unenforceable penalty. A challenge was also brought under the Unfair Terms in Consumer Contracts Regulations 1999 (which was unsuccessful and is not discussed further in this alert).

The decision and the new test

The Supreme Court concluded that neither of the clauses in question in *Makdessi* or *ParkingEye* were unenforceable penalties. Lord Neuberger and Lord Sumption gave the leading judgment, which will now become the most influential statement of the English law in relation to penalties.

The key points are as follows:

- The penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves – the rule therefore cannot apply to clauses triggered by a specific event

agreed between the parties (such as early termination fees, break costs on the early repayment of loans, a mandatory pre-payment event arising as a result of a change of control and 'take or pay' provisions in long-term oil and gas purchase contracts, provided these do not arise on breach of the relevant contract) - there must be a breach of the agreement;

- The rule may not be confined to clauses requiring the payment of money on breach and could apply to clauses withholding payments on breach, clauses requiring the party in breach to transfer property, and clauses requiring payment of a non-refundable deposit;
- The fact that a clause does not provide for payment of a genuine pre-estimate of loss does not necessarily mean that it is penal, and describing a clause as a deterrent does not add anything to the analysis;
- The "true test" for a penalty is whether the provision in question 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". For these purposes:
 - An innocent party can never have a legitimate interest in simply punishing a breaching party;
 - In the case of a straightforward damages clause, a party's legitimate interest will rarely extend beyond compensation for breach; and
 - In a negotiated contract between sophisticated commercial parties, the parties themselves should be presumed to be the best judges of what is legitimate.

In *Makdessi*, Clauses 5.1 and 5.6 were found to be primary obligations, rather than secondary obligations which arose upon breach. As such, the rule against penalties could not apply. In any event, Cavendish had a legitimate interest in making sure restrictive covenants in the SPA were observed, and that interest extended beyond merely recovering loss flowing from a breach of those covenants. Cavendish had contracted for the purchase of a company counting on Mr Makdessi's loyalty, and it might legitimately have been willing to pay much less for that company if Mr Makdessi's loyalty could not be relied upon. The parties were much better placed than the court to determine what the price of that loyalty might be.

In *ParkingEye*, the relevant provision was subject to the rule against penalties. The £85 fine was payable on breach of a motorist's primary obligation not to overstay the two hour limit. However, the car park operator had a legitimate interest in charging overstaying motorists in order to meet the running costs of the car park and generate a profit margin. The operator also had a legitimate interest in providing the landowners of the car park a reasonable turnover of the available customer parking for the potential customers of the landowners' commercial tenants. Moreover, the amount of the charge was not extravagant or unconscionable in light of charges in other car parks, the use of the particular car park and the clear wording of the signs. Significantly, this was so even though the purpose of the £85 fine was to deter motorists from overstaying.

Comment

The emphasis of the leading judgment on establishing a "legitimate interest" is likely to be of comfort to parties entering sophisticated commercial contracts, where there is often a clear commercial rationale for terms that might otherwise appear harsh. It is also reassuring that their Lordships plainly did not think that the rule against penalties should be available to interfere with bargains between sophisticated commercial parties save in exceptional cases:

"In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach."

Where a contract has been negotiated between parties with relatively equal bargaining power with the benefit of legal advice, it is likely to be difficult to rebut the presumption that a non-defaulting party has a legitimate interest in enforcing a term providing for the consequences of breach.

The judgment also confirms that the rule against penalties will not apply to primary obligations of the parties or to provisions that arise as a result of any event other than a breach of contract (including exercise of a contractual right). As a result, it may in some cases be possible to structure contractual provisions to avoid the rule against penalties altogether by making payment conditional upon aspects of performance based on

objective measures rather than the occurrence of a breach. The Supreme Court expressly noted and acknowledged this possibility, while also noting that the courts will examine the substance of the parties' agreement, rather than its form or the label attached to it.

Despite its advantages, the flexibility introduced by the Supreme Court's test may in some cases make it more difficult to predict with confidence whether the rule against penalties may apply. In particular, the distinction between primary and secondary obligations may be nuanced (as indeed it was in the *Makdessi* case itself). Similarly, there remains scope for argument as to whether the detriment envisaged by a clause is out of all proportion to any legitimate interest of the innocent party. And it of course remains to be seen how the Supreme Court's new test will be applied by lower courts in practice.

Still, provided parties can show a genuine commercial interest for agreeing the terms of remedies for breach beyond simply punishing a contract breaker, they should now be able to have a higher degree of confidence that their agreement will be upheld. This is a positive development for parties who would like to use English law without inviting restrictions on their freedom to contract.

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