

SOUNDINGS

Is my deterrent clause enforceable?

Contracts often contain deterrent clauses which require one party to pay a fine or liquidated damages to the other party if they breach the contract. Such clauses can be unenforceable if they are categorised as a “penalty clause”.

The rule on what amounts to a penalty clause has recently been revised by the English Supreme Court. Its decision should be of interest to anyone entering into commercial contracts, to ensure their clauses are enforceable.

The test for whether a clause is a penalty now requires consideration of whether the innocent party has a legitimate interest which is protected by the clause. In assessing this it is likely that its commercial and business objectives will be of paramount importance.

This article looks at the Supreme Court’s decision in *Cavendish Square Holding BV v El Makdessi and ParkingEye Ltd v Beavis* [2015] UKSC67. This is the first time this court has considered the principles governing penalty clauses since 1915.

The facts

The Supreme Court’s judgment involved two separate cases:

1. The Cavendish case

Mr El Makdessi, was a founder and owner of an advertising and marketing company. He agreed to sell some of his shares in that company to the claimant, Cavendish. Under the sale

agreement, Mr El Makdessi agreed not to engage in certain competing activities, failing which he stood to lose some of the payments for his shares up to \$40m.

In the event, Mr El Makdessi did breach the prohibitive terms, but he contended that those terms were unenforceable because they constituted penalties.

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2. The ParkingEye case

ParkingEye was the manager of a car park at a retail park and sought to enforce a parking charge of £85 against Mr Beavis, who had parked and overstayed the 2-hour limit by almost an hour. Mr Beavis refused to pay the charge and argued among other things that it was an unenforceable penalty.

The penalty rule

A 'penalty' is essentially an oppressive term which imposes a detriment on a party which has breached a contract. The penalty has no commercial justification, and does not represent a genuine pre-estimate of the innocent party's loss. One example might be a term requiring a charterer to pay a charge of US\$1m to an owner if it redelivers a ship early from a trip time charter. That is potentially such a high sum in the circumstances as to be commercially unjustifiable, and not a genuine pre-estimate of the owner's losses.

Such penalty clauses are generally unenforceable under English law.

The judgment

The Supreme Court has now reviewed the law surrounding penalties.

The court did not abolish the penalty rule. The court refused to be bound by the 'genuine pre-estimate of loss' test. It found that the fact that a clause is not a pre-estimate of loss does not necessarily mean that it is penal. This artificial categorisation was derived from a mis-reading of older case law. Thus the Supreme Court adopted a broader test. Lord Neuberger identified the essential question: was the clause in question either 'unconscionable' or 'extravagant'? That is to say, is the clause:

"... 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 interest in simply punishing the defaulter"

This begs the question: what are an innocent party's legitimate interests? In the case of a straightforward damages claim, that interest will rarely extend beyond compensation for breach, and the 'genuine pre-estimate of loss' test will "usually be perfectly adequate to determine [the clause's] validity". However "compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations".

Applying this to the two cases in question:

1. The Cavendish case

The clause in question was found not to be a penalty clause. Therefore Cavendish could enforce it against Mr El Makdessi. Although the sums of money involved under the clause bore no relation to the loss attributable to Mr El Makdessi's breach, the

court decided that Cavendish had a legitimate interest in Mr El Makdessi's compliance with the clause which extended beyond that loss. That interest was the goodwill of the business it had bought. "The fact that some breaches of the restrictive covenants would cause very little in the way of recoverable loss to Cavendish is therefore beside the point," the Court commented.

2. The ParkingEye case

The court found that the £85 charge enabled ParkingEye to manage the efficient use of parking space in the interests of retail outlets and their customers. This was to be achieved by deterring motorists who overstayed and reduced the space available to other motorists. The charge also provided ParkingEye with an income stream, enabling it to operate and make a profit, without which the services it provided would not be available. Those were "perfectly reasonable" objectives. The £85 charge was not a penalty. Although ParkingEye would not actually suffer loss as a result of overstaying motorists, it had a legitimate interest in charging them. This did not mean that ParkingEye could charge "a sum which would be out of all proportion to its interest". However, the Court held that the £85 charge was not disproportionate to its interests; it was neither extravagant nor unconscionable having regard to the level of charges imposed by local authorities.

Conclusion

This ruling marks a significant departure from the law on penalties. The test for whether a clause is a penalty now requires consideration of the question: does the innocent party have a legitimate interest which is protected by the clause? Even if the amount to be paid is not a genuine pre-estimate of loss, a clause may not be a penalty if it is supported by a legitimate interest.

In deciding whether an innocent party has a legitimate interest, it is likely that its commercial and business objectives will be of paramount importance. 'Legitimate interest' is an open-ended category which reflects the complexity of modern day commerce. However, it is not easy to predict how it will be applied in any particular case.

In the Cavendish case, the parties were commercial entities bargaining on equal terms with the benefit of legal representation. This meant that they were the best judges of the legitimate commercial interests of the other. Therefore, where parties occupy a level playing field and have negotiated a contract with legal advisors, it may be harder to argue that a clause is a penalty clause and therefore unenforceable.

Members are advised to consider the impact of these cases when formulating contractual clauses which could be construed as penalties, for example liquidated damages provisions or clauses setting out damages for loss of use or consequential losses.

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