

THE PRACTICAL IMPLICATIONS OF THE NEW PENALTIES LAW

The Supreme Court has made a substantial change to the law on penalties. The new test for whether a clause is penal, and therefore unenforceable, is whether the agreed consequences of a breach are out of all proportion to the innocent party's legitimate interest in the enforcement of the clause that has been breached.

This means that a clause may be enforceable even if it is not a genuine pre-estimate of the innocent party's loss or if it is designed to deter a breach of contract. This is a significant change in the law because concepts of deterrence and genuine pre-estimates of loss have historically been regarded as fundamental to the question of whether or not a clause is a penalty.

The Supreme Court reached this decision in the conjoined appeals of *Cavendish Square Holding BV v Talal El Makdessi* and *ParkingEye Limited v Beavis* [2015] UKSC 67. Judgment in those cases was handed down on 4 November 2015.

THE CASES

In *Cavendish v Makdessi*, Mr Makdessi sold his controlling interest in a marketing and advertising business to Cavendish. The share sale agreement contained restrictive covenants and provided, in effect, that Mr Makdessi could be deprived of certain deferred consideration and be required to transfer his remaining shares to the buyer, at a price excluding the value of goodwill, if he breached those restrictive covenants.

In *ParkingEye Ltd v Beavis*, Mr Beavis entered into a contract with a car park operator by using a car park. He overstayed a two hour period of free parking and was, as a result, required to pay a charge of £85.

Both Mr Makdessi and Mr Beavis argued that the clauses described above were unenforceable penalties. Overturning the Court of Appeal decision in *Cavendish* and upholding the decision in *Parkingeye*, the Supreme Court disagreed in both cases and held that the clauses were enforceable.

KEY POINTS

The key points from the Supreme Court judgment are as follows:

- ◆ The law on penalties is an “*ancient, haphazardly constructed edifice which has not weathered well*”. It had not been reviewed at the highest level for a century (since *Dunlop Pneumatic Tyre Company Ltd. v New Garage and Motor Company Ltd.* [1915] AC 79).
- ◆ The Supreme Court declined to abolish the doctrine of penalties, saying that it is still necessary to protect parties from oppression in contracts which are not regulated in any other way. It is a long standing rule and similar rules exist in all other developed systems of law.
- ◆ The rules on penalties apply only to the agreed consequences of a breach of contract, not to the fairness of parties' primary obligations. For example, in *Makdessi*, the relevant clauses provided for an adjustment to the purchase price. As such, they were primary obligations and the rules on penalties were not engaged.
- ◆ The rules on penalties do not only apply to clauses which provide for the payment of money. They also apply to clauses requiring a transfer of assets on breach and to clauses where one party forfeits a deposit as a result of its breach.
- ◆ Concepts of deterrence and genuine pre-estimates of loss are not helpful. The “*true test 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*”.
- ◆ The court is less likely to find that a provision is penal where the relevant contract was negotiated between legally advised and sophisticated commercial parties of equal bargaining power.
- ◆ The law will not generally uphold a contractual remedy where the adverse impact of that remedy significantly exceeds the innocent party's legitimate interest.

PRACTICAL CONSEQUENCES

The key point arising out of this judgment is that contracting parties will now have greater freedom to agree on the consequences of a breach of contract and it will be harder for parties to escape from agreements that they freely entered into.

Another point of interest is that the Supreme Court confirmed that the rules on penalties only apply to clauses which provide for the consequences of a breach of contract. In practice, this will mean that, in some circumstances, it may still be possible to “draft around” the rules on penalties by providing for sums to be payable on the happening of a certain event, rather than as a result of a breach of contract.

It is also worth noting that changes in case law will normally be applied in all future cases. Therefore these changes will operate retrospectively in the sense that the new rules will be applied to disputes about existing contracts.

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NOVEMBER 2015

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