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Landmark Supreme Court Decision – The Penalties Doctrine Lives On (In a New Guise)

Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67

Today the Supreme Court of the United Kingdom confirmed that the centuries-old doctrine of penalties still has a place in the modern commercial world of contracts, in spite of calls for its abolition, leaving the door open for Courts to interfere in contracts.

The decision is the first of the Supreme Court (and its predecessor, the House of Lords) on the scope and application of the penalties doctrine since the seminal cases of *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* (in 1905) and *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* (in 1915). It is particularly significant as it revises the principles to be derived from those cases in re-evaluating the law on contractual penalty clauses (i) in relation to commercial contracts (in the appeal between *Cavendish v Talal El Makdessi*) and (ii) at a consumer level (in the appeal between *ParkingEye Ltd v Beavis*). In the second appeal, the Court also considered the scope of the *Unfair Terms in Consumer Contracts Regulations 1999* (SI 1999/2083).

The two appeals were heard together over three days in July 2015 by Lord Neuberger, Lord Mance, Lord Clarke, Lord Sumption, Lord Carnwath, Lord Toulson and Lord Hodge, culminating in five separate judgments. The Court was unanimous that the doctrine of penalties should not be abolished, but was divided on the scope of the doctrine and the relevant test to be applied. It is clear from the majority judgment in particular (of Lord Neuberger and Lord Sumption, with whom Lord Clarke and Lord Carnwath agreed), that there is a shift in focus from the classic test of "*genuine pre-estimates of loss*" and concepts of extravagance, unreasonableness and deterrence, and a greater emphasis on "*legitimate interests*" and punishment.

The Supreme Court's decision is issued against the backdrop of detailed submissions from the parties on the application of the law of penalties in other common law jurisdictions, including Australia where the legal landscape regarding penalty clauses has changed dramatically in recent years – the scope of the doctrine has been expanded to capture contractual clauses not triggered by material breach of contract (an essential element of the doctrine according to English law). Given the close ties between English law on the one hand, and the law of other common law jurisdictions on the other, the decision is expected to resonate globally.

Clifford Chance Litigation & Dispute Resolution Partner, Julian Acratopulo, and Senior Associate, Angela Morris, who represented Mr Makdessi in the case, summarise below the key lessons for commercial parties arising out of this complex case and suggest possible next steps.

Key lessons for commercial parties arising out of the Supreme Court's decision

When is the penalties rule engaged?

- Only upon a breach of contract (in contrast to the position in Australia) – it regulates the *remedies* available for breach of a party's primary obligations, but *not* the primary obligations themselves (i.e. provisions that fix price).
- Whilst a damages clause providing for the payment of a sum of money is the most common form of penalty clause, the Court has confirmed that the doctrine extends to an obligation to transfer assets (for nothing or at an undervalue). Similarly, payment of a deposit (as a surety for the counterparty's contractual performance) does not prevent the sum

from being a penalty. However, by contrast, the Supreme Court seems to support the proposition that the retention of instalments paid under the terms of the contract, so as to become the absolute property of the counterparty, does not fall within the scope of the doctrine.

- A provision may be both a penalty clause and a forfeiture clause (providing, of course, that it has the necessary elements).

Features of a penalty clause

- Having regard to the nature and extent of the innocent party's interest in the performance of the relevant obligation (as a matter of construction, not actual intention), the test, as formulated by the majority, is whether the clause 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. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance. In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach ... But compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations*."[1]
- A clause designed to punish the contract breaker (a penal clause), as opposed to a clause that is *in terrorem* (or a deterrent) is likely to be a penalty clause. The Court has provided guidance that "[t]*he fact that the clause is not a pre-estimate of loss does not ... at any rate without more, mean that it is penal*".[2] Further, "[t]*o describe it as a deterrent (or, to use the Latin equivalent,* in terrorem) *does not add anything. A deterrent provision in a contract is simply one species of provision designed to influence the conduct of the party potentially affected. It is no different ... from a contractual inducement. Neither is it inherently penal or contrary to the policy of the law. The question whether it is enforceable should depend on whether the means by which the contracting party's conduct is to be influenced are "unconscionable" or (which will usually amount to the same thing) "extravagant" by reference to some norm.*"[3]
- As Lord Mance, in a separate judgment, concluded:

  "[I]*n each case* [it is necessary] *... to consider, first, whether any (and if so what) 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 in the circumstances extravagant, exorbitant or unconscionable. In judging what is extravagant, exorbitant or unconscionable, I consider (despite contrary expressions of view) that the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor.*"[4]
- Lord Hodge and Lord Toulson stated: *"the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract.*"[5]

Other notable comments from the Court

- As noted above, the circumstances in which the contract was made may be relevant – see, for example, Lord Mance's conclusions above. Further, the majority stated that "[i]*n 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.*" [6]

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[1] *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis* [2015] UKSC 67, paragraph 32.
[2] *Ibid,* paragraph 31.
[3] *Ibid.*
[4] *Ibid,* paragraph 152.
[5] *Ibid,* paragraph *255* (Lord Hodge); paragraph 293 (Lord Toulson).
[6] *Ibid,* paragraph 35.

- The application of the penalty rule can still turn on questions of drafting, but Courts retain the power to interfere in contracts.
- A contractual provision conferring an option to acquire shares, not by way of compensation for a breach of contract but for distinct commercial reasons is a primary obligation, notwithstanding that it only operates upon breach of contract.

What next for commercial parties?

The practical effect of the *Cavendish* decision for businesses and individuals in all sectors is that they will need to consider reviews of their contracts and contractual toolkits through a new lens, both to (i) update them as necessary (assuming that is possible) to reflect the revised approach and (ii) identify any clauses that may still fall foul of the doctrine.

Parties who have relied upon advice that a particular contractual clause is or is not enforceable are advised to seek a health check in light of today's landmark decision.

Given the Court's findings regarding clauses that provide for the withholding or reduction of deferred consideration and put and call option clauses, parties have new drafting tools at their disposal to protect their contracts from interference by Courts.

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