

AVOIDING UNENFORCEABLE PENALTY CLAUSES

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The Supreme Court in 2015 reviewed and redefined the rules governing unlawful penalty clauses. The new test considers whether there is a legitimate interest in creating damages or a fine and whether such fine imposes an obligation that is extravagant, exorbitant or unconscionable. When drafting, the new test should be applied to ensure a provision is a valid damages clause, not an unlawful penalty.

Background

In the jointly heard appeal of *Cavendish Square Holdings BV v Talal El Makdessi and ParkingEye Limited v Beavis*¹ the Supreme Court found that the clauses put forward as being unenforceable penalty clauses were in fact valid and enforceable.

Cavendish Square Holdings BV v Talal El Makdessi concerned a seller who had breached certain restrictive covenants under a share purchase agreement ("SPA"). The SPA contained provisions that if the restrictive covenants were breached the seller would (i) not be entitled to receive two final instalments of the purchase price; and (ii) be required to sell his remaining shares at a price that excluded the goodwill. The seller argued that this was an unenforceable penalty.

The facts of *ParkingEye Limited v Beavis* were that Mr Beavis parked his car in a car park managed by ParkingEye for more than the two hour limit. The clearly publicised parking charge for exceeding the two hour limit was £85. Mr Beavis disputed the fine, claiming it was an unenforceable penalty clause. In both cases, the Supreme Court found the clauses were not penalties.

Spotting a penalty clause

The traditional test for spotting a penalty, in

essence, is that the clause has the predominant purpose of deterrence rather than a genuine pre-estimate of loss. The implication of this is that penalty clauses are unenforceable; whereas provisions containing a genuine pre-estimate of loss can be valid liquidated damages clauses.

"Deterrence" and "genuine pre-estimate of loss" were originally included as part of four tests to determine the validity of damages clauses in *Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Company Ltd*². One hundred years later in *Cavendish/ParkingEye*, the Supreme Court found that "deterrence" and "genuine pre-estimate of loss" were unhelpful and the test needed redefining. The Supreme Court held that:

"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"³

The test may be divided as follows:
Has a primary obligation been breached which has triggered a secondary obligation? If so:

1. is any legitimate business obligation protected by that secondary obligation?

or

2. does the secondary obligation impose an obligation that is extravagant, exorbitant or unconscionable?

If the answer is yes then...

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Drafting tips for avoiding unenforceable penalties

Do consider whether any reimbursement or damages to an innocent party for breach of contract is created by a secondary obligation (for instance, if the secondary obligation of a supplier to pay liquidated damages is created by the breach of the supplier's primary obligation to deliver goods on time). Is there a way of clarifying that the result of any breach forms part of the primary obligation?

And, if there is a secondary obligation imposing damages:

Do make sure that there is a "legitimate interest" which is proportional to the innocent party enforcing the primary obligation. Is there a wider commercial or socio-economic justification for the clause?

Do consider whether it is a genuine pre-estimation of loss. A clause containing a pre-estimation of loss would be valid with no need to show anything further such as "legitimate interest".

Do not make it "unconscionable" or "extravagant". Perhaps consider the industry practice, for instance in ParkingEye the Court considered the standard parking charges.

Do not discard Dunlop. The tests in Dunlop are still good law and the Supreme Court set out that these tests are a useful tool for deciding whether "unconscionable" or "extravagant" can properly be applied to simple damages clauses in standard contracts.

Other things to consider

The parties

The sophistication and bargaining power of the parties may make a difference to the Court's willingness to determine that a clause is an unenforceable penalty. If a contract has been negotiated with parties of a similar bargaining power being properly advised, the Court will have a strong initial presumption that the parties are the best judges of what a legitimate provision of the contract is.

The type of agreement

- Construction contracts: make sure that it is a liquidated damages clause and not a penalty.
- Acquisition agreements: can restrictive covenants (for example, non-compete provisions) be linked to the primary obligation of the contract (i.e. the sale of the shares or the assets)?
- Articles of association and shareholders' agreements: May not create primary obligations (for instance bad leaver provisions) but can create secondary obligations imposing damages. In which case, legitimate interest and proportionality should be considered.

Footnotes

1. [2015] UKSC 67
2. [1914] UKHL 1
3. Cavendish Square Holdings BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67, paragraph 32