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Lindsay, B. (2016) Penalty clauses in the Supreme Court: a legitimately interesting decision? *Edinburgh Law Review*, 20(2), pp. 204-210.

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Deposited on: 1 December 2017

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A Legitimately Interesting Decision? Penalty Clauses in the Supreme Court

The joint appeals in *Cavendish Square Holdings v El Makdessi* and *Beavis v ParkingEye*¹ offered the UK Supreme Court its first occasion - since moving across Parliament Square - to consider the penalty doctrine. The exercise of judicial control over contractually stipulated remedies has been long controversial, and the joint appeals presented an opportunity to either modernise its principles, or to repudiate it from English law in its entirety.

A. BACKGROUND

For quite some time, the law has appeared relatively settled. The classic test, encapsulated in Viscount Dunedin's speech in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*,² hinged on whether or not the stipulated sum was arrived at through a genuine attempt to pre-estimate the loss that would ensue from breach of the related contractual term. If so, the clause would be enforceable as liquidated damages; if not, and the stipulated amount bore little relation to the actual loss, the clause would be unenforceable as a penalty. But in the supervening century at least two aspects of this orthodoxy have been questioned. First, the exclusive focus on loss may be myopic. There might be a good justification for a clause otherwise falling foul of the Dunedin formula, and the validity of this may be assessable by reference to some interest beyond the compensatory. Secondly, the so-called breach limitation,³ confining the scope of the penalty rule to clauses triggered by a breach of contract, has been often denigrated as imperilling the doctrine's protection by rendering it easily circumventable by adroit drafting and contractual structuring.

B. FACTS

These issues were brought to the fore in *Cavendish* and *Beavis*. However, the transactions in the two cases could not be more different.

(1) *Cavendish Square Holdings v El Makdessi*

Mr. Makdessi, a Lebanese businessman of considerable repute, was at the helm of the largest communications group in the Middle East. He and his partner contracted to sell the majority of their stake in the group's holding company to Cavendish. A substantial element of the purchase price related to the goodwill surrounding Mr. Makdessi. As his continuing loyalty was integral, the agreement contained a series of time-limited restrictive covenants precluding him from using his skills or contacts to compete with the business. These were breached, triggering the two clauses at issue. Clause 5.1 disentitled Makdessi, who had already received a substantial up-front sum, from receiving interim and final payments potentially totalling \$44,181,600. Clause 5.6 would force him to sell his remaining stake in the holding company to Cavendish at a value excluding goodwill, which was around 23% of the total value. When Cavendish sought to enforce these, they were met with the submission that both were unenforceable as penalty

¹ [2015] UKSC 67; [2015] 3 WLR 1373.

² [1915] AC 79.

³ Confirmed in *Export Credits Guarantee Department v Universal Oil Co* [1983] 1 WLR 399.

clauses. Burton J rejected that contention,⁴ but his decision was reversed by the Court of Appeal.⁵ The Supreme Court granted Cavendish permission to appeal.

(2) *Beavis v ParkingEye*

The British Airways Pension Fund portfolio includes the Riverside Retail Park in Chelmsford. The Fund selected ParkingEye to provide car park management services. Those wishing to park their car could do so, for free, for two hours. Drivers exceeding that period would become liable for an £85 parking charge, reducible to £50 if paid within a fortnight. These charges were ParkingEye's sole source of revenue; no fee was received from the landowners or those returning to their cars on time. Mr Beavis was not so prompt, over-parking for fifty-six minutes. He received a parking charge notice, which he ignored. Eventually, ParkingEye raised a small claim against him in the County Court, which was successful. Beavis's appeal failed in the Court of Appeal,⁶ but Beavis obtained leave to appeal to the Supreme Court, which joined his appeal with that in *Cavendish*.⁷

C. THE DECISION: GENERAL PRINCIPLES

(1) The penalty doctrine retained

Cavendish's counsel took the bold step of inviting the Supreme Court to abrogate the penalty doctrine, or at least to hold that it had no applicability in the context of high-powered commercial actors who have easy access to legal advice. Each of the Justices rejected any inroads into the general application of the doctrine. Those seeking for a principled justification for its continued operation are, with respect, liable to be disappointed.

In their joint judgment,⁸ Lord Neuberger PSC and Lord Sumption JSC confessed that the penalty rule would likely not be developed if the modern judiciary were working from a blank canvas, and their objections to abrogation arose merely out of fidelity to precedent and a distaste for judicial legislation.⁹ Lord Mance JSC shared these concerns,¹⁰ but also considered, in light of the ubiquity of the doctrine across both civil law¹¹ and common law¹² systems, and its retention in proposals for harmonisation,¹³ that it would be "odd... if the United Kingdom [sic] separated itself from so general a consensus."¹⁴ Lord Hodge JSC was similarly impressed by the apparent universality of the rule against penalties,¹⁵ and thought, as did Lord Mance,¹⁶ that the statutory control of contract terms covered too narrow a field to guard against all potential instances of oppression.¹⁷

⁴ [2012] EWHC 3582 (Comm); [2013] 1 All ER (Comm) 787.

⁵ [2013] EWCA Civ 1539; [2014] 2 All ER (Comm) 125.

⁶ [2015] EWCA Civ 402.

⁷ Beavis also challenged the charge under the Unfair Terms in Consumer Contract Regulations 1999 (SI 1999/2083). That issue will not be discussed here; save for noting that there is much to be said for the minority view of Lord Toulson JSC.

⁸ With which Lord Carnwarth JSC concurred.

⁹ Para 36.

¹⁰ Paras 162-163.

¹¹ Para 165.

¹² Para 166. His Lordship included Scotland within this category.

¹³ Para 164.

¹⁴ Para 166.

¹⁵ Paras 263 and 265.

(2) The breach limitation affirmed

Contrastingly, counsel for Mr Makdessi urged a substantial extension of the penalty doctrine by the removal of the breach limitation. To do so would be to follow the High Court of Australia in *Andrews v Australian and New Zealand Banking Group*.¹⁸ The Supreme Court declined to go down that same path. The High Court of Australia's analysis confirmed the continuing existence of a wider equitable jurisdiction. But, for Lords Neuberger and Sumption, that conclusion was historically inaccurate and predicated on a rejection of the fusion of law and equity.¹⁹ There was no convincing evidence of a continuing equitable jurisdiction in English law, and the fact that the breach limitation existed in Scotland – where law and equity have never been considered separate – was thought to justify its existence south of the border.²⁰ Lords Hodge²¹ and Mance²² did not consider this issue necessary for the disposal of the appeals, but the latter did not see the retention of the breach limitation as necessarily irrational.²³

None of these arguments offer a positive, non-historical, justification for the continued operation of the breach limitation. However, it is submitted that the Supreme Court was correct to be wary of removing that limitation by judicial fiat. To do so would have rendered every clause in every contract potentially reviewable, which would have necessitated widespread review, re-negotiation, and revision.

The Supreme Court delineated the applicability of the penalty doctrine in terms of primary and secondary obligations.²⁴ A primary obligation, being one to tender some form of performance under the terms of the contract, will not be reviewable, but a secondary obligation arising on breach of that primary obligation will be. However, as shall be seen, this distinction is not easy to apply.

(3) The test refined: legitimate interests

Both *ParkingEye* and *Cavendish* largely accepted that the clauses they were claiming the benefit of were not based on any genuine pre-estimate of loss. Counsel for Mr Beavis submitted that this was therefore the end of the matter: the *Dunedin* formula, with its exclusive focus on the disparity between the stipulation and the loss suffered, was the sole enquiry.

The Supreme Court unanimously rejected that submission. First, Lords Neuberger and Sumption thought that too much had been made of Viscount *Dunedin's* speech.²⁵ He was, after all, only one of five Law Lords in the *Dunlop* case, and no other members of the Appellate Committee expressed agreement with him, or reasoned in identical terms.²⁶

¹⁶ Paras 167.

¹⁷ Paras 260-262.

¹⁸ [2012] HCA 30; (2012) 247 CLR.

¹⁹ Para 42.

²⁰ *Ibid.*

²¹ Para 241.

²² Para 130.

²³ *Ibid.*

²⁴ See e.g. Paras 13-14.

²⁵ Para 22.

²⁶ Para 22-24.

Secondly, Viscount Dunedin himself did not view his propositions as a universal test; they were merely suggested as being of assistance in the case before him, which concerned a simple liquidated damages clause.²⁷ Thirdly, a series of cases which looked beyond a simple arithmetical calculation, and held clauses that did not involve a pre-estimate of loss as justifiable for other reasons, clutched at the proper test.²⁸

That test, as reformulated by Lords Neuberger and Sumption, was:

whether the impugned provision is a secondary obligation which imposes a detriment out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.²⁹

Each of their Lordships confirmed that the overriding test was one of extravagance or unconscionability.³⁰ The Dunedin formula was viewed as potentially still helpful in cases involving simple liquidated damages clauses,³¹ but compensation was not the sole interest that an agreed damages clause may pursue legitimately.³² Moreover, that the sum stipulated must be “out of all proportion”³³ or “extravagant, exorbitant or unconscionable”³⁴ compared to those interests suggests a very light-touch doctrine.

D. THE DECISIONS: APPLICATION

(1) *Cavendish*

The Supreme Court was divided over whether or not clauses 5.1 and 5.6 were even subject to the rule against penalties. Unfortunately, however, the exact division is unclear. Clause 5.1, removing Mr Makdessi’s entitlement to the final two payments, was characterised as forming part of the consideration paid by Cavendish for the company, and thus as a primary obligation, by Lords Neuberger and Sumption.³⁵ Lord Hodge saw the force of that argument,³⁶ but he and Lord Clarke JSC³⁷ preferred to keep an open mind. As for Lord Mance, his Lordship appeared inclined to categorise clause 5.1 as a secondary obligation, because he subjects it to the penal test that would not arise if it embodied a primary obligation.³⁸ However, further on, the clause is described as amounting “to a reshaping of the parties’ primary relationship”,³⁹ which suggests a primary obligation classification. This ambiguity is not resolved by Lord Toulson JSC, who expresses agreement with the judgments of both Lords Hodge and Mance.⁴⁰

²⁷ Ibid, quoting *Dunlop*, 87.

²⁸ Paras 26-28.

²⁹ Para 32 (emphasis added).

³⁰ Harking back to, e.g. *Forrest and Barr v. Henderson, Coulborn & Co.* (1869) 8 M 187.

³¹ Para 22.

³² cf *Ringrow v BP Australia* [2005] HCA 71; (2005) 224 CLR 656, para 27.

³³ Para 32.

³⁴ Para 152 (Lord Mance); see too Para 255 (Lord Hodge: “exorbitant or unconscionable”).

³⁵ Para 74.

³⁶ Para 270.

³⁷ Para 291.

³⁸ Para 181.

³⁹ Para 183.

⁴⁰ Para 292.

Clause 5.6, the forced share-sale provision, was again characterised by Lords Neuberger and Sumption as forming part of the parties' primary obligations.⁴¹ This is because it reflected the diminution in the consideration Cavendish would be willing to pay in the circumstances of Mr Makdessi's disloyalty. Lord Hodge again saw this as a strong argument, but preferred to conceive clause 5.6 as a secondary obligation,⁴² a contention with which Lord Clarke agreed.⁴³ Lord Mance is again uncharacteristically opaque, describing 5.6 as also part of the parties' primary relationship but yet again going on to assess its proportionality in relation to any legitimate interest.⁴⁴ Lord Toulson again simply concurs with both Lords Hodge and Mance without alluding to their dissensus on this point.⁴⁵

This uncertainty is deeply unhelpful for future cases, where the delineation between primary and secondary obligation may be key. It would have been preferable for Lords Hodge and Clarke to express a concluded view on Clause 5.1, for Lord Mance to be more explicit in his treatment of the two clauses, and for Lord Toulson to express a view on the differences between the judgments of Lord Hodge and Lord Mance.

Precise characterisation of the clauses was, however, ultimately not necessary to dispose of the case, as each of their Lordships viewed the clauses as justifiable. As for Clause 5.1, Cavendish had "a very substantial legitimate interest"⁴⁶ in ensuring that the price paid for the business was commensurate with its value, and the clause was a mechanism that ensured the value of the business reflected the fact that Mr Makdessi's loyalty could no longer be counted on.⁴⁷ The centrality of his co-operation to the goodwill of the company meant that it was irrelevant that a relatively minor breach of a restrictive covenant might trigger Clause 5.1.⁴⁸ Similar reasons justified Clause 5.6: Cavendish were entitled to provide that, after his attempts to undermine the business, they would not pay for Mr Makdessi's shares at a value which did not reflect actuality.⁴⁹ This was a perfectly legitimate way of attempting to secure compliance with the restrictive covenants.⁵⁰ Moreover, for each clause, it was important that both were the product of a "carefully negotiated agreement between informed and legally advised parties at arms' length".⁵¹

(2) *Beavis*

The Supreme Court concluded that a contract had been formed between Mr Beavis and ParkingEye,⁵² and ParkingEye accepted that the charge was operable on breach. Lords Neuberger and Sumption held that the scheme had two legitimate purposes: to free the car park from congestion to allow a steady stream of customers to park and have access to the retail park; and to provide ParkingEye with its sole stream of revenue.⁵³

⁴¹ Para 83.

⁴² Para 280.

⁴³ Para 291.

⁴⁴ Para 183.

⁴⁵ Para 292.

⁴⁶ Para 278 (Lord Hodge).

⁴⁷ Para 75; see too para 274.

⁴⁸ Para 180; see too paras 275-276.

⁴⁹ Para 82.

⁵⁰ Para 282.

⁵¹ Para 181 (Lord Mance); see too para 35 (Lords Neuberger and Sumption); para 282 (Lord Hodge).

⁵² See similarly for Scots law *University of Edinburgh v Onifade* 2005 SLT (Sh Ct) 63.

⁵³ Para 98.

Importantly, their Lordships noted that, despite the way in which it had formulated the test,⁵⁴ it was not restricted to a consideration of the interests of the innocent party.⁵⁵ Instead, the interests of not just ParkingEye, but also of the landowners, the retailer-tenants, and the wider public, could be pressed into action to justify the operation of this clause. While it may be difficult, or artificial, sometimes to separate the interests of the innocent party from its client or principal, the wide range of interests that may be taken into account when justifying a clause indicates the difficulty of impugning a clause as penal. It is therefore unsurprising that their Lordships held that an £85 charge was not exorbitant or unconscionable in light of all those interests.

E: CONCLUSIONS

Despite the Supreme Court's refusal to abolish the penalty doctrine, those who would like to see the rule against penalties meet its quietus may draw some solace from the decision. The retention of the breach limitation, and the adoption of a broader approach to the aims and interests that a clause may legitimately safeguard, severely attenuates the scope for judicial intervention in the context of agreed remedy clauses. Sophisticated parties, previously able to avoid its operation by flouting the breach limitation, now also are able to insulate clauses by identifying some legitimate objective that they may pursue. So long as the stipulated sum is not outrageous in relation to that interest, it is difficult to conceive of a case where a court would intervene in such a scenario.

The Scottish Law Commission is (re-)considering⁵⁶ the law on penalty clauses as part of its project on "Contract Law in Light of the Draft Common Frame of Reference". The equivalent test in the DCFR is whether the clause is "grossly excessive in relation to the loss resulting from the non-performance and the other circumstances."⁵⁷ The difference between this and the *Cavendish* test may be imperceptible. The more interesting question may therefore be whether the Scottish Law Commission will step where the Supreme Court did not dare to tread: either by removing the breach limitation,⁵⁸ or by jettisoning the penalty doctrine in its entirety.

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⁵⁴ Para 33 explicitly limits this to the interests of the "innocent party".

⁵⁵ Para 99. See also para 197 (Lord Mance).

⁵⁶ It previously turned to the subject in SLC Discussion Paper 103 on Penalty Clauses (1997) and SLC Report 171 (1999).

⁵⁷ Book III, 3.712.

⁵⁸ As it was so minded in 1999: SLC Report 171, Recommendation 2.