Briefing

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Penalty clauses – a move towards a flexible approach *ParkingEye Ltd v Beavis* [2015] EWCA Civ 402

The law on clauses which specify a remedy or payment for breach of contract is being reviewed by the courts. For a century since *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] A.C.79 it has been widely understood that such clauses are unenforceable if they specify a payment greater than the loss which could reasonably be caused by the breach. By contrast, clauses which try genuinely to pre-estimate that loss (often called liquidated damages clauses) are binding.

That simple 'dichotomy' is being challenged in the courts. By returning to the underlying principles which ban "penalty clauses" the courts appear to be taking a more flexible approach.

The Supreme Court (in *El Makdessi v Cavendish*, below) will face this question again in summer 2015. It may at that point lay down an entirely new law relating to penalty clauses. That analysis will potentially impact everything from international trade deals to consumer services. Before then the Court of Appeal has made a number of decisions both in the corporate and consumer environment to give guidance on when a clause specifying the consequences of a contractual breach will be upheld.

This developing approach considers the following:

- whether the proposed remedy is 'exorbitant' or excessive. Although the extent of losses which might arise from the breach are obviously relevant, they will not be determinative;
- whether the proposed remedy is 'unconscionable.' This appears to involve an assessment of the social context in which the remedy is being imposed. This was particularly considered in Parkingeye (below) which concerned whether payments could be levied for overstaying at a car-park;
- the commercial context in which the clause appears. Although this ground has been considered in both the two recent Court of Appeal cases (*Makdessi* and *Parkingeye*) it is not yet clear exactly what it involves. In one case, commercial context did not rescue a clause which had been negotiated in the multi-million pound business sale between legally advised, highly sophisticated international businessmen. In the other it was relevant to upholding the commercial right of a business to collect parking fees from consumers who overstayed in a commercial car-park and had not themselves expressly signed up to any contract.

At the same time the long-term trend has been for the law on 'penalties' to be applied more widely and to more types of clause. For example, negotiators and businesses operating contracts may not realise that a clause which provides for loss of an earn out following breach might be treated as a penalty. It is no longer an issue which only applies where a clause provides for a specific payment in response to a breach. In some ways this can affect the structuring of a deal or contract.

This article sets out some of the background to the development of the law on penalties.

The previous approach: *Dunlop*

The concept of a "penalty clause" arises where contracting parties attempt to quantify the damages payable in the event of a breach of a term or terms of the contract or attempt to specify a particular remedy. If those damages or remedy is unacceptable then the clause can be an unenforceable penalty.

Commonly (and historically) this is most often an issue with "liquidated damages" clauses. Broadly such damages must not go beyond a genuine pre-estimate of the loss which might be caused by the breach of contract. Where a clause was held to be something other than a genuine pre-estimate of loss, intended to be an unconscionable deterrent for breach of contract rather than a provision to compensate the innocent party for such a breach, then it would be held to be unenforceable.

Clearly, this is - and has been acknowledged to be - an interference with freedom of contract and courts have accordingly been reluctant to intervene unnecessarily. The burden of proof to establish that an arrangement constitutes a penalty clause rather than a valid liquidated damages clause rests with the party alleging that such an arrangement is unenforceable.

The leading case in this area is that of *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] A.C.79. This set out the relevant principles for consideration:

- The wording used in a contract (for example, "penalty" or "liquidated damages") will not be conclusive;
- Where an arrangement is intended as a deterrent for breach, this will suggest that it is not a genuine pre-estimate of loss. This is an objective test, although the parties' intentions are relevant;
- A contract is construed with reference to the time it was entered into and not the time it was breached;
- An arrangement will be a penalty where the following four factors apply:
- The payment to be made is "extravagant and unconscionable" when compared to the greatest actual loss which could be suffered as a result of breach;
  - Where a breach consists of a failure to pay a sum of money, and the payment made as a result of such breach stipulates a greater sum, this will be considered a penalty;
  - Where a number of different breaches (some trivial and others serious) would result in a single flat sum payable by way of compensation, the presumption is that this is a penalty;
  - The fact that it may be difficult to accurately pre-estimate the loss suffered as a result of breach does not preclude an arrangement being deemed a genuine liquidated damages clause.

Prior to more recent case law developments, the courts (following *Dunlop* and similar cases) usually focussed narrowly on whether a provision constituted a penalty or a genuine pre-estimate of loss. This approach is now changing and additional factors are also taken into account.

A move towards more flexibility: *Makdessi*

The Court of Appeal's 2013 decision in *El Makdessi v Cavendish Square Holdings BV and another* [2013] EWCA Civ 1539 evidences that a more flexible approach is emerging.

The case concerned an arrangement by which Mr Makdessi sold his controlling interest in a company whilst retaining a number of shares. In the event of his default in respect of certain of the terms of the arrangement, M agreed to forfeit the right to receive various earn out payments, and was obliged to sell his remaining shares. The payment to be forfeited by M in the event of breach could have amounted to in excess of $40m. However, the new shareholder (i.e. the buying company) would probably have suffered no financial loss (in principle any loss would be suffered by the target).

At first instance the High Court held that the arrangement was not penal since it was commercially justifiable. It took into account the fact that each party had been legally represented to a high standard during negotiation of terms. When considering the elements of a penalty, the Judge took into account:

- Any commercial justification;
- Whether the provision was extravagant or oppressive;
- Whether its predominant purpose was to deter breach; and
- Whether it had been negotiated on a level playing field.

In a departure from the previous, more rigid approach, this decision was overturned by the Court of Appeal which decided that the forfeit of the earn out and the terms on which the remaining shares must be sold were a penalty clause. Clarification was given on the test to be applied and the factors to be considered when deciding whether an arrangement should be deemed an unenforceable penalty.

It was acknowledged that an attempt to impose a "dichotomy" between a genuine pre-estimate of loss and a penalty is too rigid an approach. Even where an arrangement does not constitute a genuine pre-estimate of loss, it does not automatically follow that it will be penal.

The *Makdessi* arrangement included the following relevant characteristics:

- The damages which could be recovered for the breach in question were likely to be zero;
- In contrast, the amount forfeited by Mr Makdessi could be in excess of $40m;
- The arrangement covered a wide range of potential breaches, both trifling and significant. A minor breach would have the same consequences as a critical breach.

On that basis the Court held that the relevant clauses were not "genuine pre-estimates of loss" but were, instead, "extravagant and unreasonable".

This in itself was not conclusive as to whether they were penalties. If the arrangement could be commercially justified, meaning that their predominant purpose was not to deter a breach, then they may still be enforceable. However, despite the care with which the parties' respective legal advisers and negotiating teams had designed the deal (and presumably the risk values of the upsides and downsides) the Court of Appeal did not consider that there was a commercial justification for the loss of the earn out here.

The *Parkingeye* decision

The recent case of *ParkingEye v Beavis* [2015] EWCA Civ 402 addresses similar issues in a consumer-facing context. It indicates a similarly flexible approach and a move away from the historic distinction between a "penalty" and a "genuine pre-estimate of loss". Instead, a number of different factors - both commercial and social – were taken into account when considering the arrangement in question.

Some commentators have distinguished between the application of penalty clauses in commercial and consumer contexts. It is generally accepted that consumers require greater protection from oppressive contract terms than commercial parties (and indeed the recent Consumer Rights Act 2015 is an example of legislation to achieve this). Consequently, the justification for making unfair penalty clauses unenforceable in consumer contracts is arguably stronger than in circumstances where sophisticated, legally advised parties actively negotiate the terms of their agreements.

Hence it might be thought that clauses are more likely to be disapplied as penal where they affect consumers. The Parkingeye case was one example where, despite this, a clause which required an individual to pay for overstaying in a car park was considered to be binding even when the 'fee' was far in excess of any loss which could actually arise from a car staying too long (presumably a trivial amount).

Parkingeye is consequently indicative of applying the overall trend away from the previous distinctions between penalties and liquidated damages clauses into the consumer context.

The case concerned an £85 charge incurred by a motorist, for overstaying a 2-hour free car-parking period in a car park.

At first instance, it was held that the charge was enforceable and payable. The considerations taken into account were:

- Motorists using the car park did so on the terms displayed and therefore entered into a contract with the operator of the car-park. This included an obligation to leave within two hours and to pay the charge of £85 if that period was overstayed;
- The operator did not suffer a specific financial loss if the two-hour period was overstayed and thus, on the face of it, the £85 charge had the characteristics of a penalty;
- However, it was commercially justifiable since it was neither improper in purpose nor manifestly excessive in amount;
- Similarly, the charge was not an unfair term and was not rendered unenforceable by the Unfair Terms in Consumer Contracts Regulations 1999 (now being replaced by similar provisions in the Consumer Rights Act 2015).

The motorist appealed, arguing that the only purpose of the charge was to deter motorists from overstaying the two-hour period. It had no other function. The motorist argued that the operator was merely profiting from motorists' 'weakness' or negligence in failing to adhere to the two-hour time limit.

The operator contended that the true principles to consider are those of "extravagance" and "unconscionability". The £85 charge was neither, and was commercially justifiable.

The Court of Appeal referred to previous case law and the limited choice between whether the charge was a genuine pre-estimate of loss, or whether it in fact far exceeded any actual loss suffered as a result of a breach. It noted that *"it was for a long time routine to examine clauses of this kind by reference to a dichotomy between liquidated damages and penalties".*

This "dichotomy" has more recently (such as in the *Makdessi* case) been acknowledged as inadequate. The court noted that *"the modern cases […] appear to accept that a clause providing for the payment on breach of a sum of money that exceeds the amount that a court would award as compensation [...] may not be regarded as penal if it can be justified commercially and if its predominant purpose is not to deter breach"*.

In this case, consideration was given to *"a combination of factors, social as well as commercial"*. In particular:

- As at first instance, it was acknowledged that the operator suffered no direct financial loss as a result of motorists overstaying the permitted period. However, it may suffer indirect losses as a result of the terms on which it operated the car park. the operator therefore had a valid commercial interest in deterring overstaying;
- Any smaller penalty would be uneconomic to enforce against defaulting motorists;
- The "obvious benefits" to consumers and businesses in having free car parking available for limited periods can be achieved *"only if there is some mechanism for ensuring that in most cases those who make use of the facilities do not abuse them by overstaying"*;
- Whilst the £85 charge was a deterrent, therefore, it was not extravagant or unconscionable;
- Similarly, it did not breach any duty of good faith (since the conditions of parking were clearly displayed) or take advantage of consumers' weakness in misjudging time. Flat rate charges such as this are common in all types of car park, whether private or operated by local authorities. There was no significant imbalance in the parties' rights and obligations. Accordingly, the provision did not breach the Unfair Terms in Consumer Contracts Regulations 1999.

The appeal was dismissed and the £85 charge was upheld as enforceable. Although a deterrent beyond mere compensation for the innocent party, the additional factors considered led to the conclusion that the provision was justifiable.

Conclusion

The Court of Appeal appears to be introducing a consistent test for penalty clauses across commercial and consumer contracts. This test is more flexible than many have historically understood it to be. That should allow the law to adapt to modern commercial realities which were probably not foreseen when the law in this area was last substantially reviewed in 1915.

However, some doubt about its full extent and proper application must remain until the Supreme Court reaches its decision in summer 2015. There are also a number of issues to resolve around the scope of the rule and the degree to which sophisticated commercial entities can negotiate around it.

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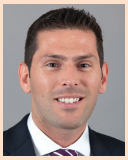

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