Liquidated Damages and the Penalty Trap

The Supreme Court has restated the law on penalties with a shift for complex commercial cases from the “genuine pre-estimate of loss” and “deterrence” tests, placing liquidated damages clauses under the spotlight.

Summary

Earlier this year, the Supreme Court handed down a conjoined judgment in the cases of Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67 which in effect, has restated the law on penalties narrowing the circumstances in which contractual clauses requiring payment upon breach, will be considered a penalty clause (and therefore unenforceable).

This note considers: (i) the law on penalties (both pre and post Cavendish and ParkingEye); and (ii) how the Supreme Court Judgment may impact the negotiation of clauses commonly found in construction contracts, in particular liquidated and ascertained damages clauses (“LADs”).

The law on penalties pre Cavendish and ParkingEye

Common features of construction contracts are obligations to provide LADs (a predetermined fixed sum payable for a specified breach of contract); these are frequently seen in design and build and building contracts. The right to enforce LADs is subject to the law on penalties.

The traditional approach to the law on penalties is set out in the well known case of Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1914] UKHL 1. In essence, a penalty is a payment of money stipulated as a deterrent and risks being unenforceable. LADs are a “genuine pre estimate of damage” aimed to compensate for a breach and therefore likely to be recoverable. However LADs were considered penal if the amount payable was “extravagant and unconscionable”; this led to a number of challenges to LADs on the basis that they were a penalty.
In recent years the Courts have suggested that a contractual provision may be enforceable even where it does not constitute a genuine pre-estimate of loss provided that it gave rise to a "commercial justification" and its primary purpose was not to deter breach of contract. Determining whether LADs are penal has therefore often remained difficult and "unclear".

The Appeals of Cavendish and ParkingEye

In Cavendish, Mr Makdessi sold part of his interest in a marketing and advertising business to Cavendish for a substantial sum. Under the share sale agreement if Mr Makdessi breached certain restrictive covenants contained therein, Mr Makdessi (i) would not be entitled to receive the final two instalments of the share price paid by Cavendish (Clause 5.1); and (ii) could be made to transfer his remaining shares to Cavendish at a price which excluded the value of the goodwill of the business (Clause 5.6). When Mr Makdessi breached the restrictive covenants, he argued that Clauses 5.1 and 5.6 were an unenforceable penalty relying primarily on the Dunlop position.

In ParkingEye, Mr Beavis was given an £85 parking charge imposed by ParkingEye for overstaying a two hour period of free parking. Mr Beavis argued that the £85 parking charge imposed was a penalty that was unenforceable.

The lower courts adopted differing interpretations on the application of the law on penalties; however for the purposes of this note these decisions are not considered in detail. Ultimately, the Supreme Court found that Clauses 5.1 and 5.6 in Cavendish and the £85 parking charge in ParkingEye, were valid and enforceable.

The Supreme Court Decision

The Supreme Court declined to abolish the penalty rule altogether and considered that the Dunlop test (i.e. was the purpose of the clause to deter the offending party or compensate the innocent party) was still applicable to standard contracts. However, significantly, the Court unanimously held that for more complex contracts\(^1\), a broader test was required, and in particular, whether "the impugned provision is a secondary obligation which imposes a

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\(^1\) Limited guidance is provided on what constitutes a ‘standard contract’ compared with a ‘complex contract’, although see paragraph 22 in which the Lords consider the Dunlop test is properly applied to ‘simple damages clauses in standard contracts’.
The Court considered that the fact that a damages clause is not a genuine pre-estimate of loss does not, without more, mean that it is penal; it may be justified by some other consideration other than the desire to recover compensation for breach. This must depend on whether the innocent party has a legitimate interest in performance of the contractual obligation extending beyond the prospect of pecuniary compensation flowing directly from the breach in question.

The Supreme Court confirmed that LADs are secondary obligations (i.e. they come into play out of breach of contract of an underlying primary obligation). The Supreme Court also considered that the penalty rule is not confined to clauses solely dealing with the payment of a sum of money for breach of contract and may, importantly in the context of construction contracts, apply to withholding clauses (although the Lords had differing views on this point and the position remains unclear).

Application to Cavendish and ParkingEye

The Supreme Court held that in both Cavendish and ParkingEye the provisions in dispute legitimately protected more than the predicated financial loss. In Cavendish, the penalty rule had not been engaged as Clauses 5.1 and Clause 5.6 were held to be primary obligations and were designed to protect the legitimate commercial interests of Cavendish (i.e. the observance of the restrictive covenants to protect the goodwill of the business). In ParkingEye, the Court held that the £85 charge was not a penalty as ParkingEye has a legitimate interest in charging overstaying motorists for the efficient management of parking space and the generation of income.

The Court held that the parties are the best judge of what “legitimate interest” is protected by the agreement. Whilst this will depend on each case, it is likely to include consideration of the wider commercial context of the contract such as reputational issues, the interest of third parties, goodwill and other losses that may not easily be quantified.

Conclusion

Whilst the Courts are generally reluctant to interfere with contracting parties’ freedom of contract, the law on penalties is an exception where they may look
to intervene if the clause is oppressive or extravagant and unconscionable. Following *Cavendish* and *ParkingEye*, the Supreme Court, in effect, has narrowed the circumstances in which the rule on penalties will apply. It follows that contractual parties may be more likely to be held to their negotiated contracts (in particular where they have equal bargaining power and have been fully advised), thereby making it more difficult to challenge the enforceability of an alleged penalty clause which they have freely entered into. Although, the application of *Cavendish* and *ParkingEye* in subsequent cases, remains to be seen.

How will *Cavendish* and *ParkingEye* affect a contractor’s/consultant’s approach to negotiating LADS?

Care should be taken following this case before entering into contracts that include LADS. In the case of consultants, LADS are unusual and generally not covered by professional indemnity insurances and we recommend that LADS are resisted by consultants. In the case of contractors, LADS can be a useful way of limiting liability to an amount that is a pre-determined and agreed fixed sum rather than going through an assessment by the courts which can result in damages being awarded at a higher amount; provided that the LADS are stated to be the Contractor’s sole liability following any delay and the level of LADS is not extravagant and unconscionable.

In any event, if LADS must be maintained, a careful assessment of the stipulated rates should be undertaken taking into account the project as a whole (including the extent to which the LADS represent a “genuine pre-estimate of the loss”). Following this case, Clients may also insist that LAD clauses identify both primary and secondary obligations, (i.e. in an attempt to meet the legitimate interest test) so careful drafting will be required. Parties should ensure they have a clear understanding of the intention/application of LADS and are properly advised at the outset.

In respect of withholding clauses, these are considered standard in construction and engineering contracts. Whilst it remains unclear whether withholding clauses are penalties, again, *Cavendish* and *ParkingEye* demonstrate that a clear understanding of the purpose of the clause and circumstances in which a client may withhold sums is necessary.

It will be interesting to see how the case law on penalties develops and the extent to which the principle will be interpreted and applied by the courts.

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