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Penalty clauses: all clear now?

As indicated in our briefing on penalty clauses in June, the *El Makdessi* and *ParkingEye* cases have been reviewed by the Supreme Court, which has now given an important ruling aimed at clarifying the law.

What's the issue?

If a court rules that a clause in an agreement is an unlawful penalty, it cannot be enforced. The classic example is a clause triggered by a breach of contract which requires the party in breach to pay a sum of money to the innocent party (often referred to as "liquidated damages"). Where the amount involved is "extravagant and unconscionable", the clause will be regarded as a penalty.

Until now, the courts have tended to approach this question by focussing on whether the clause amounted to a "genuine pre-estimate of loss" and whether the purpose of the clause was to compensate the innocent party (rather than deter breach). The Supreme Court was asked to decide whether the law on penalties should still apply and if so, whether its scope should be extended and/or clarified.

Despite the Supreme Court ruling, some uncertainty remains.

What's changed?

The Supreme Court has decided that the law on penalty clauses should remain in place, and has declined to extend it any further. It will therefore still be possible to challenge certain types of clause on the basis that they are "extravagant and unconscionable", but, in an effort to clarify the law, the Supreme Court has stated that:

- The test 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."
- Clauses may now be justified even where they do not amount to a genuine pre-estimate of loss and/or are imposed as a deterrent – provided that the purpose they serve is legitimate and the remedy is not out of all proportion to that legitimate interest.

What are the practical implications?

If anything, it is now likely to be more difficult to challenge clauses as penalties in cases where both parties are well advised and of comparable bargaining power. This was an important factor in one of the cases considered by the Supreme Court (*Cavendish v El Makdessi*), which involved a clause triggered on breach of the seller's restrictive covenants in a sale and purchase agreement. The seller argued that these provisions over-compensated the buyer by a substantial margin. The Supreme Court found that the buyer had a

legitimate interest in deterring the seller from breaching his restrictive covenants – and that although the clauses were somewhat harsh in their effect, they were not manifestly excessive by reference to the interest that the buyer was seeking to protect.

That said, it remains difficult to say where the line is drawn between a clause which is "legitimate" and one whose effect is so disproportionate that it would amount to a penalty. It may help to consider market practice in other similar situations. For example, in the other case considered by the Supreme Court (*Beavis v ParkingEye*), Mr Beavis stayed more than the 2 hour limit at the car park of a retail complex, resulting in a charge of £85. He argued that this was excessive. The Supreme Court ruled that the overstay charge was legitimate because it helped to deter abuse of the free car parking facility. As the charge was broadly in line with charges levied by local Councils and others for overstaying in public car parks, it was not "exorbitant or unconscionable". It follows that (contrary to the impression given in some media reports), businesses do not have carte blanche to impose unlimited charges in this type of situation.

In relation to liquidated damages clauses, the purpose of the provision is usually to provide a mechanism to recover compensation for loss without going through the courts. Given that, a clause which allows recovery of amounts significantly higher than the innocent party's likely loss may still be vulnerable to challenge as a penalty.

Checklist

Given the uncertainty that remains despite the Supreme Court's ruling, our view is that businesses should focus on the following:

- **Is this a clause to which the law on penalties could apply?** Is it triggered by a breach of contract with adverse consequences (other than possible termination) for the contract breaker? Or can the clause be restructured so that it is not triggered by default, such as an option to terminate early in return for payment (in which case, the law on penalties would not normally apply)?
- **If so, can the clause be said to result in a significant and unjustified windfall for the innocent party?** For example, where payments are required, are they likely to exceed the innocent party's loss by a significant margin? Are they significant in absolute terms and do they exceed the sums typically payable in similar contexts? If so, what commercial justification is there for the clause?
- **Are consumers affected?** If so, a general fairness test applies (including in relation to clauses not triggered by breach e.g. options to terminate). Terms must also be set out clearly and prominently. These requirements were satisfied in the car parking case discussed by the Supreme Court but need careful consideration.

FOR FURTHER INFORMATION, PLEASE CONTACT

10 Snow Hill
London EC1A 2AL
T: +44 (0)20 7295 3000
F: +44 (0)20 7295 3500
www.traverssmith.com



Tom Purton

Head of Commercial, IP & Technology

E: tom.purton@traverssmith.com
T: +44 (0)20 7295 3277



Richard Brown

Partner, Commercial, IP & Technology

E: richard.brown@traverssmith.com
T: +44 (0)20 7295 3254



Dan Reavill

Partner, Commercial, IP & Technology

E: dan.reavill@traverssmith.com
T: +44 (0)20 7295 3260



Ben Chivers

Partner, Commercial, IP & Technology

E: ben.chivers@traverssmith.com
T: +44 (0)20 7295 3370

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