



Penalty clauses

What to watch out for

June 2015

The Court of Appeal has recently ruled that an £85 charge for staying more than 2 hours in a retail store car park was not an unlawful penalty. Does this mean that the law on penalties is no longer applied as strictly as in the past? Or is it still an issue that businesses need to be concerned about?

The law on penalties

It is a well established rule of law that the courts will not enforce clauses which they regard as "extravagant and unconscionable."

The classic example is a clause which is triggered by a breach of contract and requires the contract breaker to pay a sum of money to the innocent party. If that sum (often referred to as "liquidated damages") does not amount to a "genuine and reasonable pre-estimate" of the innocent party's loss, it will be at risk of being an unenforceable penalty. Such a clause may be "extravagant and unconscionable" because it may significantly over-compensate the innocent party. If so, its purpose is seen as being to deter breach, rather than to provide compensation for loss.

Other clauses which can sometimes be unenforceable penalties include:

- **Accelerated payment** – where a breach of contract triggers an obligation to pay instalments at an earlier date (especially if no allowance is made for the benefit of accelerated receipt by the payee).
- **Late payment** – for example, in *Jeancharm v Barnet FC (2003)*, a clause requiring payment of 5% interest *per week* on late payments (i.e. an *annual* interest rate of over 200%) was held to be a penalty.

The ParkingEye case

In *Beavis v ParkingEye (2015)*, Mr Beavis stayed more than the 2 hour limit at the car park of a retail complex, resulting in a charge of £85 (reduced to £50 if paid promptly). Mr Beavis argued that this was an unenforceable penalty.

The Court of Appeal accepted that the

charge was designed primarily to deter breach and that £85 could not be seen as a genuine pre-estimate of loss. In many situations, both these factors would have suggested that the charge was an unenforceable penalty.

However, in this case, the "deterrence" function of the overstay charge was legitimate because it helped to prevent abuse of the free car parking facility. Had the £85 charge been significantly higher, it could have been a penalty - but since it was broadly in line with charges levied by local Councils and others for overstaying in public car parks, it was not "extravagant and unconscionable."



What does this mean?

Although reassuring in some respects, *ParkingEye* does not mean that businesses can take a relaxed view of the law on penalties. For example, *Cavendish v El Makdessi (2013)* concerned a clause triggered on breach of the seller's restrictive covenants in a sale and purchase agreement. The clause provided that the seller lost his entitlement to valuable put options together with tens of millions in deferred consideration. He could also be forced to sell his remaining shares at a significant undervalue.

The Court of Appeal concluded that the cumulative value of the benefits that the seller was deprived of far outweighed the purchaser's loss from the breach; as a result, the clause was "extravagant and

unconscionable" and could not be enforced. This highlights the need to consider the cumulative effect of more complex clauses, such as multi-layered service credit schemes.

Commercial justification

At first instance, it was held that the clause in *El Makdessi* was not a penalty because it was "commercially justified" i.e. it simply reflected the bargain struck between the parties (who were sophisticated and well advised). This argument will sometimes be worth exploring - but its scope is uncertain. In *El Makdessi*, it was undermined (on appeal) by the disproportionate nature of the clause. Both *El Makdessi* and (we understand) *ParkingEye* are being appealed to the Supreme Court.

Checklist

Given the difficulties with "commercial justification", 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 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? With more complex provisions, it may be worth running hypothetical figures through 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 *ParkingEye* but need careful consideration.

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