

Radical change to the rule against penalties in England

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Cavendish Square Holding BV v Makdessi

INTRODUCTION

This case note examines the radical change in the rule against penalties in *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67 (*Cavendish*), a recent decision of the Supreme Court of the United Kingdom.

The rule against penalties is a contract law doctrine of equitable origin which allows courts to render clauses unenforceable. We will refer to such clauses as 'penalties' or 'penalty clauses'. The conclusion that a clause is a penalty renders it void in its entirety (*cf* the position in Australia which allows for partial enforcement: *Andrews v ANZ Banking Group* [2012] HCA 30, 247 CRL 205 (*Andrews*) at [10]). The precise test for what makes a clause a penalty clause, and the rationale for the rule, are uncertain. The question of whether a clause is a penalty most commonly arises with respect to clauses where a party who breaches a contract is required to pay the innocent party a sum of money. Where this sum is a genuine pre-estimate of the loss that the innocent party would suffer from the breach, such a clause is a "liquidated damages clause" and is enforceable. Traditionally, penalties were distinguished from liquidated damages clauses on the basis that the former deter and punish breach while the latter merely compensate the innocent party. *Cavendish* represents a significant departure from that approach. The new approach in *Cavendish* follows from the Court's attempt to address deficiencies in previous formulations of the rule against penalties, so we will survey the history of the rule before setting out the new test. Beforehand, we will set out the facts addressed in *Cavendish* that led to the new formulation of the rule.

On the facts, the Court considered two different appeals, *Cavendish* and *ParkingEye*. The *Cavendish* appeal concerned the validity of two clauses in a large commercial contract for the sale of a company that were triggered by breach of contract by the seller. The first clause withheld payments from the seller which he was otherwise due while the second required the seller to sell his shares in the company to the purchaser. The *ParkingEye* case addressed the validity of an £85 'parking charge' levelled on customers who overstayed a two-hour free parking period in a car park. The Court concluded that none of the clauses it considered were unenforceable (Lord Toulson dissented on the *ParkingEye* appeal).

PREVIOUS FORMULATIONS OF THE RULE

The most influential case on the rule against penalties prior to *Cavendish* was *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79. In *Dunlop*, the Court considered a 'price maintenance clause' which pre-

vented a garage which sold Dunlop tyres and accessories from undercutting the prices offered by Dunlop. It concluded that this clause was not a penalty.

Lord Dunedin noted four tests (at 87, summarised at [21] of *Cavendish*) to aid the Court in determining whether a clause was penal. The first three tests are that a provision will be penal if:

- (a) "the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach";
- (b) the breach consisted only in the non-payment of money and it provided for the payment of a larger sum; and
- (c) the clause was a sum payable in a number of events of varying gravity (this test is presumptive rather than conclusive).

The fourth test is that a clause will not be penal by reason only of the impossibility of precisely pre-estimating the true loss. Lord Dunedin also famously stated at 86 that "[t]he essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimation of damage". This captures the classic dichotomy between clauses that deterred breach (unenforceable penalties) and clauses that attempted to reflect the loss that the innocent party would suffer (enforceable liquidated damages clauses).

In other, more recent cases, courts focused on the wider question of whether there was a 'commercial justification' for the clause in question rather than simply whether the clause provided a 'genuine pre-estimate of loss'. However, as in *Dunlop*, the test for whether a clause was penal was framed with reference to a dichotomy between unenforceable clauses whose "dominant purpose was ... to deter the other party from breach" (Colman J in *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752 at 763–4), and enforceable clauses that had purposes other than deterrence (even though they may have had a significant deterrent effect). For example, in *Lordsvale* the Court concluded that a clause that increased the interest payable by a borrower in default was not penal, because defaulting borrowers posed a higher credit risk. Therefore, the clause had a 'commercial justification' and was not simply a deterrent.

SHOULD THE RULE EXIST AT ALL?

In the course of argument in *Cavendish*, it was submitted that the penalty rule lacks sufficient justification and should be abrogated, a common theme in cases concerned with purported penalty clauses. The Court ultimately rejected these

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arguments, but we will address them, as well as a further point about the sort of clauses that can attract the rule, before turning to the Court's new formulation of the rule.

Lord Hodge identified the main arguments against the rule, at [256]–[260]. First, the rule is contrary to freedom of contract, and it applies regardless of whether there is an inequality of bargaining power between the parties. The doctrine only operates on breach and can potentially be circumvented by careful drafting. Furthermore, it promotes uncertainty in that it is unclear how 'exorbitant or unconscionable' a clause must be to be unenforceable. Finally, the legislature in England has passed various statutes regulating unfair terms in consumer contracts (as has happened in New Zealand, see the Fair Trading Act 1986, s 26A), arguably reducing the need for a rule against penalties. However, the court declined to abrogate the rule. Lord Hodge gave three reasons (at [261]): First, the rule protects weaker parties from significant imbalances of bargaining power. Second, abolition of the rule would go against the global trend of decisions upholding the rule. Finally, the rule does not prevent parties from reaching sensible arrangements to determine the consequences of breach.

WHICH CLAUSES CAN BE PENALTIES?

Cavendish resolved two questions as to the sorts of clauses that the rule against penalties can reach. First, the rule is not restricted to clauses that require the breaching party to pay money (at [154] to [159]). For example, a clause that allowed the innocent party to withhold payments could potentially be a penalty. Second, the rule only applies to clauses that are triggered by a breach of contract (at [41] to [42]). With respect to this second point, the Court declined to follow the Australian position that breach of contract is not an essential part of the rule (see *Andrews*).

THE NEW ENGLISH RULE AGAINST PENALTIES

The United Kingdom Supreme Court concluded that clauses are not necessarily penal merely because one of their purposes is to deter breach. It rejected the dichotomies that had dominated the history of the rule, noting that clauses may have both a primary deterrent purpose and a 'commercial justification'. The majority explained, at [28], that the "innocent party [may have] a legitimate interest in performance extending beyond the prospect of pecuniary compensation flowing directly from the breach in question". This was a key issue on the facts of *Parking Eye*, as the car park operator conceded that the £85 was not a pre-estimate of damages (at [97]). The Court concluded that deterrence may not necessarily be penal as long as there is a 'legitimate interest' in performance that goes beyond the right to recover damages for breach of contract (at [99]). Instead, the majority found, the rule against penalties should be framed in terms of whether the clause was "unconscionable" or ... 'extravagant' by reference to some norm" (at [31]).

The majority set out the test for a penalty clause at [32]:

The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the

primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance.

Lord Manse found at [152] that the Court should ask:

... first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether ... the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable.

Lord Hodge concluded at [255] that a clause would be penal if:

... 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.

All three tests are in essence the same, in that they ground the notion of an enforceable clause in the innocent party's interest in performance. This is because all the judges were concerned with presenting a better alternative to "the dichotomy between the compensatory and the penal" (Lord Manse at [152]).

Each test requires that the interests the innocent party is seeking to protect are 'legitimate'. While this requirement is ambiguous without further exposition, to some extent this ambiguity is resolved in light of the application of these tests to the facts — all the Judges agreed that deterring breach may be a legitimate interest in some circumstances (for example on the *Parking Eye* facts), whereas "simply punishing the defaulter" will be illegitimate (Lord Neuberger at [32]).

The reference to primary and secondary obligations in the majority's test ensures that a clause can only be penal if it applies where there has been a breach of contract. Secondary obligations are triggered on breach of contract, that is, on the failure of a primary obligation to perform. If the parties do not decide what damages will be payable, the content of secondary obligations is usually determined by the courts (Arthur Corbin "Discharge of Contracts" (1913) 22 YLJ 513 at 514).

CONCLUSION

The *Cavendish* decision marks a radical change in the rule against penalties in England. Deterrent clauses are no longer by definition unenforceable. Instead, the Court concluded that in some cases deterring breach can be legitimate, as long as the interest that is being protected goes beyond merely damages for breach of contract. This is a departure from a long line of cases where the touchstone for a penalty clause was to ask whether the clause's main purpose was to deter. In light of this, *Cavendish* is likely to have a significant impact in New Zealand when the rule against penalties next comes before our courts. While punishment for punishment's sake is still off the table, *Cavendish* raises the possibility that cases about purported penalty clauses will be argued in terms of the strength of a party's interest in receiving performance, and whether the clause in question is a more appropriate alternative to performance than a payment of compensatory damages, rather than the traditional question of whether the clause operates in *terrorem*. □