UK SUPREME COURT IDENTIFIES REVISED TEST FOR UNFAIR PENALTIES

Introduction

On 4 November 2015, a seven-member Supreme Court handed down its decision in the cases of *Cavendish Square Holding BV (Appellant) v Talal El Makdessi (Respondent)*; and *ParkingEye Limited (Respondent) v Beavis (Appellant)* [2015] UKSC 67, in which it set out the test applicable for determining unfair penalties.

Background

Cavendish Square Holding BV v Talal El Makdessi

The first appeal raised the issue in relation to two clauses in a substantial commercial contract. Mr Makdessi founded a group of companies ("the Group") which by 2008 had become the largest advertising and marketing communications group in the Middle East. Mr Makdessi owned the Group through a holding company with Mr Ghossoub. By an agreement dated 28 February 2008, Mr Makdessi and Mr Ghossoub agreed to sell shares in the holding company, with those shares subsequently transferred to Cavendish Square Holdings BV (which also became a party to the original sale agreement). Subsequently, Cavendish accused Mr Makdessi of being in breach of restrictive covenants contained in the agreement, and purported to take advantage of clauses which allowed them to not make payments to Mr Makdessi which he was otherwise entitled to under the agreement and purchase his shares.

At first instance, the case was heard by Burton J and the appeal was heard in the Court of Appeal by Patten, Tomlinson and Christopher Clarke LJJ. The issue before both courts was whether the clauses prohibiting the payments and requiring Mr Makdessi to exercise a call option pursuant to which he would sell his shares to Cavendish were valid and enforceable (as Cavendish contended), or whether they both were void and unenforceable because they constituted penalties (as Mr Makdessi argued). Burton J upheld the clauses as valid and enforceable, but the Court of Appeal reversed this decision. Cavendish appealed.

ParkingEye Ltd v Beavis

The second appeal raised the issue at a consumer level, and it also raised a separate issue under the Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083) ("the 1999 Regulations").

ParkingEye managed a car park which displayed signs notifying those parking that a failure to comply with the terms (those being predominantly a two-hour stay limit, except for those using a particular fitness centre) would result in a parking charge of £85. Having been subjected to the penalty, Mr Beavis refused to pay. Mr Beavis argued that he should not have to pay on the basis that the charge was (i) unenforceable at common law because it was a penalty, and/or (ii) unfair and therefore unenforceable by virtue of the 1999 Regulations.

Mr Beavis' arguments were rejected both at first instance (Judge Moloney QC) and by the Court of Appeal (Moore-Bick and Patten LJJ and Sir Timothy Lloyd). Mr Beavis appealed.

Decision

The Supreme Court (Lord Neuberger (President), Lord Mance, Lord Clarke, Lord Sumption, Lord Carnwath, Lord Toulson and Lord Hodge) allowed the appeal in *Cavendish v El Makdessi* and dismissed the appeal in*ParkingEye v Beavis* (thereby upholding the validity of the clauses at dispute in each case).

Lord Neuberger and Lord Sumption gave a joint judgment, with which Lord Clarke and Lord Carnwath agreed.

- Their Lordships considered at length the history of penalty clauses and decisions discussing which test was to be applied in determining whether a clause was a penalty clause. Lord Neuberger and Lord Sumption held that 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."
- In the *Cavendish* appeal, both clauses at issue served a legitimate interest in protecting Cavendish's investment in the purchase of the shares. Whilst it was possible that price adjustment clauses could be used as unenforceable "punishments", the court would need to have reason to find that to be the case, and in the present circumstances there were none. The financial consequences were a matter for the parties, who were experienced commercial people bargaining on equal terms over a long period with expert legal advice.
- In *Beavis*, the charge was not a penalty and was not contrary to the 1999 Regulations. Both ParkingEye and the landowners had legitimate interests in the charge, but in commercial terms and in ensuring the effective operation of the carpark. This did not mean that ParkingEye could charge what it liked, but the £85 was not out of all proportion to its interests. Further, parking charges were in fact beneficial to ParkingEye, the landowner, retail outlets, and the motorists themselves.

Both Lord Mance and Lord Hodge delivered concurring judgments.

Lord Mance held that the appropriate test was a two-step test to consider: (1) whether any (and if so what) legitimate business interest is served and protected by the clause; and (2) whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable. In judging what is "extravagant, exorbitant or unconscionable", the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor.

- In applying this test to the appeal in *Cavendish*, Lord Mance gave great weight to the fact that the commercial agreements had been drafted by and carefully negotiated between sophisticated, informed and legally advised parties. Considering the commercial realities between the parties and the consequences of Mr Makdessi's breach of covenant, neither of the clauses in question could be viewed as extravagant, exorbitant or unconscionable.
- In respect of *Beavis*, Lord Mance cited with approval the first instance judgment of Judge Moloney QC who stated, "although there is a sense in which this contractual parking charge has the characteristics of a deterrent penalty, it is neither improper in its purpose nor manifestly excessive in its amount. It is commercially justifiable, not only from the viewpoints of the landowner and ParkingEye, but also from that of the great majority of

motorists who enjoy the benefit of free parking at the site, effectively paid for by the minority of defaulters, who have been given clear notice of the consequences of overstaying." Similarly, on whether the charge fell foul of the 1999 Regulations, His Lordship agreed with Judge Moloney QC (and the Court of Appeal) who concluded "(a.) It is difficult to categorise as not in good faith a simple and familiar provision of this sort of which very clear notice was given to the consumer in advance. b. There is not a significant imbalance between the parties' rights and obligations, when the motorist is given a valuable privilege (two hours free parking) in return for a promise to pay a specified sum in the event of overstaying, provided that sum is not disproportionately high. (c.) The charge in question is not disproportionately high, and insofar as it exceeds compensation its amount is justifiable, and not in bad faith or detrimental to the consumer." The charge was therefore upheld as valid and enforceable.

Lord Hodge considered jurisprudence from both the English and Scottish courts, and overseas. His Lordship concluded that, in answer to the question as to whether the rule that the courts do not enforce penalty clauses should be abrogated or at least altered so as not to apply in commercial transactions where the contracting parties are of equal bargaining power and each acts on skilled legal advice, it should not.

- The correct test for a penalty 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. Where the test is to be applied to a clause fixing the level of damages to be paid on breach, an extravagant disproportion between the stipulated sum and the highest level of damages that could possibly arise from the breach would amount to a penalty and thus be unenforceable. In other circumstances the contractual provision that applies on breach is measured against the interest of the innocent party which is protected by the contract and the court asks whether the remedy is exorbitant or unconscionable.
- Clauses that authorised the withholding of sums otherwise due to the contract-breaker may fall within the scope of the rule against penalties. However, in the *Cavendish* appeal, the clause was enforceable. Cavendish had a very substantial legitimate interest to protect by making the deferred consideration depend upon the continued loyalty of the sellers through their compliance with the restrictive covenants – the clause was commensurate with Cavendish's legitimate interests. In relation to the call option clause, the terms were harsh but not unconscionable and were, in the particular context of the purchase of a marketing business in the Middle East, a legitimate means of encouraging the sellers to comply with their obligations which were critical to Cavendish's investment.
- In the *Beavis* appeal, Lodge Hodge held that the only relevant questions were (i) did ParkingEye have a legitimate interest to protect by the imposition of the parking charge (ii) whether the level of the charge was exorbitant or unconscionable. In the circumstances, it did have a legitimate interest to protect, and the charge was not manifestly excessive or unconscionable.

Lord Toulson agreed with the majority that the appeal in *Cavendish v El Makdessi* should be allowed but dissented in *ParkingEye v Beavis*. On the correct test, Lord Toulson "highlighted and endorsed" Lord Hodge's formulation. However, Lord Toulson took the view that the disputed clause infringed the 1999 Regulations. His Lordship noted that the burden was on the supplier to show that a non-core term which is significantly disadvantageous to the consumer is one which the supplier can fairly assume that the consumer would have agreed in individual negotiations on level terms. In this case, this burden was not met – the penalty

clause made no allowance for circumstances, allowed no period of grace and provided no room for adjustment. More broadly the penalty clause placed the whole cost of running the car park on the shoulders of those who overstay by possibly a very short time, although their contribution to the cost will have been very small.

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