Supreme Court judgment in Cavendish Square & Parking Eye appeals: reformulation of penalty clause test to protect "legitimate interests" of innocent party

By Andrew Davies and Hannah Curtain

In its judgment in Cavendish Square v El Makdessi and ParkingEye v Beavis [2015] UKSC 67, delivered on 4 November 2015, the Supreme Court considered an issue which has not been considered at the highest level of appeal for a century, namely the principles underlying the law relating to contractual penalty clauses ("the penalty rule"). The test has been reformulated to protect the "legitimate interests" of the innocent party, rather than turning on whether the clause represents a genuine pre-estimate of loss.

Background to the appeals

1. Cavendish Square raised the issue of the enforceability of a purported penalty clause in relation to a substantial commercial contract. ParkingEye raised the issue at a consumer level, and also raised a separate issue under the Unfair Terms in Consumer Contracts Regulations 1999 ("the Regulations").

2. The appeal, which was heard by seven Justices of the Supreme Court last July, represents a wide-ranging examination and revision of the penalty rule. This revision was much-needed. The penalty rule, as last examined by the House of Lords in *Dunlop Pneumatic Tyre Co Ltd v new Garage & Motor Co Ltd* [1915] AC 847, was described by Lord Neuberger PSC and Lord Sumption JSC, with whose judgment Lord Carnwath JSC agreed, as *"an ancient, haphazardly constructed edifice which has not weathered well, and which in the opinion of some should simply be demolished, and in the opinion of others should be reconstructed and extended"* [3].

The rule against penalties

3. The Supreme Court declined the invitation to demolish the rule against penalties, or to explicitly reconstruct and extend it. However, the decision has abolished the perceived need to categorise a provision by reference to the dichotomy between a genuine pre-estimate of loss (enforceable), or an unenforceable penalty clause.

4. The first question is *"In what circumstances is the penalty rule engaged ?"*. The answer is that *"the penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves"* [13]: see *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399. Leaving aside challenges going to the reality of consent, such as those based on fraud, duress or undue influence, the courts do not review the fairness of bargains, either at law or in equity. Thus, where a contract contains an obligation on one party to perform an act, and also provides that, if he does not perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which is capable of being a penalty; but if the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply

provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation, and cannot be a penalty [14].

5. The second question is *"What makes a contractual provision penal ?"*. Almost exactly a century ago, in *Dunlop*, Lord Dunedin set out four propositions familiar to all contract lawyers. His second proposition, usually regarded as critical, is as follows:

> *"The essence of a penalty is a payment of money stipulated in terrorem of the offending party; the essence of liquidated damages is a genuine pre-estimate of the damage".*

6. Lord Neuberger and Lord Sumption regarded the elevation of Lord Dunedin's four propositions by subsequent case-law into a *"quasi-statutory code"* as *"unfortunate"* [22]. Later important cases, such as *Lordsvale v Bank of Zambia* [1996] QB 752, *Cine v UIP* [2004] 1 CLC 401, and *Murray v Leisureplay plc* [2005] IRLR 946, returned to the possibility of a broader test in less straightforward cases, based on *"commercial justification"* for clauses which might otherwise be regarded as penal [26], [27] and [28].

The meaning of "penal"

7. In the view of the Supreme Court, the law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions: between a penalty and genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent. The real question, when a contractual provision is challenged as a penalty, is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both; the fact that the clause is not a pre-estimate of loss does

not therefore, at any rate without more, mean that it is penal. To describe it as a deterrent (*"in terrorem"*) does not add anything [31].

8. 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 interests of the innocent party in the enforcement of the primary obligation. Compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations; a damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach [32] and [28]. In his separate judgment, Lord Hodge JSC observed that *"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"* [255].

9. Application of this test led to the conclusion in *Cavendish Square*, overturning the decision of the Court of Appeal and reinstating Burton J's decision, that the clauses were not penal. In *ParkingEye*, it was common ground that the parking arrangement led to the conclusion that there was a contract between Mr Beavis and the operator. The £85 charge was payable upon a breach of contract (overstaying the 2 hour free period), and it was not a genuine pre-estimate of damages (since the operator lost nothing by the unauthorised use). The charge had two main effects. One was to manage the efficient use of parking space in the interests of the retail outlets, and of the users of those outlets. The other purpose was to provide an income stream to enable the operator to meet the costs of operating the scheme and to make a profit. Those two objectives were *"perfectly reasonable in themselves"* and, subject to the penalty rule and the Regulations, the imposition of a charge to deter overstayers is a reasonable mode of achieving them [98].

10. Thus, the £85 charge was not a penalty, because the operator had a legitimate interest in charging motorists, which extended beyond the recovery of any loss. None of this meant that it could charge overstayers *"a sum which would be out of all proportion to its interest or that of the landowner for whom it is providing the service"* [100]. But there was no reason to suppose that £85 (which was a common charge for overstaying in the UK) was out of all proportion to its interests. In his separate judgment, Lord Mance JSC recognised that the £85 charge for overstaying has to have, and indeed is intended to have, a deterrent effect. However, *"What matters is that a charge of the order of £85 (reducible on prompt payment) is an understandable ingredient of a scheme serving legitimate interests"* [199]. The Court did not however consider what a disproportionate, and penal, sum of money might be in this context.

The Unfair Terms in Consumer Contracts Regulations 1999

11. The same considerations which showed that the £85 charge is not a penalty demonstrated that it is not unfair for the purpose of the Regulations. Essentially, it is not within the basic test for unfairness in regulations 5(1) and 6(1) (*"contrary to the requirements of good faith, it creates a significant imbalance in the parties' rights and obligations under the contract, to the detriment of the consumer"*: see the decision of the Court of Justice of the European Union in *Aziz v Caixa d'Esalvis de Catalunya* [2013] 3 CMLR 89. Any imbalance in the parties' rights did not arise contrary to the requirement of good faith, because the operator and the landlord had a legitimate interest in imposing a liability on Mr Beavis in excess of the damages that would have been recoverable at common law. A reasonable motorist would have agreed to the term imposing the £85 charge in a

negotiation. The absence of a graduated charge for overstaying did not make the term unfair.

12. Lord Toulson disagreed with the other members of the court on the result in *ParkingEye*. He considered that the operator had not discharged the burden of establishing that the term in question, for the purposes of the Regulations, was one which the supplier could fairly assume that the consumer would have agreed in individual negotiations on level terms. By substituting their own judgment of reasonableness of the clause for that question, Lord Neuberger and Lord Sumption's approach *"waters down the test adopted by the CJEU"* [315].

Conclusion

13. This is a landmark ruling which represents a reformulation of the penalty rule as it has been understood and applied for the last century. Whilst the old principles may have been ripe for reconsideration, the new test is a marked departure from the certainty of the strict dichotomy between a genuine pre-estimate of loss and an unenforceable penalty. It remains to be seen how the Courts will interpret the meaning of a party's "legitimate interests", and the threshold at which a detriment will be considered disproportionate in relation to any particular transaction.

Andrew Davies and Hannah Curtain
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