

## When is a contract term an unenforceable penalty?

### Background

For the first time in a century, the Supreme Court has considered the common law rule on penalty clauses in commercial and consumer contracts. This thorough review is welcome as the traditional approach to analysing penalties had become inflexible and confusing.

### What is the modern penalty rule?

The Supreme Court has drawn a distinction between:

- *secondary obligations* (which are penal if they impose a detriment on the contract breaker out of all proportion to any legitimate interest of the innocent party); and
- *conditional primary obligations* (which fall outside the penalty regime altogether).

### Practical tips for avoiding an unenforceable penalty

Use conditional primary obligations	Draft potentially penal provisions as conditional primary obligations. This will help avoid the ambit of the penalty regime. But remember substance remains key.
Describe the innocent party's legitimate interests	It is no longer appropriate to use language on the lines of " <i>the parties agree this is a genuine pre-estimate of loss</i> ". Instead, consider recording in the agreement any legitimate interest of the innocent party in seeing the relevant obligations performed. And highlight the importance of those obligations to the bargain as a whole.
Ensure both parties have proper legal advice	The court recognises the usefulness of liquidated damages and other provisions attempting to set down the implications of breach. They are not seen as objectionable in themselves. The court will be reluctant to meddle with the parties' bargain unless it really has to, particularly where the parties are of relatively equal bargaining power and have received sophisticated legal advice.
Watch forfeiture of rights/value	The penalty doctrine is not limited to obligations to pay money. Bear in mind that it also applies where the contract breaker loses an entitlement to a right or sum otherwise due or has to transfer property for nothing or at an undervalue.

### What was the historic penalty rule?

The old penalty test assumed a complete distinction between what is and is not a genuine pre-estimate of loss. It then treated as a penalty anything which did not fall into the first category. More recently, the courts had tried a more flexible approach by exploring whether the provision was extravagant and unconscionable with key characteristics of deterring breach but without any commercial justification. These tests have been superseded by the Supreme Court's new approach.

## What are secondary obligations?

Secondary obligations are provisions which attempt to provide an alternative to court awarded damages for breach of a primary obligation. To take a simple example: “*You will comply with Clause X. If you breach Clause X, you will pay us a specified sum.*” Here, the payment stipulation is a secondary obligation dealing with the consequences of breaching the primary obligation to comply with Clause X.

## What are conditional primary obligations?

Conditional primary obligations are provisions which do not impose an obligation to perform an act but simply say that, *if* a contracting party does not perform or other circumstances exist, it will have to pay (or will not be entitled to) a specified sum. They fall outside the penalty doctrine altogether. For example: “*We will pay you a specified sum, but only if you are not in breach of Clause X.*”

How you frame a provision is important as conditional primary obligations do not enter the realms of penalty law. But substance remains key. You cannot necessarily avoid the penalty principle simply by making relevant contractual provisions conditional. The court will examine objectively the parties’ intentions when they entered into the contract and challenge any mechanism which is a disguised punishment for breach. Finally, based on the Supreme Court’s recent judgement, the court may be more easily persuaded that a provision is a primary obligation if the innocent party has a legitimate interest to protect.

## What is a legitimate interest?

This is a key question for both:

- *secondary obligations* – the modern test involves asking whether a secondary obligation imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in seeing a primary obligation performed. Only then is it penal;
- *conditional primary obligations* – the court will also consider the innocent party’s legitimate interests when analysing whether a provision is a primary or secondary obligation.

A legitimate interest means an interest in performance or an appropriate alternative to performance. In simple cases, this will be an interest in financial compensation. In more complex cases, the innocent party may have other legitimate reasons for wanting an obligation to be performed. If the innocent party has a legitimate interest in enforcing a provision beyond the need for financial compensation, consider spelling this out in the contract.

Tim Nosworthy, partner Corporate & Securities Group, comments: “*Statements about legitimate interests are unlikely to sway a court conclusively one way or the other. But they should help set the scene and focus the parties’ minds on the issue in their negotiations.*”

Ed Sautter, partner Litigation & Dispute Resolution Group, comments: “*We already frequently see disputes between parties as to what business common sense means in arguments regarding contractual interpretation and courts often acknowledge that there is no monopoly on the merits of those arguments. There is no reason to believe that we won’t see the same sorts of arguments about legitimate interests in the context of penalties.*”

## Cavendish v Makdessi

This case involved the price mechanics in a share sale and purchase agreement (SPA). The sellers were individuals. They were remaining on the target's board of directors and retaining a minority shareholding in it.

The SPA set out complex price arrangements for the sellers' sale shares including a cash payment on completion and further cash payments comprising an earn out based on consolidated operating profit after tax. To protect the target's goodwill (on which a significant proportion of the purchase price had been based), the SPA imposed restrictive covenants on the sellers not to compete in certain territories.

The SPA contained a complex mechanic under which, if any seller was in breach of the restrictive covenants:

- he forfeited his right to unpaid future consideration;
- he lost the right to exercise a put option in relation to his retained shares (at a price which reflected goodwill);
- the buyer was entitled to exercise a call option over that seller's retained shares (at a price which did not take any account of goodwill).

The Supreme Court said the defaulting shareholder mechanic was a conditional primary obligation which fell outside the ambit of the penalty doctrine altogether. It had nothing to do with punishment. It was partly a price adjustment provision and partly a legitimate way of severing the sellers' connection with the target if they had breached the restrictive covenants and were no longer contributing to goodwill.

## ParkingEye v Beavis

The court considered whether a car park manager could enforce fines against motorists who overstayed two hours free parking in the car park of a privately owned retail centre.

The Supreme Court said car park operators have a legitimate interest in imposing parking fines to ensure efficient management of limited parking spaces as well as to meet operating costs and make a profit. These objectives are reasonable and the charge in this case was not excessive to achieve them.

The relevant provision was a secondary obligation so the penalty rule was engaged. But the parking charge was saved from being a penalty because ParkingEye was protecting legitimate interests (its own and the car park owner's) and the amount was not out of all proportion to those interests.

## Why not abolish the doctrine of penalties?

The doctrine of penalties is an obvious interference with freedom of contract. The Supreme Court considered whether to abolish it altogether but decided to keep it. After all, most major legal systems have a penalty rule of some kind. Also, some parties to commercial contracts share the same characteristics as consumers without benefitting from the same statutory unfair contract protections.

The case for abolishing the penalty rule has relied heavily on the confusing state of the law until now. While it has left open some areas of difficulty, the Supreme Court's thorough analysis of the common law doctrine of penalties has extended the life of the doctrine for the foreseeable future.

## Why not extend the doctrine of penalties?

The Supreme Court considered and rejected the idea of introducing an equitable penalty test to sit beside the common law regime. The court said there would be major legal and commercial implications in transforming a rule for controlling remedies for breach of contract into a jurisdiction to review the many types of contingent obligations which modern contracts contain such as termination on insolvency, break-fees on early loan repayment and closing out futures contracts.

*Cavendish Square Holding BV v Talal El Makdessi / ParkingEye Limited v Beavis* [2015] UKSC 67

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