CONSTRUCTION LAW UPDATE:
Are Penalty Clauses now an Open Goal?

In this update we look at the Supreme Court’s decision in Cavendish Square v El Makdessi and ParkingEye v Beavis. In particular, we explore the effect this decision has on liquidated damages and the construction industry generally. Does the decision open the flood gates to penalty clauses or do additional considerations of “commercial interest” and “unconscionability” bring the law into the 21st Century?

Who would have thought that back in 2013 when Mr Beavis left a Chelmsford car park 56 minutes late that it would generate such interest throughout the construction industry.

In the Supreme Court’s decision in the combined appeals of Cavendish Square v El Makdessi and ParkingEye v Beavis [2015] UKSC 67 (‘the Appeals’) the Court helpfully set out the history of penalty clauses (which were brutally described as an ancient, haphazardly constructed edifice which has not weathered well) before bringing the law up to date to reflect modern sophisticated contractual relationships.

Background on Penalty Clauses

It is long established law that a contractual provision is unenforceable if it is classed as a penalty. This is distinguished from liquidated damages which are of course enforceable and utilised in the majority of construction contracts.

In Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd (1915), Lord Dunedlin provided a definition of the distinction between the two: “the essence of a penalty is a payment of money stipulated as in terrorem of the offending party [that is, to deter or punish breach of contract]; the essence of liquidated damages is a genuine covenanted pre-estimate of damage”.

Lord Dunedlin set out four tests which he thought would be helpful or even conclusive in determining whether a sum is a penalty or liquidated damage. The tests were:

- It will be held to be penalty if the sum stipulated is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach;
- It will be held to be a penalty if the breach is solely not paying a sum of money, but the provision stipulated a sum greater than the sum which ought to have been paid (the exception to the rule being the addition of interest);
- There is a presumption (but no more) that it is penalty when a single lump sum for compensation is due for a number of events - some serious but some trifling; and
- A clause will not be held to be penalty just because it is almost impossible to make a precise pre estimate of the actual loss.

You should read this Construction Law Update if:

- Your construction contracts utilise liquidated damages provisions
Over the following century the four tests became entrenched and “achieved the status of a quasi-statutory code in the subsequent case law” while commercial relationships and the complexity of contracts has changed dramatically during that period.

**Factual background of the Cases**

The factual backgrounds of the cases differed dramatically but both centred on whether a contractual provision could be construed as a penalty.

In Cavendish Square v El Makdessi (which we previously covered in an update following the Court of Appeals decision in the case), Mr Makdessi entered into an agreement to sell some of his shares in a group of advertising companies (‘the Company’) to Cavendish. The payments by Cavendish to Mr Makdessi were to be staged with two payments due after the sale.

As part of the agreement between the parties there were clauses which stated that if Mr Makdessi competed with the Company’s interest within a two year period then he would not be entitled to two staged payments and he would be obliged to sell his remaining shares in the Company to Cavendish for a sum without taking the value of goodwill into account.

Mr Makdessi did not contest that he had competed with the Company’s interest after the sale and had breached the agreement, but he stated that the clauses relating to the staged payments and sale of shares were penal and therefore unenforceable.

In ParkingEye v Beavis, Mr Beavis overstay in a car park for 56 minutes. The car park was managed by ParkingEye who sent a parking charge notice to Mr Beavis demanding that he pay an £85 charge. When Mr Beavis did not pay the sum, ParkingEye issued Court proceedings and Mr Beavis argued that the sum of £85 was a penalty and therefore unenforceable.

The real questions therefore when determining whether a provision is a penalty is whether it is penal, not whether it is a pre-estimate of loss. Whether it is enforceable should depend on whether the provision is “unconscionable” or “extravagant” by reference to some norm. This is a significant departure from the previous position that the Courts had adopted, confirming the recent and more liberal approach that the courts have taken when asked to consider alleged penalty clauses.

The new test for penalty clauses is whether the provision 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 clause cannot simply punish a party but must relate to their interest in the performance of the contract.

In Cavendish Square v El Makdessi, the Court found that Cavendish had a legitimate interest in the observance of the restrictive covenants which extended beyond the recovery of that loss. It had an interest in measuring the price of the business to its value. The goodwill of this business was critical to its value to Cavendish, and the loyalty of Mr Makdessi was critical to the goodwill. The fact that some breaches would cause very little in the way of recoverable loss to Cavendish was therefore beside the point. For that reason the provision was held not to be a penalty.

In ParkingEye v Beavis, the Court noted that one of the car parking codes of practice suggested that a breach should attract a charge of no more than £100 although ParkingEye conceded that the £85 charge was not a genuine pre-estimate of damage.

The owner of the car park had an objective of providing parking spaces for their commercial tenants’ prospective customers and ensuring a reasonable turnover of that parking so as to increase the potential number of customers. To that end, ParkingEye were employed to provide a traffic space maximisation scheme for the car park with the predominant purpose of the £85 parking charge being to deter motorists from overstay.
The Court stated that the parking charge had two main objects, to manage the efficient use of parking space by deterring people from overstaying as well as providing an income stream to enable ParkingEye to meet the costs of operating the car park. The Court was unequivocal that these two objectives were perfectly reasonable.

Given that ParkingEye would not suffer a substantial loss when people overstayed the charge was out of all proportion to its loss but it still had a legitimate interest in charging motorists. The Court found that the £85 was not out of all proportion to ParkingEye’s interests and was neither “extravagant” nor “unconscionable”. The Court therefore held that this provision was not a penalty.

The Commercial Significance to the Construction Industry

The Court’s decision brings the law on penalty clauses into the 21st century and can potentially have a big impact on how liquidated damages are calculated.

The Court will now allow parties more freedom to negotiate expanded liquidated damages provisions particularly when the clauses are negotiated and scrutinised by lawyers from both sides. Notwithstanding this the Court did not provide guidance as to how the terms “legitimate interest”, “unconscionable” or “extravagant” should be applied so including huge liquidated damages sum in the next contract you enter into would not be advised and may still be held unenforceable.

What is clear is that a genuine pre-estimate of loss is no longer the only consideration when arriving at a liquidated damages figure. Legitimate commercial interests should now be at the forefront of employers’ minds, particularly when there could be non-monetary damages if a project is late. Consider, for example, the loss of reputation if the Olympic stadium had been delivered late, something that cannot be properly quantified as a pre estimate of loss.

While it is still important that the method used to calculate the genuine pre estimate of loss is formally documented, any legitimate interest that is considered to increase the liquidated damages sum should also be documented and justified equally as methodically.

The tiny print

No action should be taken on the matters covered by this leaflet without taking specific legal advice.