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The English Law's Approach to Liquidated Damages Clauses in Light of Cavendish Holdings Bv v Makdessi [2015] UKSC 67

Introduction.

This essay seeks to assess the law's position with regards liquidated damages clauses. In particular, the essay will seek to identify the distinction between a liquidated damage clause and a penalty clause and address whether or not it can be said that so called penalty charge clauses are now regarded as being acceptable in English law.

Liquidated Damages Clauses.

In English contract law, damages have traditionally been regarded as being awarded to recompense the party who has contracted for some consideration on the reliance of a promise by another party for the loss of profit caused by breach of this agreement or to undo the harm caused by the breaking of this promise by the defaulting party. However, in many complex commercial transactions parties may find it difficult to quantify potential damages in their pre-contractual negotiations. Accordingly parties in commercial contracts have occasionally agreed what the damages will be between them. Historically, because of the dominant nineteenth century view regarding freedom of contract these clauses were allowed as the parties will and autonomy was regarded as being of paramount importance.

These clauses have taken two forms; liquidated damages and penalty clauses. Whilst liquidated damages clauses are described as genuine pre-estimates of loss, penalty clauses are not and are included as a form of inducement designed to prevent or disincentives the other party from breaching the contract by threatening punitive damages as a result. Whilst traditionally liquidated damages have been accepted by the courts, punitive damages have not been. Despite the nineteenth century contract theories emphasis on freedom of contract, the courts rejected punitive clauses in contracts as far back as Kemble v Farren in 1829.

However, the difficulty that has been faced by the Courts has historically been distinguishing between the two clauses. In Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd the tyre manufacturers Dunlop wished to ensure that their buyers, the New Garage Co, did not resell their tyres at a lower price. They therefore included a clause in the agreement providing that if the garage did so sell the tyres at a lower than agreed price they breached the agreement and would have to pay Dunlop a sum for each sold below the arranged price. The clause expressly stated that the sums payable would be liquidated damages and not punitive damages but as found in Kemble the courts will not regard such a statement as definitive. The House of Lords, overturning the Court of Appeal held that it was a genuine pre-estimate of loss and so was indeed a liquidated damages clause rather than a punitive clause. In trying to distinguish between punitive clauses and true liquidated damages clauses Lord Dunedin laid down a set of principles for when a clause may be considered a liquidated damages clause rather than an unenforceable penalty clause.

These were that a clause will be regarded as a penalty clause if; "the sum it stipulates for is extravagant and unconsciable in comparison with the greatest loss that could conceivably be proved to have followed from the breach". Secondly, the breach would be regarded as a penalty clause if the breach of contract was not to pay a required sum and the liquidated damages clause is higher than this figure. Thirdly, that there is a presumption that a clause will be penal in nature when there is payable a lump sum by way of compensation on the occurrence of one or more events, some of which may be regarded as trifling. On the other hand, Lord Dunedin stated that a genuine pre-estimate is acceptable, even if the estimation itself was impossible to carry out, and the actual figure agreed was essentially the true bargain between the parties.

The principles set down in Dunlop consolidated the somewhat confused position of the law prior to this point. However, Dunlop was still regarded as the leading authority on when a clause will be regarded as an unenforceable punitive clause. Despite this, the formulaic nature of the test in Dunlop resulted in some difficulty for the Courts as seen in Lordsvale Finance Plc v Bank of Zambia for example. This test has been overhauled and reformulated following the Supreme Court's decision in the conjoined cases of Cavendish Square Holdings Bv v Makdessi and ParkingEye Ltd v Beavis.

The New Test.

ParkingEye v Beavis was a high profile case primarily because of the consumer implications that were involved as a member of the public challenged an £85 parking fine imposed by ParkingEye through the High Court, Court of Appeal and finally Supreme Court. However, the conjoined cases are important because they allowed in the Supreme Court to reconsider the English law's approach to the consideration of penalty charges.

In Makdessi, a businessman sold his share of a company to the claimants, Cavendish. A clause in the agreement provided that if certain restrictive covenants were breached, the final instalments of Cavendish's purchase price would be forfeited. This was argued to be a punitive clause, and not a liquidated damage clause. However, the Supreme Court rejected this, holding that the clauses in both Makdessi and ParkingEye were not in fact penalty charges but liquidated damage clauses. More importantly, in doing so, their Lordships found that the test for considering when a particular clause should be regarded as a penalty clause or not as set down in Dunlop was outdated and in need of revision. This was, according to their Lordships, because the criteria set down in Dunlop had been interpreted in an over-literal way ever since, and had resulted in the law in the area being in a rather artificial state. As such, the reasonableness of the parties pre-estimate of loss was argued to hold too much evidential weight in consideration of whether or not the term was intended to be a penal clause or not. This led to the courts, in cases like Alfred McAlpine Capital Projects Ltd v Tilebox Ltd placing too much emphasis on the figure of the pre-estimate rather to assess its 'genuineness' or not.

Instead of the test in Dunlop being applied in the future, their Lordships held in Makdessi that the test that should now be applied by courts in considering whether or not a clause is said to be "penal" or not, is whether or not the clause in question imposes a secondary obligation on a party and imposes a detriment on the contract breaker that is "out of all proportion" to any legitimate interest that the other party has in the performance of the primary obligation.

This test has been argued to be an improvement over the test in Dunlop because it allows the Courts to view the clause within the entire commercial context of the case. The test in Dunlop had resulted in a rather over-formulaic approach which denied the courts any real discretion in considering the parties intent behind the inclusion of a clause. This in turn also restricted the parties autonomy and freedom of contract, as sophisticated commercial parties, well-advised and with resources and legal advisors should it is argued, be able to include such provisions if the inclusion of the clause performs a genuine commercial interest. It was suggested by Lord Sumption in Makdessi that there were genuine reasons in Dunlop for the tyre manufacturer to include such a clause outside of the scope of it being a "genuine pre-estimate of loss". For example, Dunlop were entitled to ensure that their brand was protected from cheap resales which may have had a detrimental impact on their corporate image and branding. This would not be capable of being valued within a "genuine pre-estimate" of loss, but nor would the inclusion of the clause merely be an in terroram incentivisation for the party to comply with its primary obligation under the contract, which was to buy tyres.

Analysis.

The new test set down in Makdessi therefore simplifies the courts' consideration of when a clause may be regarded as being penal in nature, and also allows the courts discretion by allowing a wider consideration of the overall commercial context of a clause. By considering firstly, whether the obligation imposed is a secondary one, and secondly whether it is out of all legitimate proportion to "any" legitimate interest that the first party has, the Supreme Court has also reaffirmed the principle of freedom of contract. Freedom of contract and autonomy of sophisticated commercial parties was argued to be ignored by the Court of Appeal in Makdessi and this criticism has been remedied by the Supreme Court's decision.

However, an issue raised by these cases is that whilst Makdessi concerned an experienced businessman with the resources and bargaining power to properly negotiate individual clauses in an agreement. As such, traditional notions of freedom of contract may be properly applicable to that particular case, and it is argued, it would be a strange decision by which a court would refuse to uphold such a freely bargained agreement for some paternalistic reasoning. However, the same is not true of the appellant in ParkingEye who was instead a consumer dealing with a business in the course of their trade.

In ParkingEye, the respondents ParkingEye operated a car park in which the appellant, Mr Beavis had parked. The car park had a stay duration limit of two hours and signs indicated clearly that any overstay would result in an £85 charge being imposed on the driver. The appellant stayed for nearly three hours and subsequently received a charge of £85. Applying the new test set down in Makdessi it could clearly be argued that ParkingEye had a legitimate interest in ensuring that the car park was not clogged up by overstaying customers, and an £85 fine was held to be not out of all proportion to this interest by the Court. However, as a consumer, Mr Beavis also argued that he was protected by the provisions of the Unfair Terms in Consumer Contract Regulations 1999 (the Regulations). These provisions provided that a term in a consumer contract that has not been individually negotiated will be unfair if it causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment to the consumer. By reference to the non-exhaustive list of terms which may be regarded unfair as included in Schedule 2 to the Regulations, the Court held that this may be the case where any consumer is required to pay a "disproportionately high" sum in compensation for the breach of an obligation. Because the Court had already decided that £85 was not disproportionately high enough to be considered 'penal' in nature, it was also held that the figure of £85 was not disproportionately high for the purposes of the Regulations.

This is notable because such a determination is likely to be applied in the future under the Consumer Rights Act 2015 (CRA) which has now replaced the Regulations. This is because the wording of the Regulations is replicated in s62(4) CRA. Any penalty imposed by a business on a consumer under the CRA will, according to the decision in ParkingEye be upheld as long as it is not considered 'disproportionately high'. This will be so even if the fines are levied over a large number of people or consumers and this is in line with earlier decisions of the Supreme Court as seen in Office of Fair Trading v Abbey National Plc. It may be argued therefore in light of the ParkingEye decision, that the rule against penalty charges has been severely restricted. The question of whether they will be determined to be disproportionate will be an issue of discretion for the court, and the CRA and its provisions will be off little help to consumers if the penalties are kept within what the court considers reasonable.

Conclusion.

The law on penalties in English law was fundamentally altered by the decision in Makdessi and ParkingEye. According to the new test, a clause will only be unenforceable for being penal in nature if it imposes an obligation on a party that is “out of all proportion” to any legitimate interest that the other party has. It is argued that whilst this may be defensible with regards arguments of freedom of contract and party autonomy, it may lead to unfairness and difficulty for consumers who may be expected to receive some protection in the form of statute, but who are unlikely to succeed in arguing that clauses are ‘disproportionately’ high.

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