At the beginning of November, we reported on the combined decision handed down by the Supreme Court in the cases of Parkingeye v Beavis and Cavendish Square Holding BV v Talal El Makdessi, which reviewed the law on penalty clauses. In our latest alert, we consider the implications of the decision for contract drafters.

**Penalties: has anything changed?**

As reported in our previous article, Lords Neuberger and Sumption described the law relating to penalties as "an ancient, haphazardly constructed edifice which has not weathered well...... the prisoner of artificial categorisation".

Part of the problem has been (in the view of the Supreme Court) the over emphasis on the four suggested considerations or tests referred to in the case of Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] which subsequently achieved " the status of a quasi-statutory code". Those "Dunlop tests" are summarised below:

1. Is the clause extravagant and unconscionable contrasted with the damages recoverable on breach?
2. If the breach is a failure to pay, is the sum stipulated as payable on the breach greater than the failed payment?
3. Is a single lump sum by way of compensation payable on the occurrence of one or more or all of several events, some of which may result in serious damage and others insignificant damage?
4. Is the sum payable on breach a genuine pre-estimate of damage (even if the consequences of the breach make precise pre-estimation almost an impossibility)?
The Supreme Court pointed out that the four tests formulated in Dunlop were never intended to present a finite fully comprehensive set of rules that would cover every scenario where the law of penalties was applicable – certainly, the four tests represent a "useful tool" but they are not easily applied to cases that are more complicated.

The "four test" approach has resulted from (again, in the Supreme Court's view) "unsatisfactory distinctions between: a penalty and genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent".

Put another way, the penalties rule has often been presented as reflecting a clear distinction between a compensatory provision and one of deterrence but (as explained by Lord Mance in the Supreme Court decision) this over-simplifies the issue, as the two categories are not in fact mutually exclusive. Where a clause acts as a deterrent but protects a legitimate interest (which may not be properly compensated by damages for breach) and is not extravagant nor unconscionable, it should not be unenforceable as a penalty.

Consequently, the Supreme Court set out its formulation of the test for an unenforceable penalty clause as follows:

"whether [the clause] is a secondary obligation which imposes a detriment on the contract-breaker which is out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation".

In short, the law against penalties has not changed but in this decision, the Supreme Court has taken the opportunity to re-state the test for a 'penal' clause, as set out above.

What now for contract drafters?

In view of the Supreme Court decision, contracting parties should consider the following when drafting clauses that set out a particular financial remedy in circumstances of non-compliance:

1. **To which clauses might the penalties rule apply?**

   a. **Primary or secondary obligation?**

      The doctrine is only activated by secondary obligations - clauses which are triggered by and set out the consequences of breach of some other primary obligation.
This doesn't only capture 'classic' liquidated damages clauses which require the payment of sums in the event of breach, but also potentially, clauses providing for forfeiture of a deposit, or forced transfer of assets at an undervalue, if such clauses are triggered by breach of some other 'primary' obligation.

What does this really mean? The Supreme Court gave the following example (in summary):

- where a contract contains an obligation to perform an act, and if that act is not performed, the non-performer has to pay the other party a specified sum of money, the obligation to pay that specified sum is a secondary obligation which is capable of being a penalty (subject to the re-stated test);

in contrast:

- if the contract imposes no 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.

b. Withholding clauses?

As referenced above, the rule against penalties can also potentially apply to other types of clauses including those which provide for the retention or withholding of sums for non-performance of certain obligations.

When drafting, it is prudent therefore to frame payment as a condition of compliance (so opening up the argument that it is a primary obligation) as opposed to a separate, secondary clause allowing for withholding if the primary obligation is breached.

2. What do I need to do to make sure my clause is enforceable?

a. Is there still a role for the 'genuine pre-estimate of loss'?

Although the Supreme Court held that "the real question...is whether [a clause] is penal, not whether it is a pre-estimate of loss", the judgment went on to say that in the case of a straightforward damages clause, the innocent party's interest "will rarely extend beyond compensation for the breach".
Therefore, we can reasonably conclude that if a liquidated damages clause does amount to a genuine pre-estimate of loss, then it is more likely to be enforceable. The 'genuine pre-estimate of loss' consideration is still therefore a good rule of thumb or starting point, certainly in more straightforward cases.

b. **Legitimate interest**

In more complex cases, the Supreme Court's re-statement of the rule against penalties makes it clear that a key part of the consideration is whether there is a 'legitimate interest' that goes beyond damages for breach of contract.

This is likely to be of particular relevance where issues of goodwill or reputation are concerned, where to the innocent party, the risk of non-compliance may go beyond the purely financial.

In such circumstances, it may be prudent to include some express acknowledgement within the drafting (perhaps as part of the recitals) setting out the commercial interests that the party is seeking to protect.

c. **Proportionality**

The detriment imposed must be proportionate to the interest the party is seeking to protect or in other words, it must not be extravagant nor unconscionable. It is prudent to consider this at the drafting stage in terms of how the clause will be viewed if tested at a later stage. As an example, PFI contracts often contain escalating deductions where services supplied are not in accordance with agreed service levels; such deductions must be proportionate to the interests that the customer is seeking to protect.

While the concept of "deterrence" seems to have been resigned to the side lines by the Supreme Court in this decision, remember that a clause that sets out primarily to punish the other party runs a higher risk of being held unenforceable.

d. **Is bargaining power relevant?**
While the Supreme Court rejected the suggestion that the rule against penalties ought to be abolished in commercial contracts, it stated that "in a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of that breach".

In circumstances where this is the case, the parties (or at least the party wishing to rely on a more complex liquidated damages clause) may wish to make clear in the drafting that the parties have agreed the clause in a circumstance of comparable bargaining power, having taken legal advice.

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