

Group Briefing

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Escaping the grip of the penalty clause

Check your contracts!

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This document contains a general summary of developments and is not a complete or definitive statement of the law. Specific legal advice should be obtained where appropriate.

A clause in a contract which provides for payment of a sum of money on breach of the contract may be unenforceable if it is a penalty clause.

HOW DO YOU KNOW IF A CLAUSE IS A PENALTY CLAUSE?

The traditional test is to ask whether the amount payable on a breach is a genuine pre-estimate of the loss the innocent party may incur in the event of a breach. If it is not, the clause is a penalty and so unenforceable.

The UK Supreme Court recently introduced a new test. It said that a clause will be a penalty clause if it 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 under the contract.

As it stands, the traditional test is the test applicable in Ireland. However, if this matter comes before the Irish courts, the recent decision of the UK Supreme Court might persuade the Irish courts to adopt the new UK approach.

THE CASES BEFORE THE UK SUPREME COURT

Makdessi v Cavendish Square Holdings BV: Mr Makdessi breached certain non-compete provisions in a share purchase agreement. The agreement stated that in the event of a breach, Mr Makdessi would

forfeit part of the consideration due to him, and the purchaser, Cavendish, would have the option to buy his remaining shares at a lower price. In effect, this meant that Mr Makdessi would receive \$44 million less for his shares. He argued that the relevant clauses were penalty clauses and so unenforceable.

ParkingEye Ltd v Beavis: Mr Beavis left his car in a car park managed by Parking Eye for almost three hours. The maximum stay was two hours and the terms of use provided that a fee of £85 would apply where this limit was exceeded.

Mr Beavis refused to pay the £85 charge on the ground that it was a penalty clause.

WERE THE CLAUSES ENFORCEABLE?

The UK Supreme Court held the neither clause breached the rule against penalties, and that both were enforceable.

Makdessi: The Supreme Court, overturning the Court of Appeal, noted that the clause was a price adjustment clause: to receive the highest price for his shares, Mr Makdessi had to comply with the non-compete provisions. The Court accepted that the sanction imposed on Mr Makdessi for breach was not in any way connected to the loss which Cavendish would incur as a result of the breach. However, it considered that the object of the clause was not to punish Mr Makdessi,

but rather to protect Cavendish's legitimate interests in seeking to protect the goodwill of the company. The Court noted that Cavendish and Mr Makdessi were sophisticated commercial parties, and that both had received expert legal advice prior to entering into the agreement.

ParkingEye: The Court noted that the £85 charge was not a genuine pre-estimate of the loss ParkingEye might incur if the two-hour limit was exceeded. However it said that ParkingEye had a legitimate interest in trying to deter motorists from occupying parking spaces for long periods and that it needed to make a profit from managing the car park. It said the charge was not extravagant or unconscionable having regard to these legitimate interests. The clause was therefore enforceable.

WHAT DID THE UK SUPREME COURT SAY ABOUT PENALTY CLAUSES?

- » The rule against penalties is an interference with freedom of contract. When parties to a contract are on an equal footing, the courts will be slow to interfere with what they have freely agreed.
- » The rule against penalties applies not only to clauses requiring the payment of money, but also to clauses imposing an obligation to transfer assets (for nothing or at an undervalue) or clauses requiring forfeiture.
- » Contractual obligations may be divided into two categories: (i) primary; and (ii) secondary. Primary obligations arise in the ordinary course of performance of a contract, e.g. an obligation to pay a sum of money for performance of a service. Secondary obligations only arise on breach of a primary obligation, e.g. an obligation to pay a sum of money where the contract has been breached.
- » Only secondary contractual obligations can amount to penalties. The application of the penalty rule may, therefore, depend on how the relevant obligation is framed (i.e. as a primary or a secondary obligation).
- » The test of whether a clause is penal is whether it is a secondary obligation

which 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.

- » When considering whether a clause is penal, first consider whether any legitimate business interest is served and protected by the clause. Next consider whether the provision made for that interest is extravagant, exorbitant or unconscionable.

WHAT DOES THIS MEAN IN PRACTICAL TERMS?

The new test set out by the UK Supreme Court is more flexible, and it recognises that the parties to a contract may be interested in the performance of the contract for more than purely monetary reasons. The test also promotes contractual certainty and it gives parties more confidence that what the contract says will be enforced. However, there is still scope for dispute.

A party seeking to uphold a clause which is being challenged as a penalty clause will highlight the legitimate interest it was seeking to protect by including the clause in the contract. On the other hand, the party challenging the validity of the clause will say that it imposes a detriment on it which is out of all proportion to this apparent 'legitimate interest' and is extravagant, exorbitant or unconscionable.

Argument over what constitutes a 'legitimate interest' and what is meant by the terms 'extravagant, exorbitant or unconscionable' is inevitable. Each case will depend on its own facts. The key practice point that emerges here is that it is essential to document precisely what legitimate interest is being protected. In *Makdessi*, the Court of Appeal applied the penalties doctrine largely because no clear commercial justification could be established by Cavendish on the evidence.

In Ireland, the traditional 'genuine pre-estimate of loss' test continues to apply. However, the decision of the UK Supreme Court may be persuasive when the issue of penalty clauses next comes before the Irish courts.

Our flowchart on the next page sets out some useful questions to help you

identify whether a clause might be a penalty clause under the new UK test.

IDENTIFYING A PENALTY CLAUSE: THE APPROACH OF THE UK SUPREME COURT