Cavendish Square Holding BV v Makdessi
ParkingEye Ltd v Beavis
[2015] UKSC 67

Summary

Facts

(1) The *Makdessi* case concerned a contract under which Makdessi sold a controlling interest in his company (Team Y & R Holdings Hong Kong Ltd, or 'TYR' for short) to Cavendish Square Holding ('Cavendish'). Under clause 11 of the contract, Makdessi was forbidden, for as long as he held any remaining shares in TYR and also for two years after he gave up all of his remaining shares in TYR, from engaging in any activity that might harm TYR's business interests (principally, setting up a competing business or helping a competing business). Clause 5 governed what would happen if Makdessi breached this term. Clause 5.1 provided that any payments still due to Makdessi under the contract for the sale of the shares in TYR would no longer be payable. Clause 5.6 provided that Cavendish would have the option of purchasing the rest of Makdessi's shares in TYR at a special price. Makdessi did breach Clause 11, and Cavendish invoked Clauses 5.1 and 5.6 against him. Makdessi argued that Clauses 5.1 and 5.6 fell foul of the common law rule against penalty clauses and were therefore unenforceable.

(2) In the *ParkingEye* case, the defendant, Beavis, parked his car in the Riverside Retail Park car park on 15 April 2013. The car park was run by ParkingEye Ltd on behalf of the owners of the retail park, the British Airways Pension Fund. Signs in the car park indicated that the car park was managed by ParkingEye and that customers who parked in the car park for longer than 2 hours, or did not park within the marked bays, would have to pay £85. Beavis stayed in the car park for 2 hours 56 minutes, and subsequently received a letter from ParkingEye (who had obtained Beavis' details from the DVLA) requiring him to pay £85 (reduced to £50 if prompt payment were made). Beavis argued that this charge was unenforceable because (a) it amounted to a contractual penalty, or (b) it was rendered by unenforceable by the provisions of the Unfair Terms in Consumer Contracts Regulations 1999 (which provisions are now subsumed within Part 2 (ss 61-76) of the Consumer Rights Act 2015).

The rule against penalties: general principles and issues

A number of points about the common law rule against contractual penalties emerge from the judgments of the 7 members of the UKSC who decided both these cases:

(1) All of the UKSC Justices agreed that it would be wrong to abolish the common law rule against contractual penalties: (i) the rule was too firmly established for it to be abolished through anything other than legislation; (ii) getting rid of the rule against penalties would put the UK out of step with most other legal systems, including the other common law legal systems; and (iii) there was no real evidence that the rule against penalty clauses, as set out by the UKSC in *Makdessi* would work unsatisfactorily. See Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) at [36]-[39], Lord Mance at [162]-[169] (rejecting at [168] the suggestion that the rule against penalties should only be applied in non-

commercial contexts), and Lord Hodge (at [256]-[267], also rejecting at [267] the idea that the rule should only apply in non-commercial contexts). (Lord Clarke agreed with everything Neuberger/Sumption, Mance and Hodge said about penalties ([291]), and Lord Toulson agreed with Mance and Hodge on everything they said about the law on penalties ([292]).)

(2) All of the UKSC Justices also agreed that the rule against penalties needed some refinement: that the idea – derived from Lord Dunedin's judgment in *Dunlop Pneumatic Tyre Co Ltd* v *New Garage and Motor Co Ltd* [1915] AC 79 – a contractual provision requiring D to pay C £x would amount to a penalty if the provision was intended to deter D from committing a breach of contract by holding over him the prospect that if he did so, he would be held liable to pay C a sum of money (£x) that did not amount to an honest pre-estimate of the loss that C would suffer as a result of D's breach, was too crude to be acceptable: see Neuberger/Sumption at [31] ('the law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions: between a penalty and a genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent... The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss... A damages clause may be neither or both'); Mance at [152]: 'the dichotomy between the compensatory and the penal is not exclusive. There may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden'; Hodge at [248]: 'I doubt whether it is helpful to rely on the concept of deterrence [to identify what a penalty clause is].'

(3) Rather, a clause requiring a D to pay a certain sum of money to C if D breaches a contract between D and C will only amount to a penalty clause if:

Neuberger/Sumption: 'the impugned provision 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' ([32]).

Mance: either (a) '[no] legitimate business interest is served and protected by the clause' or (b) 'assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable' ([152]).

Hodge (with the agreement of Toulson: [293]): 'the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract' ([255]).

(4) While these tests focus on the *content* of the term requiring D to pay money to C, Neuberger/Sumption observed at [35] that 'the circumstances in which the contract was made are not entirely irrelevant. 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 breach.' Mance said much the same at [152]: 'In judging what is extravagant, exorbitant or unconscionable, I consider...that the extent to which the parties were negotiating at arm's length, on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor.'

(5) The UKSC Justices *rejected* the High Court of Australia's finding in *Andrews* v *Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 that the rule against penalty clauses could extend to the case where in a contract between D and C, it was provided that should a certain eventuality occur D would be liable to pay a certain sum to C where that eventuality did not involve D breaching his contract with C. See Neuberger/Sumption at [42] (though they also observed at [15] that 'the classification of terms for the purpose of the

penalty rule depends on the substance of the term and not on its form or on the label which the parties have chosen to attach to it'); Mance at [130] (not taking Orwell's advice against using double negatives): 'I do not see the distinction between situations of breach and non-breach as being without rational or logical underpinning' and Hodge at [241]: 'the rule against penalties in both English and Scots law [applies] only in relation to secondary obligations – penal remedies for breach of contract.'

(6) The UKSC Justices agreed that the rule against penalty clauses extends beyond clauses requiring a D to pay a sum of money to C if D commits a breach of a contract between D and C.

They agreed that the rule extended to (i) clauses requiring D to transfer property to C (see Neuberger/Sumption at [79]; Mance at [154], [170]; and Hodge at [230]), and (ii) clauses providing that on committing a breach of contract, certain monies that would otherwise have been payable to D would no longer be payable (see Neuberger/Sumption at [73]; Mance at [157], [170]; and Hodge at [269]).

There was some slight disagreement over whether the rule extended to (iii) forfeiture clauses, providing that on D's committing a breach of contract, either (a) some proprietary or possessory interest that had been transferred to D by C under the contract, would revert back to C, or (b) a deposit paid by D to C as security for D's performance would be forfeited and no longer repayable to D.

Mance and Hodge agreed (as did Clarke ([291]) and Toulson ([294])) that a forfeiture clause (of type (a) or (b)) could amount to a penalty. Hodge laid down the correct approach that the courts should adopt to such clauses: 'if the forfeiture is wholly disproportionate either to the loss suffered by the innocent party or to another justifiable commercial interest which that party has sought to protect by the clause [it should be held to be unenforceable as a penalty]. If the forfeiture is not so exorbitant and therefore is enforceable under the rule against penalties, the court can then consider whether under English law it should grant equitable relief from forfeiture, looking at the position of the parties after the breach and the circumstances in which the contract was broken' ([227]). Mance said pretty much the same thing at [160], as did Toulson at [294]. (Note that the equitable jurisdiction to relieve against forfeiture will only apply to type (a) forfeiture clauses, not type (b).)

Neuberger/Sumption thought that a type (b) forfeiture clause could be a penalty ([16]), but said at [17] of a type (a) forfeiture clause that 'Where a proprietary interest...is granted or transferred subject to revocation or determination on breach, the clause providing for determination or revocation is a forfeiture *and cannot be a penalty*...' (emphasis added). However, at [18] they went on to say it 'is less clear...whether a provision is capable of being both a penalty clause and a forfeiture clause' and that they could 'see the force of the arguments to that effect advanced by Lord Mance and Lord Hodge'.

Application

Turning back to the cases (the least significant aspect of this case), the UKSC held that the common law rule against penalties did not apply in either *Makdessi* or *ParkingEye* – either because the clauses in dispute were incapable of amounting to penalties, or because they were capable of amounting to penalties but did not because they served a legitimate interest of the claimant's.

In *Makdessi*, Neuberger/Sumption held that Clause 5.1 could not amount to a penalty clause as it merely adjusted how much Makdessi was paid for his shares in TYR given the fact that Makdessi's harming TYR's business interests reduced the value of TYR to

Cavendish ([73]-[74]). Clause 5.6 did not amount to a penalty because while it was intended to deter Makdessi from doing anything to harm TYR's business interests, that was a perfectly legitimate thing for Cavendish to try to do. Lords Mance and Hodge took the view that both Clauses 5.1 and 5.6 were capable of amounting to penalty clauses, but advanced various reasons why they should be regarded as serving legitimate interests of Cavendish, and not in an extravagant or unconscionable way.

In *ParkingEye*, Neuberger/Sumption held that the £85 charge for staying more than two hours in the car park was not a penalty: (i) it served the car park owners' interest in keeping the retailers using the retail park happy by ensuring a regular turnover of customers, and (ii) it served ParkingEye's interests in making enough money from managing the car park to cover their costs (including paying a fee to the owners of the car park) and make a profit, and (iii) the charge was not so excessive that it was 'out of all proportion to its interests' ([100]). Neuberger/Sumption held that there was no reason why they should only take into account interest (ii) (the claimant, Parking Eye's interest) and not interest (i) (the interest of the entity for which ParkingEye was working) should be taken into account in determining whether there was a legitimate interest underlying the scheme for charging car owners who stayed too long in the car park ([99]). Mance (at [199]) and Hodge (at [286]-[287]) essentially agreed with this analysis.

On the issue of whether the £85 charge in *ParkingEye* fell foul of the Unfair Terms in Consumer Contracts Regulations 1999, Neuberger/Sumption took the view that the clause providing for that charge should *not* be regarded as 'unfair' as 'contrary to the requirement of good faith,...it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer'. Asking themselves whether 'ParkingEye, "dealing fairly and equitably with the consumer [could] reasonably assume that the consumer would have agreed to such a term in individual contract negotiations[?]' ([108]), Neuberger/Sumption thought that the answer was 'yes' ([109]) – Beavis got two hours of free parking, in return for taking a risk that he would incur a not exorbitant charge of £85 for staying too long. Mance agreed ([212]), as did, more perfunctorily, Hodge ([289]). Lord Toulson dissented on this point on the basis that not enough evidence had been submitted to the court to convince that 'a party who was in a position to bargain individually, and who was advised by a competent lawyer, would have agreed to the penalty clause [sic] as it stood' ([314]).

Comments

(1) *The significance of* Makdessi. The real significance of *Makdessi* is that it opens the door to contracting parties' inserting into their contracts clauses that are explicitly intended to deter the other party from committing a breach by requiring them to pay a non-compensatory sum if they do so. So long as the clause in question serves a legitimate interest of the claimant in seeing that the defendant performs his contract, and does not do so in a disproportionate way, then the courts will uphold the clause – when there is little doubt that they would not have done so before *Makdessi*. An example might be a *Publisher* that enters into a contract with *Author* under which *Author* undertakes to supply a manuscript by a particular date, and *Publisher* undertakes to publish the manuscript. If *Publisher* knows that *Author* is unreliable and frequently misses his deadlines for submitting his books, *Publisher* might insert a term into the contract specifying that *Author* has to pay *Publisher* £250,000 if *Author* is (say) three months' late in submitting the manuscript. Should *Author* not have turned in a manuscript three months after the deadline, and *Publisher* attempts to sue *Author* for £250,000, *Publisher* might well be able, after *Makdessi*, to rebut *Author*'s attempts to argue that this amounts to a

penalty. *Publisher* might be able to argue: 'This clause served a legitimate interest of ours in encouraging *Author* to meet his deadline, and wasn't extravagant or unconscionable – in considering what sum to require *Author* to pay we finely tailored it to take into account his resources, and what was the minimum sum that might prod him into turning in his manuscript on time.'

(2) *The rationale of the rule against penalty clauses*. Some of my colleagues here in Cambridge would like to get rid of the rule against penalty clauses; I do not. In thinking about this issue, it's worth remembering that there are always three parties to a contract, not two. In an action for breach of contract, one party to the contract (C) is asking a third party (the State) to do something bad to the other party to the contract (D). Given this, there is nothing wrong with the third party (again, the State) asking C 'Why should we help you hurt D?' Normally, the answer is obvious – 'Because our market-based economic system vitally depends on contracts being upheld. If you don't hurt D, you will send out a message that contracts aren't worth the paper they are written on, and economic collapse won't be too far behind your doing this.' But this doesn't apply when it comes to C asking the courts to hurt D pursuant to a penalty clause – that is, a clause which has been inserted into C's contract with D not because the clause is needed to protect some legitimate interest of C's but purely for the purpose of making money off D should D ended up breaching his contract with C. In such a case, there is no economic interest in allowing C to hurt D in accordance with the terms of the penalty clause in the C-D contract. To understand this point, students need to acquaint themselves with the economic concept of *rent-seeking*. A rent is a charge that someone is allowed to make for allowing someone else access to a valuable resource. The activity of rent-seeking is the activity of trying to put yourself in a position to charge other people for access to a valuable resource – usually by lobbying the government to grant you a monopoly right over that resource. Rent-seeking is usually economically inefficient in that it usually adds nothing to the sum of human happiness and by allowing you to dip into other people's wallets, does a lot to add to the sum of human misery. Inserting a penalty clause into a contract is a classic example of inefficient rent-seeking behaviour: by inserting the clause into a contract between C and D, C is trying to persuade the government to allow C to charge D for the privilege of breaching the C-D contract when charging D for doing this does not serve any legitimate purpose: C is simply inserting the clause into her contract with D for the purpose of giving herself access to D's wallet. The law is right to resist C's attempt to do this, we should resist the siren voices that attempt to lure us into thinking that the law is violating C's rights, or acting inconsistently with the basic principles of contract law, by doing this. The law on penalty clauses is part and parcel of the economic foundations of contract law, not a weird aberration.

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