Fenwick Elliott
The construction & energy law specialists
Issue 53, November 2015

Welcome to the November 2015 edition of *Insight*, Fenwick Elliott's newsletter which provides practical information on topical issues affecting the building, engineering and energy sectors.

**This issue consider the law of penalties in the construction context; the appeal in each of *Cavendish Square Holdings v Makdessi and ParkingEye Limited v Beavis*; the decision of the Supreme Court in the conjoined appeals and how liquidated damages practice is likely to change in the wake of the Supreme Court's decision.**

Insight

# The brand new law on liquidated damages

On 4 November 2015, a seven-strong bench of the Supreme Court[1] considered the law of penalties for the first time when it handed down its decision in the conjoined appeals in *Cavendish Square Holdings BV (Appellant) v Tatal El Makdessi (Respondent)*. The decision (which reconsiders the law on penalty clauses in relation to commercial contracts between sophisticated parties (in the *Cavendish Square Holdings v Makdessi* appeal), and at a consumer level under the Unfair Terms in Consumer Contracts Regulations 1999 (in the *ParkingEye Limited v Beavis* appeal)), is one of the most important common law decisions in a century in the construction law context, since it impacts upon the law relating to liquidated damages.

## The law of penalties in the construction context

Most construction contracts contain a provision for liquidated damages in the event of certain specified breaches of contract by the contractor,[2] and the level of liquidated damages is agreed by the parties prior to the contract being entered into. Prior to the decision of the Supreme Court in *Cavendish Square Holdings BV (Appellant) v Tatal El Makdessi (Respondent)*, in order to be recoverable, the predetermined level of liquidated damages had to represent a genuine pre-estimate of the employer's likely loss should the specified breach occur. There was no requirement for the employer to prove that it had actually suffered the loss provided for by the liquidated damages provision, and the employer would still be entitled to the amount of liquidated damages stipulated by the contract even if its actual loss was lower. This all sounds too good to be true from the employer's perspective, but there was a catch: if the level of liquidated damages did not represent a genuine pre-estimate of the employer's loss, it was open to challenge by the contractor further down the line on the basis it represented a penalty clause which is not recoverable as a matter of English common law.

The common law on penalty clauses was established a little over 100 years ago by the decision in *Dunlop v Matthew Tyre Co Limited v New Garage Motor Co Limited* (1915) AC 79, which laid down various principles to help distinguish liquidated damages from penalties. Whilst the principles set out in *Dunlop v Matthew Tyre Co Limited v New Garage Motor Co Limited* have been refined by the courts since 1915, the law on liquidated damages has historically been evolutionary as opposed to being the subject of drastic change.

The traditional test under the old law was that provided the employer had made a genuine attempt to pre-estimate its loss (rendering the clause compensatory), the courts would be unlikely to regard it as a penalty. However, if the amount of liquidated damages bore absolutely no resemblance to the loss, was extravagant and unconscionable, and was intended to deter a breach of contract, then the court would be more willing to construe it as an unenforceable penalty.[3]

## The *Cavendish Square Holdings v Makdessi* appeal

### The facts

In *Cavendish Square Holdings v Makdessi*,[4] Mr Makdessi agreed to sell a controlling stake in what was to become the largest advertising group in the Middle East to Cavendish under the terms of a share sale agreement ("*the Agreement*"). The Agreement contained restrictive covenants requiring Mr Makdessi not to become involved in a competing business in default of which (i) he would forfeit the final two instalments of deferred consideration that were to be payable to him by Cavendish for his shares, and (ii) he would be required to transfer all his remaining shares to Cavendish at a price which excluded any goodwill value. Mr Makdessi accepted he had breached the restrictive covenants, but he denied the clauses were enforceable on the basis they were penalties.

### Decision at first instance

Mr Justice Burton found that the purpose of the restrictive covenants was not to deter a breach of contract, but to adjust the consideration between the parties. Cavendish was entitled to assess the value a breach of the restrictive covenants by reference to the greatest loss that could conceivably be proved to have followed from the breach, as any breach could have a very substantial impact on the goodwill of Cavendish's business. Accordingly, the clauses were not found to be penalty clauses.

# Insight

### Decision of the Court of Appeal

In reaching its decision, the Court of Appeal reviewed various authorities on the law on penalties and commented that the early cases (starting with *Dunlop v Matthew Tyre Co Limited v New Garage Motor Co Limited)* had established that the purpose of a penalty clause was to deter breaches of contract, and a clause would only be a penalty if it was "*extravagant*" and "*unconscionable*". The Court of Appeal noted that the modern cases take a more flexible approach and focus on the dominant purpose of clauses: if the dominant purpose is to deter a breach of contract and the charge is commercially justified, then it will not be rendered a penalty clause.

The Court of Appeal overturned the decision of Mr Justice Burton and agreed with Mr Makdessi that the two clauses were unenforceable penalty clauses. The provisions were not a genuine pre-estimate of loss, but were extravagant and unreasonable compared with the likely damage arising from the breach; they also had no commercial justification. As a result, they were unconscionable, intended to deter a breach of contract, and penal.

Cavendish appealed to the Supreme Court, the issues before which were: (i) whether the rule against penalties applies to commercial contracts between sophisticated parties with equal and substantial bargaining power; (ii) if the rule does apply to such contracts, whether the penalty clauses are within the scope of the rule; and (iii) if the clauses are within the scope of the rule, whether they are penalties.

## The *ParkingEye Limited v Beavis* appeal

### The facts

In *ParkingEye Limited v Beavis*, Mr Beavis drove into the Riverside Retail Park car park in Chelmsford that was managed by private car park operator, ParkingEye. The car park displayed prominent signs at its entrance and on noticeboards within the car park advising there was a maximum stay of two hours, after which time a parking charge of £85 would apply (that would reduce to £50 if paid within 14 days). Mr Beavis overstayed the maximum stay by one hour, as a result of which he was charged £85. He refused to pay the £85 on the basis that the clause was a penalty and was therefore unenforceable.

### Decision at first instance

Judge Moloney QC found in favour of ParkingEye and held that a motorist who parked in the car park did so on the terms and conditions at the entrance and on the noticeboards, which represented the contract between ParkingEye and Mr Beavis. The contract included an obligation to leave within two hours, in default of which there was an agreement to pay the £85 charge. The judge acknowledged that the charge had the characteristics of a penalty as ParkingEye did not suffer any identifiable financial loss as a result of Mr Beavis' breach.

ParkingEye had a back-to-back contract with the owners of the car park that provided for: (i) an initial two-hour free period; (ii) ParkingEye to pay a fixed weekly charge to the owners; and (iii) ParkingEye to retain any £85 charges it recovered from motorists parking in the car park. The charges were used to fund the operating costs of the car park, weekly payments to the owner of the car park, and to generate profit for ParkingEye; ParkingEye's business model was therefore reliant upon motorists breaching the two-hour free period.

Judge Moloney QC found that the predominant purpose of the £85 charge was to deter motorists from breaching the two-hour free period (and therefore the contract), which would at first glance render it a penalty. However, the charge was commercially justifiable, it was not improper or excessive in amount, nor was it unfair pursuant to the Unfair Terms in Consumer Contract Regulations 1999 ("*UTCCR*"). It was accordingly upheld.

Mr Beavis appealed to the Court of Appeal. His appeal centred on whether (i) the £85 charge was unenforceable at common law on the basis it was a penalty; and (ii) the charge was unfair (and therefore unenforceable) under the UTCCR.

### Decision of the Court of Appeal

The Court of Appeal followed the first instance court's approach of examining the £85 charge having regard to the actual loss suffered; the deterrent effect of the clause; and whether it was justifiable commercially in reaching a conclusion as to whether the clause was extravagant and unconscionable under *Dunlop v Matthew Tyre Co Limited v New Garage Motor Co Limited.*

The court held that the penalty charge was not a genuine pre-estimate of loss; it was aimed at deterring motorists from overstaying the two-hour permitted period (i.e. deterring a breach of contract); it was not extravagant or unconscionable; and crucially, it was justifiable for both commercial and social reasons. The £85 charge was therefore upheld.

Mr Beavis (supported by the Consumers' Association as intervener) appealed to the Supreme Court.

# Insight

## Decision of the Supreme Court in the conjoined appeals

The Supreme Court was unanimous that the doctrine of penalties should not be abolished, but their lordships rejected the traditional test set down in *Dunlop v Matthew Tyre Co Limited v New Garage Motor Co Limited* that a clause will be a penalty if it is not a genuine pre-estimate of loss and is extravagant or unconscionable, or if its purpose is to deter a breach of contract. The majority[5] of the Supreme Court held that the correct approach in commercial cases was to have regard to the nature and extent of the innocent party's (e.g. the employer's) interest in the performance of the obligation that was breached as a matter of construction of the contract.

The test, formulated by the majority, is whether the clause in question 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. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance. In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach, and we therefore expect that Lord Dunedin's four tests would usually be perfectly adequate to determine its validity. But compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations."*

The Supreme Court went on to explain the practical application of the test in terms that a penalty clause whose purpose is to punish the contract breaker is likely to be an unenforceable penalty clause. On the other hand, a clause that is intended to deter a breach of contract is less likely to be a penalty clause, even if it does not represent a genuine pre-estimate of loss. In order to determine whether or not a clause is a penalty, the key is to consider whether the liquidated damages clause is out of all proportion to the employer's legitimate interest in enforcing the contractor's obligations under the contract. If it is, it will be penal and unenforceable.

Applying this new test to the facts, the Supreme Court unanimously held in the *Cavendish Square Holdings v Makdessi* appeal that the clauses in question were not penal. The clauses were primary obligations under the contract, (as opposed to secondary obligations that only come into play once a breach of contract occurs (i.e. an obligation to pay liquidated damages if the works are delayed)), as they provided for an adjustment to the purchase price that was equivalent to other primary price calculation clauses in the contract which meant the penalty rule was not engaged. Further, the clauses were justified commercially by Cavendish's legitimate interest in protecting the goodwill of the business, and the parties were the best judges of how that interest should be reflected in the contract.

In the *ParkingEye Limited v Beavis* appeal, the Supreme Court held that whilst the £85 charge was a secondary obligation which was intended to deter motorists from a breach of contract (i.e. overstaying), it was not a penalty. This was so because not only ParkingEye, but also the car park owner had a legitimate commercial interest in charging motorists who overstayed which extended beyond the recovery of any financial loss. The interest of the car park owner was the provision and efficient management of customer parking for the retail outlets; the interest of ParkingEye was income from the £85 charge which met the running costs of what was considered by the Supreme Court to be a legitimate commercial scheme, plus a profit margin. The reasoning behind the imposition of the charge was entirely reasonable, and because it was in proportion to ParkingEye and the car park owners' commercial interests, it was not found to be penal.

## Practice points

- Liquidated damages are secondary obligations and are in principle caught by the new rule for penalties.
- The Supreme Court made it clear that as a general rule, if a liquidated damages clause has been negotiated in a commercial contract made between two parties of comparable bargaining power, and has survived scrutiny by the parties and their legal advisers, then there will be a strong initial presumption that the clause is not out of all proportion to the employer's legitimate interests in timely completion. This is the case even if it is penal in its nature and impact; it is intended to deter a breach of contract; and it is not representative of any actual financial loss the employer may have suffered.
- Going forward, reputational issues, goodwill, the interests of third parties, and other losses that cannot be easily quantified will be able to be taken into account in determining the level of liquidated damages. These losses will fall under the banner of commercial "*interests*".
- If the employer seeks a level of liquidated damages that does not appear to you to be commensurate to the commercial impact of the works being delayed, then the liquidated damages clause may be worth challenging on the basis it is unenforceable.
- To mount a challenge to a liquidated damages clause (and also before you enter into any new contracts), ask the employer for documentary proof of the legitimate commercial interest

to which the liquidated damages clause allegedly relates. If the documents provided appear to suggest that the liquidated damages provision does not represent a reasonable and proportionate protection of the employer's legitimate commercial interest in the works being delayed, then you should resist, or otherwise renegotiate the level of liquidated damages on the basis that it is out of all proportion to the employer's legitimate interests in timely completion.

- If you are unable to challenge your liquidated damages provision, you may be able to argue that: the employer is responsible for the delay; there has been a breach of condition precedent by the employer (i.e. the employer has failed to comply with the notification or certification provisions called for by the contract); or you are entitled to an extension of time. Continue to keep these alternative options under review.
- If you are successful in any challenge as to the level of liquidated damages, you should bear in mind that it remains open to the employer to pursue a claim for general damages in the usual way. The quantum of any such claim for general damages may, however, be lower than the equivalent liquidated damages provision, as the latter now allows for commercial considerations to be taken into account and does not require strict proof of financial loss.

## Conclusion

The decision of the Supreme Court in *Cavendish Square Holdings BV (Appellant) v Tatal El Makdessi (Respondent)* has replaced the century-old test in *Dunlop v Matthew Tyre Co Limited v New Garage Motor Co Limited* with a modern test that reflects the fact that in some circumstances, parties have a legitimate commercial interest in enforcing the performance of contractual obligations which go above and beyond compensation for any identifiable commercial losses they may suffer as a result of the breach, or the deterrence of a breach of contract. In the construction context, this new test requires a consideration of the commercial justification for the liquidated damages clause at the time the contract was entered into, and whether it is out of all proportion to the employer's legitimate commercial interest in the works completing on time.

Whilst the new test is ultimately to be welcomed, there is plenty of scope for satellite litigation as to what might amount to a "*legitimate*" commercial interest which will no doubt be played out in the courts in the years to come.

### *Footnotes*

1. A Supreme Court bench would usually comprise three or five judges: the fact that seven judges heard the appeal demonstrates its importance.
2. The most common breach to which liquidated damages will attach is a failure by the contractor to complete the works on time (which is why they are often known as delay damages), but liquidated damages may also apply to other types of breach as might be specified by the parties to the contract, an example being plant performance shortfalls in EPC contracts.
3. When the Technology and Construction Court considered the decision in Dunlop v Matthew Tyre Co Limited v New Garage Motor Co Limited in the construction context in Alfred McAlpine Capital Projects Ltd v Tilebox Ltd [2005] EWHC 586 (TCC), the judge, Mr Justice Jackson (as he then was), held that there had to be a substantial discrepancy between the level of damages stipulated in the contract and the level of damages that was likely to be suffered before it could be argued that the pre-estimate was unreasonable. Indeed, Mr Justice Jackson noted that there had only been four instances in previous cases where liquidated damages had been struck down as a penalty, and in each case there had been a "wide gulf" between the damages that were likely to be suffered and those stipulated by the liquidated damages provision. The court further held that the point in time at which the assessment as to whether the liquidated damages provision was a genuine pre-estimate of loss was the time at which the contract was entered into, not the time when the breach occurred.
4. Which was considered before ParkingEye Limited v Beavis.
5. Of Lord Neuberger and Lord Sumption (with whom Lord Clarke and Lord Carnwath agreed).

Should you wish to receive further information in relation to this briefing note or the source material referred to, then please contact Lisa Kingston.
lkingston@fenwickelliott.com.
Tel +44 (0) 207 421 1986

Follow us on and for the latest construction and energy legal updates

Fenwick Elliott LLP
Aldwych House
71-91 Aldwych
London WC2B 4HN
**www.fenwickelliott.com**