Overstaying Your Welcome (Liquidated Damages or a Penalty)

In a joint judgement given on the 4 November 2015, concerning the cases of Cavendish Square Holding BV (Appellant) v Talal El Makdessi (Respondent); ParkingEye Limited (Respondent) v Beavis (Appellant) [2015] UKSC 67 on appeal from [2012] EWCA Civ 3852 Comm, [2013] EWCA Civ 1539 and [2015] EWCA Civ 402, the Supreme Court has addressed the question of when a liquidated damages clause becomes an unenforceable 'penalty'.

REBECCA REDHEAD
Director of Legal Services
rebecca.redhead@systech-int.com
+44 (0) 207 940 7656

Introduction

Liquidated damages are commonly found in construction contracts, most usually in respect of failing to complete Works on time. They are a pre-agreed amount of damages that the innocent party may claim from the breaching party and have the considerable advantage that the party seeking to rely upon them does not have to prove it actually suffered the damage/loss.

However, it is not all one-sided as the provision of liquidated damages in the contract can be advantageous to the party in breach in that:

• They may limit the damages that the breaching party is liable for; and

• They assist in the management of the works in that the party in default may chose to accelerate the works, to avoid/reduce the amount of liquidated damages that it may be required to pay or, alternatively, avoid the acceleration costs but incur a greater amount in liquidated damages.

Unlike some other European legal systems, English Law does not permit the imposition of a 'penalty' against the breaching party – that is rather than be compensatory, the sum exceeds the amount of losses that the innocent party could, at the time of contracting, be reasonably envisaged to suffer arising from the breach. The leading judgement to support this position is the decision of the House of Lords in Dunlop Ltd v New Garage Co Ltd [1915] A.C. 79

It is therefore not uncommon for a party to a construction contract, who is faced with the imposition of liquidated damages, to seek to argue they are in fact a penalty and hence unenforceable.

A Commercial Outlook

Recently there has been a series of judgments that have suggested the Courts would consider the commercial justification of a sum inserted as liquidated damages, which may not be directly supported by the actual losses caused by the breach.

For example:

•In Philips Hong Kong Ltd v Attorney General of Hong Kong (1993) 61 BLR 41 Lord Woolf highlighted the value to commercial parties of being able to say, with relative certainty, the extent of their liability and the risks that they faced; and

• In Lordsvale Finance plc v Bank of Zambia [1996] QB 752, 762G Coleman J said:

"However, the jurisdiction in relation to penalty clauses is concerned not primarily with the enforcement of inoffensive liquidated damages clauses but rather with protection against the effect of penalty clauses. There would therefore seem to be no reason in principle why a contractual provision the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach".

Background of the Cases

In Cavendish Square Holding BV (Appellant) v Talal El Makdessi (Respondent), Mr Makdessi had agreed to sell to Cavendish a controlling stake in the holding company of an advertising and marketing communications group in the Middle East.

The Contract contained provisions that:

• If Mr Makdessi was in breach of certain restrictive covenants (against competing activities) he would not be entitled to receive the final two instalments of the price paid by Cavendish; and

• Mr Makdessi could be required to sell his remaining shares to Cavendish, at a price excluding the value of the goodwill of the business.

Mr Makdessi had breached these covenants but argued that the above provisions were unenforceable as they were penalty clauses.

At first instance Burton J had rejected Mr Makdessi's submissions but the Court of Appeal had overturned this holding the clauses were unenforceable penalties.

In ParkingEye Ltd (Respondent) v Beavis (Appellant) the Respondent managed a car park, where upon there was free car parking for a period of 2 hours. However, there were also numerous notices that stated failure to comply with a two hour time limit would "result in a Parking Charge of £85".

Mr Beavis had overstayed the two hour limit by almost an hour but refused to pay the £85 submitting that the fine was a penalty, and not a genuine pre-estimate of loss because if he had left the car park within the 2-hour limit then:

• The space would have remained vacant; or alternatively

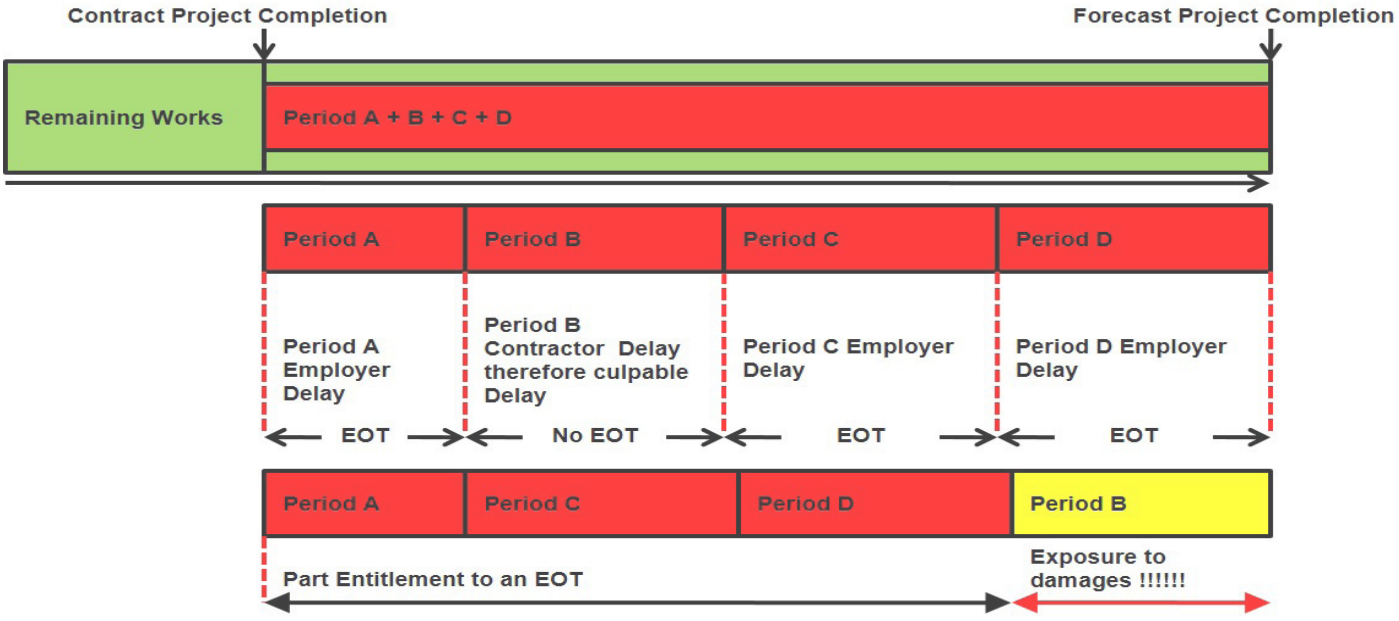
• It would have been occupied by another car that was entitled to park there free for 2-hours

and hence Parking Eye had not suffered any loss by Mr Beavis remaining there and hence the £85 must be a 'deterrent' rather than 'a genuine pre-estimate of loss'.

Mr Beavis had also argued the charge was unfair and unenforceable by virtue of the Unfair Terms in Consumer Contracts Regulations 1999.

The Court of Appeal had upheld the Court of 1st Instance decision that had rejected both of Mr Beavis' arguments.

LAD Assessment Diagram



Supreme Court's Decision

The Supreme Court allowed the appeal in Cavendish Square Holding BV v Talal El Makdessi and dismissed the appeal in ParkingEye Ltd v Beavis, thus upholding the validity of the disputed clauses in both cases (with 1 dissenting judgement in respect of ParkingEye).

In reaching its judgment the Supreme Court found:

• *"the law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions: between a penalty and genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent. These distinctions originate in an over-literal reading of Lord Dunedin's four tests [in Dunlop] and a tendency to treat them as almost immutable rules of general application which exhaust the field"*;

• *"The concepts of 'deterrence' and "genuine pre-estimate of loss" are unhelpful. The true test is whether 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"*;

Lord Mance proposed a 2-stage test, namely:

i) To consider whether any (and if so what) legitimate business interest is served and protected by the liquidated damages clause, and if so

ii) Whether the provision made for that interest is extravagant, exorbitant or unconscionable.

Whereas Lord Hodge identified the test as being:

"whether 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. A clause fixing a level of damages payable on breach will be a penalty if there is an extravagant disproportion between the stipulated sum and the highest level of damages that could possibly arise from the breach"

In applying the above to the facts of Cavendish the Supreme Court considered that:

• Cavendish had a legitimate interest in the observance of the restrictive covenants, in order to protect the goodwill of the Group generally;

• The goodwill of the business was critical to Cavendish and the loyalty of Mr Makdessi was critical to that goodwill;

• It could not assess the precise value of that obligation or determine how much less Cavendish would have paid for the business without the benefit of the restrictive covenants; and

• The parties were the best judges of how that value should be reflected in their agreement.

In applying the above to the facts of ParkingEye the Supreme Court considered that:

• Mr Beavis had a contractual licence to park in the car park on the terms of the notice posted at the entrance, including the 2-hour limit. The £85 was a charge for contravening the terms of the contractual licence;

• This is a common scheme, subject to indirect regulation by statute and the British Parking Association's Code of Practice;

• The charge had two main objects:

i) The management of the efficient use of parking space in the interests of the retail outlets and their users by deterring long-stay or commuter traffic, and

ii) The generation of income in order to run the scheme

• The £85 charge is not a penalty, there was a legitimate interest, for both ParkingEye and the Landowners, in charging overstaying motorists and this extended beyond the recovery of any loss. The interest of ParkingEye was in income from the charge, which met the running costs of a legitimate scheme plus a profit margin whilst the interest of the Landowners was the provision and efficient management of customer parking for the retail outlets; and

• The charge was neither extravagant nor unconscionable, having regard to practice around the United Kingdom, and taking into account the use of this particular car park and the clear wording of the notices.

Conclusions and Commentary

Clearly this Judgment will have significant implications to all those seeking to avoid the imposition of Liquidated Damages clauses.

Although, in giving its judgement, the Supreme Court refused to abolish the rule of law that 'penalties' are unenforceable, in reflecting upon whether or not a sum/rate is a penalty it is no longer satisfactory to merely consider if it is a 'genuine pre-estimate of loss'. Instead the sum/rate must be viewed in a wider, commercial context and thought must be given to any legitimate commercial and/or legal interests that the other Party might be trying to protect.

Where such interests do exist then it appears likely the Courts will enforce the provisions unless they are extravagant, exorbitant or unconscionable.