



Giliker, P. (2017). Case Note England and Wales, UKSC 4 November 2015, Cavendish Square Holdings BV v. Makdessi; ParkingEye Ltd v. Beavis. *European Review of Private Law*, 25(1), 173-180.
<http://www.kluwerlawonline.com/abstract.php?area=Journals&id=ERPL2017010>

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England and Wales

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UKSC 4 November 2015, *Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis* <http://www.bailii.org/uk/cases/UKSC/2015/67.html>

1. Introduction

The UK Supreme Court decision in *Makdessi* marks an important turning point in the treatment of penalty clauses in England and Wales. The Court reviewed the leading case of *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*,¹ and, in an important ruling, re-examined the distinction between valid contractual clauses which specify, for example, the damages payable on breach of contract (liquidated damages clauses) and invalid penalty clauses which are contrary to public policy and will not be enforced. It sought, in particular, to give clarity to the previously complex law on this topic and identify its underlying principles.

The judicial regulation of penalty clauses has a long history in UK law dating back to the sixteenth century, but the Court also noted that it is not merely a feature of the common law.² Reference was made to the 2010 *Unidroit Principles of International Commercial Contracts*³ and Principles of European Contract law⁴ as evidence that judicial intervention has been accepted across legal systems in the Western world. Nevertheless the argument facing the UK Supreme Court in 2015 was not whether the time had come to extend the idea of penalty clauses in the interests of public policy, but whether it should *abolish* the doctrine altogether on the basis that it is outdated, incoherent and unnecessary. Interestingly this was raised in two cases: the first (*Makdessi*) involving experienced commercial parties where the agreement had followed extensive negotiations in which both sides had been represented by highly experienced commercial lawyers and the second (*Beavis*) involving a consumer charged £85 (approximately 100 Euros) for overstaying the free parking time limit in his local retail park. Essentially it was a case of both David and Goliath questioning the validity of clauses they regarded as penal. The Court was asked whether the clauses in question were

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¹ UKHL 1 July 1914, *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* <http://www.bailii.org/uk/cases/UKHL/1914/1.html>.

² Note, in particular, the comments of Lord Mance in UKSC 4 November 2015, *Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis* <http://www.bailii.org/uk/cases/UKSC/2015/67.html> at paras 164-165. See, for example, F. FAUST, “Contractual penalties in German law”, 23. *ERPL (European Review of Private Law)* 2015, p 285, M. CANNARSA “Contractual penalties in French law”, 23. *ERPL* 2015, p 297 and F.P. PATTI, ‘Penalty clauses in Italian law’, 23. *ERPL* 2015, p 309 and, for comparative studies see: L MILLER, “Penalty clauses in England and France: a comparative study”, 53. *ICLQ (International and Comparative Law Quarterly)* 2004, p 79 and L.A. DIMATTEO, “Behavioural Case for Contractual Penalties under the Common Law”, 23. *ERPL* 2015, p 327.

³ *Unidroit Principles 2010*: Article 7.4.13 (Agreed payment for non-performance)

(1) Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm.

(2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.

⁴ Principles of European Contract Law Article 9:509. See also the Draft Common Frame of Reference, Book III. – 3:712.

unenforceable as penalty clauses, but also (in *Beavis*) whether the clause was unfair by virtue of the Unfair Terms in Consumer Contracts Regulations 1999⁵ (which transpose the EU Unfair Terms Directive).⁶ This note will examine the ruling of the Supreme Court and its impact on the law of contract in England and Wales.

2. *Goliath v Goliath: Cavendish Square Holding v Makdessi*

As Lord Hodge indicated, this case raises three principal issues:

- (i) What is the scope of the rule against penalties in English law?
- (ii) Should the rule be abolished or altered so that it does not apply to commercial transactions where the parties are of equal bargaining power and act on skilled legal advice?
and
- (iii) If not, how to apply the rule to the case under appeal?

The facts of the case involve a complex agreement in which the defendant agreed to sell to the claimant a controlling interest in the advertising and marketing company which he had founded. The agreement provided that for a period after the sale the defendant would not compete with his old business and that, if he did, the claimant would be entitled to withhold the final two instalments of the purchase price (clause 5.1) and would acquire an option to buy the defendant's remaining shares at a price which disregarded goodwill (clause 5.6). The motivation behind these clauses was for the purchaser to retain the continued loyalty of Mr Makdessi as a means to preserve the value of the company's goodwill, which might be lost if he worked elsewhere. When Makdessi defaulted, the question arose whether these clauses were unenforceable penalty clauses. As might be imagined, the sums involved were large,⁷ in circumstances where it would be difficult for Cavendish to identify and cost the actual losses suffered as a result of Makdessi's default. Makdessi complained that clause 5.1 would deprive him of part of the agreed consideration due under the contract, while clause 5.6 would give Cavendish a right on any default of Mr Makdessi to force him to part with his remaining shareholding at a price likely to be well below its actual value.

The UK Supreme Court accepted that the time had come to review the penalty rule, described as 'an ancient, haphazardly constructed edifice which has not weathered well'.⁸ Nevertheless, it refused to take the drastic steps of abolishing the rule or of restricting its application to non-commercial cases where the parties were not at arm's length and equally balanced: 'we do not consider that judicial abolition would be a proper course for this court to take'.⁹ The aim, therefore, was to provide a more 'realistic' approach to the substance of

⁵ Statutory Instrument 1999 No 2083. These have now been repealed and, from 1 October 2015, replaced by Part 2 of the UK Consumer Rights Act 2015.

⁶ Council Directive 93/13/EEC of 5 April 1993, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31993L0013:en:HTML>.

⁷ The value of the unpaid interim and final payments due to Mr Makdessi were estimated to be around \$44 million.

⁸ UKSC 4 November 2015 (n 2 supra) at para. 3 per Lords Neuberger PSC and Sumption JSC (Lord Carnwath JSC agreeing).

⁹ UKSC 4 November 2015 (n 2 supra) at para. 36 per Lords Neuberger PSC and Sumption JSC (Lord Carnwath JSC agreeing). See also Lord Mance at para 162 and Lord Hodge at para 256. One reason given for not abolishing the rule is that the penalty rule is common to almost all major systems of law, be they common or civil law systems. It was also noted that the English Law Commission in 1975 (Working Paper No 61, *Penalty Clauses and Forfeiture of Moneys Paid*) had recommended expanding the doctrine, not abolition. Contrast the views of Sarah Worthington: S. WORTHINGTON, 'Common Law Values: The Role of Party Autonomy in

contractual provisions operating on breach, together with a more ‘principled’ approach to the interests that may properly be protected by the terms of the parties’ agreement.

This realistic approach involved examining the clauses in question not in terms of the consequences of individual breaches of contract, but in terms of the general interest being protected and whether, in this light, the clauses could be regarded as exorbitant or unconscionable. This is a matter of construction and takes place by reference to the circumstances *at the time of contracting*, not with the benefit of hindsight.¹⁰ The key, therefore, was the overall picture at the time the clauses were agreed. The Court was critical of an ‘over –literal’ interpretation of the judgment of Lord Dunedin in the previously leading case of *Dunlop*. In that case, Lord Dunedin had formulated four tests which, he argued, might prove helpful or even conclusive in construing whether a clause to pay a stipulated sum was a penalty or a valid liquidated damages clause. They were:

- (a) that the provision would be penal if ‘the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach’;
- (b) that the provision would be penal if the breach consisted only in the non-payment of money and it provided for the payment of a larger sum;
- (c) that there was ‘a presumption (but no more)’ that the provision would be penal if it was payable in a number of events of varying gravity; and
- (d) that the provision would not be treated as penal by reason only of the impossibility of precisely pre-estimating the true loss.¹¹

In contrast, the Supreme Court found the question whether the clause represented a genuine pre-estimate of the loss or was a deterrent should not be seen as decisive. The true test for a penalty clause, therefore, could be stated as follows:

*... 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.*¹²

Lords Mance and Hodge adopted slightly differently worded tests, but concurred that the key issues at stake in future will be (i) whether a legitimate interest is served by the clause and (ii) whether provision for that interest is ‘extravagant, exorbitant or unconscionable’.¹³ Applying this test, the Court found that it was not penal either to revise the price calculation in clause 5.1 nor to bring an end to the shareholder relationship in clause 5.6 when Mr Makdessi had breached his non-competitive obligations. The clauses were found in a carefully negotiated agreement between informed and legally advised parties at arm’s length. The presence of goodwill was at the heart of the contract. Cavendish were found to have a very substantial and legitimate interest in protecting the value of the company’s goodwill and, in view of this legitimate interest, the clauses could not be considered exorbitant or unconscionable.

Private Law’ in A. Robertson and M. Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (Oxford: Hart Publishing 2016), Ch 14.

¹⁰ UKSC 4 November 2015 (n 2 supra) at para. 9 per Lords Neuberger PSC and Sumption JSC (Lord Carnwath JSC agreeing) who explained that ‘[t]his is because it depends on the character of the provision, not on the circumstances in which it falls to be enforced’. See also Lord Hodge at para. 243.

¹¹ UKHL 1 July 1914 (n 1 supra) at p. 87.

¹² UKSC 4 November 2015 (n 2 supra) at para 32.

¹³ UKSC 4 November 2015 (n 2 supra) at paras 152 and 255. Lord Toulson endorsed Lord Hodge’s formulation at para 293.

This represents a substantial restriction on the scope of the courts to intervene, particularly where, as here, the parties are dealing on equal terms with experienced and sophisticated professional advisers. The basis for this is freedom of contract. In the words of Lords Neuberger and Sumption: ‘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.’¹⁴ A further limit must, however, be noted. The courts will only examine clauses which stipulate the remedy available for breach of contract.¹⁵ Here, the UK court chose not to follow the example of the Australian courts which have recently abandoned the breach requirement, noting its inconsistency with established and unchallenged House of Lords authority.¹⁶ This does raise issues, however, in terms of drafting. For example, Lords Neuberger and Sumption were willing to construe clause 5.1 (which permitted Cavendish to withhold the final two instalments of the purchase price) as a primary obligation – namely a price adjustment clause – to which the rule against penalties would not bite.¹⁷ If followed, this provides a great incentive for parties to draft their contractual provisions as primary in nature and thus avoid any regulation under this rule. The Supreme Court argued that courts would be able to spot ‘sham’ agreements,¹⁸ but at the very least further litigation on this point is likely to arise. It also represents a further limitation of the courts’ powers to intervene in that it does not permit them to examine the fairness of primary obligations. This is fully appreciated by the Court; Lords Neuberger and Sumption commenting that there is a:

*... fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach. Leaving aside challenges going to the reality of consent, such as those based on fraud, duress or undue influence, the courts do not review the fairness of men’s bargains either at law or in equity. The penalty rule regulates only the remedies available for breach.*¹⁹

3. David v Goliath: ParkingEye Ltd v Beavis

In contrast, the facts of *Beavis* could not be more straightforward. Mr Beavis parked at a retail park where large and prominent signs indicated that parking was free for 2 hours but that £85 would be charged for exceeding this time limit. The car park was operated by a private company, ParkingEye Ltd, on behalf of the owners. Mr Beavis overstayed by almost an hour but refused to pay the charge of £85, arguing that it was excessive. The charge applied regardless of the period of overstay – so a stay of two hours and one minute would technically give rise to the £85 charge.

¹⁴ UKSC 4 November 2015 (n 2 supra) at para 35. See also Lord Woolf in UKPC 9 February 1993, *Philips Hong Kong Ltd v Attorney General of Hong Kong* <http://www.bailii.org/uk/cases/UKPC/1993/3.html>.

¹⁵ This is an established rule, see Lord Roskill in *Export Credits Guarantee Department v Universal Oil Products Co.* 1 WLR (Weekly Law Reports) 1983 p (399) at pp 403 and 404.

¹⁶ HCA 6 September 2012, *Andrews v Australia and New Zealand Banking Group Ltd* <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/HCA/2012/30.html> and FCAFC 8 April 2015, *Paciocco v Australia and New Zealand Banking Group Ltd* <http://www.austlii.edu.au/au/cases/cth/FCAFC/2015/50.html> at para 95: breach is not an essential aspect of the doctrine.

¹⁷ Lord Carnwath agreed. Lords Hodge and Clarke preferred to keep ‘an open mind’: n 2 supra at paras 270 and 291. Lords Neuberger and Sumption were equally prepared to construe cl 5.6 as a primary obligation, although Lords Hodge and Clarke did not agree with this view: paras 280 and 291.

¹⁸ Lords Neuberger and Sumption remarking (supra n 2) at para 15 that ‘the penalty rule depends on the substance of the term and not its form or on the label which the parties have chosen to attach to it.’

¹⁹ UKSC 4 November 2015 (n 2 supra) at para 13.

The Supreme Court agreed that such a clause would be subject to the rule against penalties, but that, in the circumstances, it did not amount to a penalty. The Court examined whether (i) ParkingEye had a legitimate interest to protect in its imposition of its parking charge and (ii) whether the level of the charge was exorbitant and unconscionable. It found that the £85 charge had two objects:²⁰

- (i) To manage the efficient use of parking spaces in the interest of the retail outlets and indeed the public wishing to park their cars at the retail park. This was to be achieved by deterring customers from staying for more than 2 hours;
- (ii) To provide an income stream to enable ParkingEye to meet the costs of operating the scheme and make a profit from its services, without which those services would not be available.

The Court found these objectives to be perfectly reasonable. Applying the legitimate interest test, ParkingEye had a legitimate interest in charging overstaying motorists and the charge could not be considered extravagant nor unconscionable nor out of proportion to its interests, given that it was comparable (albeit higher) to charges made by local authorities for parking and taking into account the use made of this particular car park and the clear wording of the notices.

Mr Beavis also argued that the charge was unfair under the Unfair Terms in Consumer Contracts Regulations 1999. The Court (with the exception of Lord Toulson) disagreed, despite recognition that the charge might fall under the description of potentially unfair terms at para 1(e) of Schedule 2.²¹ In circumstances where signs clearly indicated the two hour time limit and it was reasonable to expect the defendant to comply with it, any imbalance of the parties' rights did not arise contrary to the requirements of good faith. Again the majority relied on the fact that the claimant had a legitimate interest in inducing the defendant not to overstay to maximise the use of the car park by the public and that the charge was deemed no higher than necessary to achieve this objective. Lord Toulson expressed concern that Lord Neuberger and Lord Sumption, in examining the fairness test, seemed to find no difference in substance between the fairness test under the Regulations and the test whether it offended the penalty doctrine at common law.²² This, in his Lordship's view, 'waters down the test adopted by the CJEU and at the very least [indicates] that the point is not *acte clair*.' Needless to say no preliminary reference under Article 267 TFEU was considered necessary by the majority. One would hope that a national court would recognise that the Unfair Terms Directive may require a different approach to that applied in domestic law generally, although arguably the judgment of Lord Mance on this point represents a more sensitive treatment of the fairness test.²³

4. Conclusion

In the search for certainty and clarity, the UK Supreme Court in *Makdessi* limits further the ability of the courts of England and Wales to intervene to protect parties, both businesses and consumers, from clauses which, in the claimant's view at least, apply a disproportionate

²⁰ UKSC 4 November 2015 (n 2 supra) at para 98, Lord Carnwath agreeing. See also Lord Hodge supra at paras 286.

²¹ The Unfair Terms Directive 93/13/EEC has an indicative and non-exhaustive list of the terms which may be regarded as unfair terms, including 'requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation': Annex 1 (e), to Council Directive 93/13/EEC of 5 April 1993, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31993L0013:en:HTML>.

²² UKSC 4 November 2015 (n 2 supra) at para 315, citing Lords Neuberger and Sumption (Lord Carnwath agreeing) at para 107.

²³ UKSC 4 November 2015 (n 2 supra) at paras 200-213.

penalty towards a breach of contract. This, particularly in the consumer context, may lead to what might be regarded as harsh results. For the Court, the £85 charge in *Beavis* was seen as a commercially legitimate sum likely to induce motorists to comply with the time limit for free parking and thus ensure a steady flow of customers to the retail park while making it commercially viable for a company to regulate parking at a profit. From a different perspective, however, a pensioner delayed in a queue whilst waiting to purchase his goods who returns to his car one minute late is unlikely to regard £85 as an appropriate charge for his overstay, particularly in circumstances he does not consider to be his fault. The underlying rationale of the Supreme Court is, however, enlightening. Lords Neuberger and Sumption state at para 33 that: 'The penalty rule is an interference with freedom of contract. It undermines the certainty which parties are entitled to expect of the law.' Such a negative view of the rule against penalties might be justified in the context of arm's length commercial negotiations but is more contentious in the consumer context. Yet, the response of the UK Supreme Court to the plight of Mr Beavis is less than sympathetic: 'The risk of having to pay was wholly under the motorist's own control. All that he needed was a watch'.²⁴ It falls, therefore, to other means to intervene to protect parties from contractual unfairness. In this light, the majority reading of the Unfair Terms in Consumer Contracts Regulations 1999 in this case may be seen as a matter for concern, indicating that even provisions openly seeking to regulate the fairness of contractual terms may not succeed in protecting consumers in English law from charges perceived by the vulnerable at least to be exorbitant, extravagant and unconscionable.

²⁴ UKSC 4 November 2015 (n 2 supra) at para 109.