Penalty Clauses: The Modern Approach and an Uncertain Future

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Summary

1. “Penalty clauses” concern clauses by which a party to a contract agrees that if he breaches the contract he will pay the injured party a fixed sum, will forfeit sums which would otherwise have been due to him, or must transfer property at an undervalue. The potential problem with such clauses is that they can operate unfairly. What if a person agrees to pay £1,000 if he breaches a contract in a certain way, when actually that breach might cause little or no actual loss to the other party? Should the law allow itself to be an agent of unfairness in such cases? It is an area of the law in which there has always been a tension between, on the one hand, people being able to make, and be held to, the bargain that they want to make and allowing parties fairly to estimate in advance, so as to avoid dispute in the future, what their losses will be if they break their contracts, and on the other hand preventing the exploitation of the vulnerable or the unwise, who enter into a contract hoping and expecting not to break it but then end up being “stung” by unreasonable and unfair consequences when they do break it.

2. The law has long sought to police where the boundary should lie in this field between the permissible and the impermissible, notwithstanding that the Court of Appeal has characterised this as “a blatant interference with freedom of contract”. It used to draw a distinction between the impermissible “penalty clause” and the permissible “liquidated damages clause”, which was a genuine pre-estimate of the loss which would be suffered by an injured party on breach. It would enforce the latter, but not the former.

3. On 26th November 2013 the Court of Appeal (judgment given by Christopher Clarke LJ, with whom Tomlinson and Patten LJJ agreed) in Makdessi v. Cavendish Square Holdings BV [2013] EWCA Civ 1539. Following a detailed analysis of past authority the Court found that the more modern case law had adopted a broad test in relation to alleged penalty clauses as to “whether the clause was extravagant and unconscionable with a predominant function of deterrence; and robustly declining to do so in circumstances where there was a commercial justification for the clause” (paragraph 104).

4. This marks an authoritative and definite step away from the old, simplistic, dichotomy between “the penalty clause” and “the liquidated damages clause”. It is equally clear, however, that the new test will still present difficulties of application in practice for the future.
The Old Law

5. The “textbook” case which many of us will have read at university is Dunlop Pneumatic Tyre Company Limited v. New Garage and Motor Company Limited [1915] AC 79. Lord Dunedin drew a distinction between the penalty, being “a payment of money stipulated as in terrorem [meaning “intended to deter”] of the offending party”, and the liquidated damages clause, being “a genuine covenanted pre-estimate of damage”. Further:-

(a) Hallmarks of a penalty were that:-

I. “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”; and

II. “A single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage”.

(b) On the other hand, “it is no obstacle to the sum stipulated, being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the kind of situation when it is probable that pre-estimated damage was the true bargain between the parties”.

6. Subsequent case law, for the next 80 years, was to focus on this dichotomy between the penalty clause and the liquidated damages clause.

The Modern Trend Begins

7. The tide began to turn against the old dichotomy in Colman J’s judgment in Lordsvale Finance PLC v. Zambia [1996] QB 752. Colman J noted in that case whereas “it is perfectly true that for upwards of a century the courts have been at pains to define penalties by means of distinguishing them from liquidated damages clause”, in fact “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”. A
provision was found to be inoffensive if it was “commercially justifiable, provided always that the dominant purpose was not to deter the other party from the breach”.

8. From this case it was apparent that the fact that a payment on breach may not really be a pre-estimate of loss does not mean that it must be penal, provided that there was good commercial purpose and that its dominant purpose was not to deter breach.

9. This approach was later cited with approval by Mance LJ in Cine Bes Filmcilik ve Yapimcilik v. United International Pictures [2004] 1 CLC 401.

The New Test: The Makdessi Case

10. Having reviewed all of the authorities Christopher Clarke LJ considered in the Makdessi case that the cases showed “the Court adopting the broader test of whether the clause was extravagant and unconscionable with a predominant function of deterrence; and robustly declining to do so in circumstances where there was a commercial justification for the clause” (paragraph 104).

Application on the Facts of the Makdessi Case

11. Mr Makdessi was one of the owners of what was in 2008 the largest advertising and marketing communications group in the Middle East. He and a fellow shareholder sold the majority of their shares in the business, with the ultimate purchaser, following a further transfer and novation, being Cavendish Square Holdings BV (hereafter “Cavendish”). The terms of the contract included provision that should Mr Makdessi breach various restrictive covenants he would forfeit the right to various payments which would otherwise be made to him and could be subject to a compulsory sale of his remaining shares at a value which did not reflect the goodwill in the business, and would lose valuable options to sell his shares at a price which did reflect the goodwill in the business.

12. Mr Makdessi admitted breach of restrictive covenant but contended that the clauses which mandated the serious consequences set out above (which would have resulted in a potential loss of tens of millions of US Dollars) were penalty clauses.
13. “As predisposed as [the Court of Appeal was] to hold Mr Makdessi to his bargain” (paragraph 119), the Court of Appeal agreed that they were penalty clauses to be struck down:-

(a) They were not genuine pre-estimates of loss. Instead, they were extravagant and unreasonable; and

(b) Further, they did not serve a justifiable commercial or economic function such as is exemplified in the case law, such as modest increased interest in the case of a loan default, generous damages for wrongful dismissal, an allocation of credit risk, or the provision of needed capital of a promised guarantee of a loan did not materialise.

**Conclusion: An Uncertain Future?**

14. The Makdessi case is an interesting and important case in the field of penalty clauses. It is a comprehensive analysis of the case law and sets out a test which practitioners can apply “on the ground”. There will, however, no doubt remain uncertainty, and it will still be difficult to predict whether a clause is penal or not, involving as it does an analysis of all of the terms of the contract. The Court in Makdessi itself recognised that there was a “degree of ambiguity as to what is meant by the terms ‘extravagant’ and ‘unconscionable’” (paragraph 125). Further, the concept of whether a clause is “commercially justifiable” is not always capable of obvious answer, involving value judgments as it does. This is illustrated by the Makdessi case itself, in which there was much argument over precisely whether the clauses were commercially justifiable with Cavendish arguing that the clauses were a legitimate “adjustment” of the consideration paid under the contract. Both the text books and practitioners will continue to struggle to separate the penalty clause from the legitimate commercial allocation of risk.

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