Guidance N… …l Penalties

Template documents

To ensure that our template do… …riate practice in the light of the *Cavendish* and *ParkingEye* cas… ***penalties"*** (cases heard by the Supreme Court in November 20… …pdated, and amended all of our documents which provide that fo… …ntract there is to be payment or deduction of liquidated damages… …r amounts.

A "***liquidated damages***" clause… …contract which fixes the amount of damages to be paid as a re… …on breach of a particular stated obligation under the contract.

Only some of our templates hav… …ainder did not need any change in the light of *Cavendish* and *Pa…*

The law

In the Annex below, we set ou… …to the subject of unenforceable ***"penalties"*** in contracts. It exp… …*Cavendish* and *ParkingEye* alter and clarify the law on the subjec…

Practical guidance

We recommend that, *before* y… …t any business contracts, you consider the practical points be… …al background explained in the Annex below) whether you are g…

- use one of our agreem… …or not it contains a liquidated damages, service credits…
- draft your own contract, … …ased on a draft provided to you by the other party to you…

We suggest that, wherever po… …you use one of our templates, whether or not it is one which … …for liquidated damages, service credits or similar remedy for any… … of contract.

We also recommend that you co… …ts and those in the Annex below if you review any of your *existing*…

Advantages and disadvantage… …ated damages clause or other specific remedy in a contract

Including a clause in a contract… …mages clause or which sets out some other specific remedy t… …a particular obligation can be advantageous because:

- there will be certainty fo… …consequence of that breach and any amount to be paid (a…

- it avoids a dispute betwe
- there will be no need for eek an assessment of damages to be paid.

On the other hand, letting the c f damages - rather than setting out either an agreed amount (ting the amount) of Liquidated damages or some other spe ontract - has some potential disadvantages because:

- it involves the parties to t nd trouble of going to court
- the court can and will on when the breach occurs, not in advance
- the amount that a court w e unpredictable.

However, as mentioned in the A advantages of a contract stating either the amount to be paid a some other specific remedy to apply, a degree of uncertainty w arty might seek to challenge the validity of that term, i.e. by trying *alty* in law and that it is therefore unenforceable.

Existing and future contracts

The *Cavendish* and *ParkingEye* ss likely now than before that a liquidated damages or similar cl as an unenforceable *penalty*. As a practical point, that means th less reason now, not more, to revisit your existing contracts t s in them may be regarded as penalties.

The following points will be rele that you enter into, and also to any contracts you have entered 15.

Decide whether or not to inclu on

When you first plan to negotia ou should consider whether to leave it to the courts to assess d tead the contract should include any clause/s providing any liqui r any other specific remedy(ies) for any particular breach(es) of c

You may wish to rely on a pr ages" or other type of remedy clause being enforceable. Typic ere you wish to prescribe, and in effect, place a limit on your liabil obligation in question.

Before you agree to the terms o your interest to gauge whether a remedy clause would (or migh a penalty in law. If you conclude that it could well be a penalty, y o agree a substitute term which would not be a penalty, or if you e the risk that a court might find it to be a penalty. If you take tha act occurs, and at that time you find yourself in dispute (i.e. the other party what if any compensation is to be paid or o apply), you will then have to accept what the court decides.

Relevant tests of validity

Since it is important for the part aring terms of contract to judge whether a remedy clause they v act might be a penalty, they will have to take account of the tes es set out in the Cavendish and ParkingEye cases. It was stated ases that in order to show that a remedy set out in a contract fo obligation is not a penalty, the main hurdles to be overcome ar

- where there is a breac party can show that it has a "legitimate interest" in tha med; and
- the remedy set out in th ch is not out of all proportion to that legitimate interest.

As explained in the Annex belo sarily a penalty if it is not a pre-estimate of loss or it does no r, payment of a compensatory amount.

It may be difficult for the parties e clause meets these tests, and they may well differ in their opini e interest".

Drafting tips

When drafting a contract contain s clause (or some other specific remedy for breach):

- it might be helpful to se est in the recitals section of the contract or in the remedy explain the commercial rationale behind the clause
- it is recommended that ferences in the contract to the liquidated damages or s constituting a "genuine pre-estimate of loss".
- it is recommended that y that both parties have received appropriate legal advice o a contract have been properly advised and are of a g position there is a strong presumption that a clau as a penalty. For that reason, although it may make ne or you, it will be of benefit to you if the other party is prope

Where loss, or little loss, arise bligation in question

In the ParkingEye case, car driv a charge of £85 if they stayed beyond the free 2 hour period p that this charge was a deterrent against overstaying, that it w for loss arising from wrongly overstaying, and that it was not ether there was any loss - there may in the ParkingEye case ha ss arising in the circumstances. Despite this, the court neverth harge was not a penalty since ParkingEye had a "legitimate vers from overstaying and the amount of the charge was not o legitimate interest.

This approach may have positi…llowing situations if the parties wish to include a clause under…o be required to pay liquidated damages for a particular breach…

- where a non-commerci…a government or public body, charity, or other not for p…fer any financial loss if the other party breaches a contrac…
- where there *would* be a …breach, but it would be difficult to quantify it.

In either such case, the level of…n be set by reference instead to damage to reputation, goodwil…parties caused by the relevant breach since that will fall unde…e to commercial "interests", i.e. "legitimate interests". In either …contract clause is less likely to be unenforceable as a penalt…reme Court judgments in the *Cavendish* and *ParkingEye* case…

Challenging a liquidated dama…

If you have entered into a contr…idated damages clause but you feel that it is not commensurate…pact which would occur on your breach of the obligation concern…th challenging its validity on the basis that it is unenforceable as…

It is recommended that, in orde…use in an existing contract or to assist when putting together a …he other party for documentary evidence of their legitimate co…ant to the liquidated damages clause concerned. If the evid… clause does not represent a reasonable and proportionate … party's legitimate commercial interest in the breach not occur…llenge it in an existing contract, or, before signing a new contra… of liquidated damages, on the basis that it is out of all prop…y's legitimate interests in your complying with the contract.

Liquidated damages clauses are…ontracts to provide a remedy for delay, typically for late delivery o…n of construction or other works or services. If you are unable to…a liquidated damages provision, you might instead be able to a… particular facts, that the other party has caused the delay in q…onsible for delay because it is in breach of a condition precede…comply with the notification or certification provisions required… case of construction and some other contracts, you may well a…uments successfully so that, for example, you establish that yo…ch as alleged, and that on the contrary you are entitled to an e…m the contract.

Successful challenge

If you are the party which will be… damages on your breach of the contract, then, before you deci…dated damages clause or try to negotiate its removal from a d…o bear in mind that if no such clause applies, the other party … general damages in the usual

way. The amount of general dar ards could however be less than the damages which are payable mages clause in view of the fact that the Supreme Court has sai dated damages can now validly take into account commercial co oes not require proof of financial loss.

Conclusion

The court's decision and reason d ParkingEye cases is helpful in that it has now clarified for co er, when, and how, they might include in their contracts an a cular types of breach of their contract. The decision offers m such agreed remedies in that it has lessened the likelihood in m eed remedies will be treated by the courts as unenforceable pen

New case la n contracts

Cavendish and ParkingEye

The Supreme Court of the Unit als on 5 November 2015 in two cases, *Cavendish Square Hold lessi* and *ParkingEye Limited v Beavis ("Cavendish" and "Park* facts in these two cases were quite different from each other e cases together because the central issue in both cases was tain contract terms amounted to unenforceable penalties.

As a result of this recent deci *that a contract clause will be construed by the courts as a y".* We have set out the legal background to these cases belo of this Annex, outlined the facts and reasoning in both cases.

The Guidance Note on Contrac commends some *practical steps that you should take, and key po to in mind, in relation to penalties* when negotiating contracts, in consider whether or not your proposed contract should leave ss damages rather than include clauses providing a specific rem es of breach of contract. Where relevant, our template agreeme o take full account of the recent Supreme Court case.

Freedom of contract

There is a general principle in parties to a contract are free to make whatever bargain they w act"), that their bargain will be enforced by the courts, and tha fere with what the parties have agreed.

Exceptions to freedom of con

However, over a very long perio have created various exceptions to this general principle. In thos ep in and override certain types of contract term even though th reed to the term as part of their bargain. Where the court interve eclare or render a term void and unenforceable or limit its appli *elevant party from the adverse effects of the term in question*. T principle of "freedom of contract" are commonly found where one commercial entity and the other is a consumer, but there are a re both parties are commercial entities. One category of these e court concludes that the relevant term, although agreed by the p le" (i.e. it is one which does or might adversely and unfairly af at in all of the circumstances it amounts to a "penalty" in law. I alty, the court will not enforce it, and the contract will operate as not been included in the contract by the parties.

Specific remedies agreed by t in the contract

Contracts sometimes include a for breach. A typical example of a remedy agreed and included parties (where both parties are commercial entities) is the case in breach of a particular stated obligation, it will pay to the oth ages set out in the contract as compensation for that breach. I vision, the sum payable on that breach will instead be an amou d by the court, and that amount might well be more or less than rties set out in the contract.

The disadvantage of letting the t of damages rather than setting out an agreed amount (or a for amount) in the contract is that, firstly, it involves the parties to t and trouble of going to court, secondly, the court can and wi if and when the breach occurs, and, thirdly, the amount that a s likely to be unpredictable. In contrast, where a particular su in the contract as payable on breach of a particular obligatio rtainty for the parties as to the amount to be paid as damages, ids a dispute between them and there will be no need for them t assessment of damages to be paid. However, there may still nty despite inclusion of a term fixing the amount of damage ach because one party might successfully go to court to challe erm by trying to show that it is a penalty.

Typical remedies for breach (a ther events) in contracts

There are various types of dam which parties to contracts often include in their contracts to pro for particular situations, and we have outlined some of them belo

1. Liquidated damages

A common example of a the amount of damages for a breach of contract is a "liq . For example, where a seller of goods fails to deliver by a might state a sum (or a formula to be used to calculate th seller to the buyer. The stated sum will typically represe arising from late delivery, and it

will usually (but not alway…ontract as "liquidated damages" (see the bullet point exam…*les of clauses likely to be found not to be penalties, an…e"* below). Before the recent Cavendish and ParkingEy… will often have stated that the "liquidated damages" sum…timate" of the loss that will be suffered by the innocent p…o why that will no longer be the most prudent practice.

Such a "liquidated damag…e valid and enforceable, but in certain cases it might be …challenge the validity of such a clause as a penalty, whet…mercial entities or where one of them is a consumer. Oth…ust liquidated damages clauses, might also be capable …, depending on the particular circumstances, on the bas…nalties – see below.

2. Clauses which potentiall…es

Where a contract term is …a "penalty", it is void in law and not legally enforceable. …ll then entitled to contractual damages assessed by the…mon law rules. It is therefore in the interest of the party wh…oposed "liquidated damages" or other type of clause to be …eing to the terms of the contract whether or not it is (or mig…

Either a "liquidated damag…er type of contract clause *might* amount to a penalty, if, as…contract by one party, the effect of the clause is to caus…triment, but it is important to emphasise that whether it… depend on its particular effect, how it is drafted, how the…particular context, and all other relevant circumstances.

3. <u>Examples of clauses wh…auses</u>

The following are all exar…*might* amount to unenforceable penalties, *depending on th…*

- liquidated damages…
- imposition of loss of…
- withholding of a pay…
- deferral or reduction…
- payment of a break…
- payment of default i…
- requirement to trans…eration or at an undervalue
- a take-or-pay paym…
- a compulsory buy-o…es of shareholder default.

4. <u>Examples of clauses lik…o be penalties, and therefore, enforceable</u>

Both pre- and post- *Cave*…these clauses (amongst others) will be valid and enforceab…es:

- A "liquidated dam… a "sliding scale". An example would be a contrac… requiring X tons to be delivered by the seller in six …ious dates following the date of the contract, and …uidated damages in respect of each instalment fo…te. The clause should be valid provided that "£Y" …ve to the greatest loss likely to occur for each day …vered late
- A term of a loan a… interest rate for the period after the borrower defa…nstalment, if it is commercially justifiable. If, as a …ender finds that the borrower is a greater credit ris…est rate may often be justified. After *Cavendish ar*…e increase is intended to be, or is, a deterrent agai…be legally valid if the increase is not unconscionable
- A term of a contra…er of options or requiring him to sell back shares a…e is an employee and is a "bad leaver", given that …uted to the business in the way anticipated
- A requirement in a…reach to pay a break fee where the other party exe…m of the contract to terminate it due to that breach…scionable or extravagant in the circumstances (i.e.…e greatest amount of damages that could possibly
- A term of a contra… limited partnership whereby an investor has to sel… a typical discount of 80-90% to cost or fair marke… meet a capital call, since this mechanism is a leg… the interests of the fund and its other investors
- A term in a contrac…it paid by the buyer to the seller or into escrow wh…comply with the contract, if the amount of the dep…On a property sale, the market norm is 10% and s…posit in a property sale contract will usually be enfo…e in another type of transaction the amount of the… that type.) If, in any type of transaction, the am…uired is greater than the market norm, the clause …seller can show that there are special circumstan…f that greater amount, i.e. where it is not unconscion…particular circumstances.

The law and practice on contr…

The courts have for over 100 y…ciples when examining contract clauses to decide whether the…w but the recent judgments in Cavendish and ParkingEye ha…en up and updated the long established English law rules on…cases, the judges examined the history and current state of the…ties and concluded that the rule against penalties had over a…en misunderstood and as a consequence applied in many …ecessary and unjust. They said that a different approach should…n this area.

The old law (pre-November 20

In the case of a "liquidated d ell over a 100 years (until the Supreme Court judgment in 201 he courts applied to the clause to decide whether or not it was a was a "genuine pre-estimate" of the innocent party's likely loss. I rt *not* to be such a genuine pre-estimate, it was deemed to be did not require or expect, as a condition of enforceability of th tract parties must pre-estimate precisely the amount of loss if so). *If the liquidated damages sum stated in the clause was a* the innocent party could claim that sum without having to show ally suffered any loss or that his loss was equal to or greater tha damages sum: in fact he could claim that sum even if his loss w that sum.

The "genuine pre-estimate" test efore 1915, but it was refined by the court in the *Dunlop v New G* 915. The court stated in *Dunlop* that if such a sum was not "extra able", then generally it was to be regarded as a "genuine pre-est ry and not penal, and therefore not an unenforceable "penalty". ent, the court set out guidelines in the Dunlop decision making t d and would not be treated as a penalty clearer than before. For hat if a contract clause provided for a stated fixed sum to be pa number of different obligations under the contract, and the su e however serious the breach, then it was more likely to be de ven if the contract described the fixed sum as "liquidated damag se, for example, required a sum to be paid for breach of only one d it also provided a sliding scale of payments (see the bullet poin uld be less likely to be regarded as a penalty because it indicated empted to pre-estimate loss.

The new law on penalties (pos

The following will help explain h *ingEye* cases have superseded *Dunlop* and why they have now hat a clause will be construed by a court as a penalty.

The *Cavendish* and *ParkingEye* here a contract clause provides for payment of an amount on br he pre-estimate of loss, that fact does *not*, without more, make it of whether a clause is a penalty clause is now that if the detrime party in breach of contract is out of all proportion to the innocen rest" in the enforcement of the obligation that has been breach penalty. In other words, a clause will be a penalty if it produces arty (because of his breach of contract) which is "extravagant, nable" in the overall context of the particular contract. This m er things, there cannot be any legitimate interest in the innocen the defaulter.

The difficulty for the parties neg erms of contract will be working out what is a "legitimate intere all proportion to that legitimate interest, and they may well di what is a "legitimate interest". However, the judgment in Cave helpfully included some general guidance as to when a particula kely to fail this test. It said that it

will depend on the circumstan when the relevant contract is concluded and that a court will umption that the best judges of what is a legitimate remedy for al obligation are the contracting parties themselves, particularly been freely negotiated between commercial parties with similar with the benefit of appropriate expert legal advice. Neverthele reaches of simple contracts, a genuine pre-estimate of moneta ill prevent a contractual remedy from being found to be penal ", since it will be rare that the innocent party's legitimate intere mpensated for the breach.

The court also considered whe es applies *only* where a clause operates in the case of a *bre* her it can also apply where a provision takes effect *other th each of contract*. Consider the following scenarios

(i) A contract might one party to carry out some act and might provid ent on *failure* to carry it out, i.e. there is to be a his might amount to a penalty depending on all

(ii) A contract might arried out by one party, a stated sum will be paya *ot say that there is an obligation* on that party to ree to choose to do one or the other, i.e. either c e stated sum, but it is *for him* to choose, and he i other words, the contract sets out two alternati with the contract, each being a "primary obligatio e relevant act is not a breach of contract, and so sum is not a consequent or "secondary obliga or any breach. Since there is no remedy for breac e. either to carry out the act or pay the stated su tion. The Supreme Court found this to be so in th ee below;

(iii) There might inste tract term requiring the transfer of property or wit ertain circumstances other than breach (e.g. pa onsideration by a purchaser conditional on th restrictive covenants) in which case that will also ach;

The court in Cavendish and Pa use will not be a penalty clause where it is a conditional primary or the court to interpret whether a provision is in reality "primary t concludes that in substance a provision is "secondary", that c ossibility that the remedy that it provides is a penalty. Careful can help make clear whether a provision is primary or secondar ver drafting, the court concludes that in reality a provision is seco to find that it is a penalty. In the case of "(ii)" above, the provisio *ubstance* be a "penalty" for not carrying out the relevant act b it as described in "(ii)" might increase the chance that a cou instead as "primary" so that it cannot be a "penalty" in law.

ParkingEye

In this case Mr Beavis overstaye o hour parking limit in a car park serving a retail park and was ch so. Notices throughout the car park advised drivers of this cha ough he argued that the charge was a penalty (and so unenforc that the parking charge was not an unenforceable penalty.

The decision was based on the o main reasonable aims behind the charge: (i) it promoted the ef in the car park which was in the interest of the retail outlets an eterring long-stay or commuter traffic; and (ii) the generation of o meet the costs of, and provide a profit from, running the parking

The court said that ParkingE charge on overstayers was a reasonable means of meeting th ilst ParkingEye had a legitimate interest in charging motorists wh r limit, it could not charge a sum out of all proportion to its interes er for whom it was providing the service of the car park. Howev not out of all proportion to its interests despite the fact that th y loss (since ParkingEye would not suffer any loss by the prese yond 2 hours). The charge was aimed at deterrence, not compe f itself make it a penalty.

The court also addressed the ap rms in Consumer Contracts Regulations 1999 to the £85 cha at Mr Beavis was a consumer. We have not covered that aspec s blog is only intended as a discussion of the changes in the interesting to note that the court considered that the charge nder the Regulations for the same reasons that it met the "leg

Cavendish

In *Cavendish*, the Supreme C er provisions in a share sale agreement were penalty clauses

It is common in share sale agre e purchase price to be payable at a date which is later than the ccurs ("deferred consideration") and for it only to be paid if cer ditions have been met and the seller has complied with restric activities following completion. The purpose of those restriction aser's newly acquired interest in the goodwill of the business he strictions are more common and more important where the purch s a director or consultant of the purchaser's business to expand

In this case, Mr Makdessi and M ed and controlled almost 90% of the shares in a business that Cavendish held the remaining shares. Cavendish then entere n them to acquire some of their shares, resulting in Cavendish h Mr Makdessi and Mr Ghossoub a 40% stake. Part of the purcha y Cavendish on completion and the remainder was payable in t e years Those two instalments formed a large portion of the p are purchase arrangements Mr Makdessi agreed to be non-exe ss.

To protect the very substantia ss, Mr Makdessi undertook to Cavendish not to compete in a s. He agreed that, if he did not

honour that restriction after c ould forfeit the two remaining instalments of the purchase pri uld forfeit the option to require Cavendish to buy his remaining n took into account the goodwill value at completion and Caven an option to purchase from him his remaining shares for a sum t goodwill.

Mr Makdessi breached his unc d that the forfeiture and option clauses amounted to penalties w e.

The court said that both the forfe were *in reality* an adjustment to the purchase price, and were n of contract, i.e. not alternatives to damages. As such, the forfe s were primary, not secondary, obligations, and so could not be dered to be unfair. In any event, the court thought that althoug a deterrent, they were not a punishment since Cavendish st in enforcing the restriction undertaken by Mr Makdessi. Ho that it would have been clearer that the clauses did not create s ney had been drafted positively, i.e. in such a way that the de s payable on condition that Mr Makdessi complied with the res ively, i.e. in such a way that the right to payment of the deferred he breached the restriction.

One can perhaps better unde the decision by regarding the agreement between Mr Makdes oviding for Mr Makdessi only to be entitled to earn the full purch that he sold if he acted in a way that preserved their value in n, and that his breach of the restriction adversely affected th had sold to Cavendish and his own retained shares (i.e. he had e goodwill in the business). The overall aim of the agreement wa Mr Makdessi was not loyal to the business, Cavendish would be involvement with it and would acquire it at a price reflecting h phisticated business people Mr Makdessi and Cavendish were i cide on these matters and it was not for the court to value of Mr ith the restriction which he had agreed would apply after comp e in this way, it is easier to see that even if the nature and effe that does not of itself make it a "penalty" in law.

Final thoughts

The changes and clarifications provided by the Cavendish and ParkingEye cases are to be we e the law is now clearer than it was before but also because th ts the expectations of business people in the modern commercia