CASE UPDATE

UK Supreme Court refines the law on penalty clauses in *Cavendish Square Holdings v El Makdessi*

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Introduction

1. In November 2015, the UK Supreme Court released a consolidated judgment covering two cases: *Cavendish Square Holdings BV v Talal El Makdessi* ("*Cavendish Square*"), and *ParkingEye v Beavis* ("*ParkingEye*").[1] Both cases were on appeal from the English Court of Appeal. The UK Supreme Court's judgment is noteworthy for the following reasons:

   (a) The UK Supreme Court introduced a new test for identifying penalty clauses. The 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".** In connection, the court also provided the following two-step guide:

      (i) First, a court had to see whether any (and, if so, what) legitimate commercial interests are served and protected by the clause.

      (ii) Second, if there are such interests, the court had to see whether the provision was extravagant or unconscionable in the circumstances.

   (b) The UK Supreme Court cautioned that courts should only be concerned about regulating remedies for a breach, rather than regulating the fairness of contractual provisions.

   (c) The UK Supreme Court noted that the rule on penalty clauses ("the penalty rule") could apply to provisions stipulating for secondary obligations *other* than those requiring payment of money. The crucial point, however, was that these provisions had to be triggered only upon a breach of contract.

Facts of Cavendish v El Makdessi

2. This case involved Mr Makdessi's attempt to sell a controlling stake in the holding company of the largest advertising and marketing communications group in the Middle East to Cavendish Holdings ("Cavendish"). The contract contained provisions providing for consequences if Mr Makdessi breached certain non-compete covenants.

[1] [2015] UKSC 67.

For any queries relating to this article, please contact:

Lun Chee Leong
luncheeleong@leenlee.com.sg

Christopher Tan
christophertan@leenlee.com.sg

Authors:
Lun Chee Leong
Christopher Tan

With special thanks to:
Lee Kok Thong (Trainee)

Lee & Lee
50 Raffles Place, #06-00
Singapore Land Tower,
Singapore 048623
T : (65) 6220 0666

3. The material clauses in the contract were:

   (a) Clause 5.1, which provided that in the event of breach, Mr Makdessi would not be entitled to receive the final two instalments of the purchase price.

   (b) Clause 5.6, which provided that in the event of breach, Mr Makdessi would have to sell to Cavendish his remaining shares at a price reduced by the value of the goodwill of the holding company.

4. Eventually, Mr Makdessi was found to have breached the anti-competitive covenants. Mr Makdessi claimed that Clauses 5.1 and 5.6 were unenforceable as penalty clauses. The English Court of Appeal overturned the first instance decision, and held that the clauses were unenforceable penalties. Cavendish appealed.

Facts of ParkingEye v Beavis

5. This case involved a car-park manager's (ParkingEye) imposition of a £85 parking charge should a car-owner overstay beyond a free two-hour parking limit. A car-owner, Mr Beavis, overstayed the two hour limit by nearly an hour. ParkingEye demanded payment of the £85. In refusing to pay, Mr Beavis argued, among other things, that the charge was a penalty. The Court of Appeal upheld the first instance decision holding that the charge was not a penalty. Mr Beavis appealed.

Decision of the English Court of Appeal

6. In *Cavendish Square* (CA), the English Court of Appeal held that the penalty rule was engaged. This is because the court found that Clauses 5.1 and 5.6 were deterrent in nature. Thus, the clauses fell within the scope of the traditional test for penalties, enunciated by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* ("*Dunlop*")[2] as being "a payment of money stipulated as *in terrorem* of the offending party".

7. In *ParkingEye*, however, the English Court of Appeal held that the parking charge was not a penalty. The court agreed with the trial court's holding that the parking charge was "neither extravagant nor unconscionable having regard to the level of charges imposed by local authorities for overstaying".

Decision of the UK Supreme Court

8. The UK Supreme Court found that the material clauses in both cases were *not* penalty clauses. In making this finding, the court made the following observations on the penalty rule:

   (a) **First, there was much to criticise about the traditional penalty rule.** This was for a few reasons. One, Lord's Dunedin's comments on identifying penal clauses, which were intended to be mere guidelines, have since been turned into a quasi-statutory rule. As a result, courts have struggled to apply the rule to situations outside traditional penalty clauses. Two, and as a consequence of the first point, the rule has been subject to "artificial categorisation" and "unsatisfactory distinctions".

[2] [1915] AC 79.

(b) **Second, the penalty rule should not be removed, but revised.** This is because the penalty rule was a long-standing one, and was common to almost all major systems of law. In addition, it was consistent with other well-established contractual principles regulating the remedy of a contractual breach, such as the rules on specific performance. Further, given that the problems from the penalty rule arose from how it had been applied rather than the nature of the rule itself, the UK Supreme Court decided that revision of the rule was the best way forward.

9. Nevertheless, the UK Supreme Court cautioned that a court should only be concerned about regulating the remedies for a breach. A court should not be assessing or regulating the fairness of contractual obligations between parties.

10. With the foregoing in mind, the UK Supreme Court fashioned its new test for penalties. **The test was "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".** In elaboration, Lord Mance provided the following two-step matrix as a guide:

    (a) First, a court had to see whether any (and, if so, what) legitimate commercial interests are served and protected by the clause. In short, if there is any commercial justification for the clause.

    (b) Second, if there was (or were) such interest(s), the court had to see whether the provision was nevertheless extravagant, exorbitant, or unconscionable in the circumstances.

11. **The new test would be applicable even in situations going beyond traditional penalty clauses.** This is so long as the provision stipulating the secondary obligation would be triggered only upon a contractual breach. Hence, the UK Supreme Court stated that the penalty rule may be applicable to provisions such as those stipulating an obligation to transfer assets for free (or at an undervalue), or stipulating for the forfeiture of deposits.

12. Nonetheless, the UK Supreme Court pointed out that Lord Dunedin's guidelines in *Dunlop* would still be applicable to straightforward liquidated damages clauses. The penalty rule, however, would not apply to the retention of instalments paid under a contract.

13. In arriving at its holding, the UK Supreme Court decided not to adopt the Australian position in *Andrews v Australia and New Zealand Banking Group Ltd* ("*Andrews*").[3] In *Andrews*, the High Court of Australia held that a provision stipulating a secondary obligation could be penal even if the provision was not triggered by a breach of contract.[4] The UK Supreme Court disagreed. Among other reasons, the Australian approach would entail a review of the fairness of all types of contractual obligations, something their Lordships were very hesitant to do.

[3] [2012] HCA 30. For a more detailed case update, please see *(link to L&L's case update)*
[4] [2012] HCA 30, at [78].

The position in Singapore

14. The position on penalty clauses in Singapore is still closely aligned with the old English position. The current and material parts of the law may be summarised as follows:

    (a) The law to be applied is still embodied in the principles laid down by Lord Dunedin in *Dunlop*: *Xia Zhengyan v Geng Changqing*.[5]

    (b) The concept of "commercial justification" (the precursor to the concept of "legitimate commercial interests" in *Cavendish Square*) is yet to be part of the law in Singapore: *Pun Serge v Joy Head Investments Ltd*.[6]

    (c) The penalty rule can apply to provisions outside traditional damages clauses. Such provisions include those stipulating that, upon breach, a party will have to pay a higher default interest rate, or to sell property at an undervalue: *Hong Leong Finance Ltd v Tan Gin Huay*;[7] *E C Investment Holding Pte Ltd v Ridout Residence Pte Ltd*.[8]

Concluding remarks

15. As a whole, *Cavendish Square* demonstrates the English courts' willingness to recognise parties' freedom to contract. This is because the test for penalties in *Cavendish Square* no longer considers whether a provision stipulating the secondary obligation is a genuine pre-estimate of the innocent party's loss. Instead, the denominator is now the legitimate commercial interests of the parties behind the provision.

16. It is suggested that the new English position, represented by *Cavendish Square*, is not radically different from the existing position in Singapore. Hence, if the English position is adopted here, it would only be a refinement of the penalty rule in Singapore.

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The following partners lead our departments:

Kwa Kim Li
Managing Partner
kwakimli@leenlee.com.sg

Quek Mong Hua
Litigation & Dispute Resolution
quekmonghua@leenlee.com.sg

Owyong Thian Soo
Real Estate
owyongthiansoo@leenlee.com.sg

Tan Tee Jim, S.C.
Intellectual Property
tanteejim@leenlee.com.sg

Adrian Chan
Corporate
adrianchan@leenlee.com.sg

Louise Tan
Banking
louisetan@leenlee.com.sg

[5] [2015] 3 SLR 732, at [78].
[6] [2010] 4 SLR 478, at [42].
[7] [1999] 1 SLR(R) 755, at [26].
[8] [2011] 2 SLR 232, at [129].