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UK Supreme Court Re-Formulates The Test For Determining Unenforceable Contractual Penalties

It is a basic and long-standing common law principle in the law of contract that a provision in a contract which is construed a penalty cannot be enforced. In an eagerly anticipated judgment, a seven judge Supreme Court has now "clarified", in reality re-formulated, the applicable test for determining whether a particular contractual provision should be struck down as being a penalty. This decision is almost certain to be followed in Bermuda, in the British Virgin Islands and in the Cayman Islands.

Previously the law had stood with the well-known decision of the House of Lords in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 and the classic four-fold test propounded by Lord Dunedin which the Supreme Court noted had unfortunately "achieved the status of a quasi-statutory code in the subsequent case-law". In the combined appeals in a commercial case *Cavendish Square Holding BV* v *Talal El Makdessi* and a consumer case *ParkingEye Ltd v Beavis* [2015] UKSC 67 the Supreme Court has now re-stated the applicable principle as a single test of:

"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".

The majority reasoning was provided in a joint judgment of Lords Neuberger and Sumption with which Lord Carnworth agreed, and in separate judgments of Lord Mance and Lord Clarke who agreed the re-formulation of the test by Lords Neuberger and Sumption.

As is apparent in the re-formulation, in order for a contractual provision to be struck down as a penalty it is necessary to have an affirmative answer to two separate and consecutive questions: First, is the impugned provision a secondary obligation? If not, then *caedit questio*. If it is, then one must go on and consider the second question, whether the impugned provision 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? If it does then it will be unenforceable as a penalty.

There is nothing novel about the first question. As Lords Neuberger and Sumption explained:

"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. … 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 of a party's primary obligations, not the primary obligations themselves." [Paragraph 13]

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"This means that in some cases the application of the penalty rule may depend on how the relevant obligation is framed in the instrument, i.e. whether as a conditional primary obligation or a secondary obligation providing a contractual alternative to damages at law. Thus, where a contract contains an obligation on one party to perform an act, and also provides that, if he does not perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which is capable of being a penalty; but if the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation and cannot be a penalty ."[paragraph 14]

"However, the capricious consequences of this state of affairs are mitigated by the fact that, as the equitable jurisdiction shows, the classification of terms for the purpose of the penalty rule depends on the substance of the term and not on its form or on the label which the parties have chosen to attach to it" [Paragraph 15]

An interesting question that Lords Neuberger and Sumption shied away from is the relationship between penalties and relief from forfeiture, although they acknowledged the possibility that a contractual provision could be both a penalty and a forfeiture. Lords Mance and Hodge, on the other hand, were prepared to grapple with this relationship and concluded that a clause could be considered to be both a penalty and a forfeiture so that the court could consider whether relief against forfeiture should be given: "in an appropriate case the court should ask first whether, as a matter of construction, the clause is a penalty and, if it answers that question in the negative, it should ask (where relevant) whether relief against forfeiture should be granted in equity having regard to the position of each of the parties after the breach" Lord Toulson agreed with them and Lord Clarke was inclined to agree as well.

In reaching their conclusion on the correct formulation of the test lords Neuberger and Sumption made a number of pertinent observations:

"the penal character of a clause depends on its purpose, which is ordinarily an inference from its effect. As we have already explained, this is a question of construction, to which evidence of the commercial background is of course relevant in the ordinary way. But, for the same reason, the answer cannot depend on evidence of actual intention" [paragraph 28]

"A damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach. This must depend on whether the innocent party has a legitimate interest in performance extending beyond the prospect of pecuniary compensation flowing directly from the breach in question." [paragraph 28]

"The availability of remedies for a breach of duty is not simply a question of providing a financial substitute for performance. It engages broader social and economic considerations, one of which is that the law will not generally make a remedy available to a party, the adverse impact of which on the defaulter significantly exceeds any legitimate interest of the innocent party". [Paragraph 29]

"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 and a tendency to treat them as almost immutable rules of general application which exhaust the field" [paragraph 31]

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"The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not therefore, at any rate without more, mean that it is penal. To describe it as a deterrent (or, to use the Latin equivalent, in terrorem) does not add anything. A deterrent provision in a contract is simply one species of provision designed to influence the conduct of the party potentially affected. It is no different in this respect from a contractual inducement. Neither is it inherently penal or contrary to the policy of the law. The question whether it is enforceable should depend on whether the means by which the contracting party's conduct is to be influenced are "unconscionable" or (which will usually amount to the same thing) "extravagant" by reference to some norm." [paragraph 31]

This led up to their conclusion at paragraph 32 of the judgment that:

"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. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance. In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach, and we therefore expect that Lord Dunedin's four tests would usually be perfectly adequate to determine its validity. But compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations."

Lords Neuberger and Sumption then went on to stress that this rule is an interference with the principle of freedom of contract and undermines certainty in the law which is of particular significance in commercial contracts. They made a welcome observation in paragraph 35 of the Judgment that

"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."

Interestingly, although they recognised that if the rule had not been developed a long time ago it is unlikely that it would have been developed today, nevertheless they declined an invitation to abolish the rule. They similarly declined to follow the lead of the High Court of Australia in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 and extend the rule to a non-breach of contract situation.

It remains to be seen how the re-formulation of the rule works out in practice and how the courts will deal with the inter-relationship of the law of penalties and relief from forfeiture should it arise. In the commercial context the judgment provides strong support for leaving the parties to their bargain and the reformulated test should make it more difficult in future to challenge a contractual provision in a commercial contract as a penalty. So although in one sense the new formulation could be seen as introducing additional uncertainty into the law, in practice it is likely to lead to more certainty in commercial contracts.

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