Campbell Johnston Clark

In The Penalty Area

The rule against contractual penalties is part of every litigator's toolkit, and almost from instinct most can recite that a clause is unenforceable if it says that a defaulting party will pay far more than the most the other could lose, or is deterrence - *in terrorem* - and not a genuine pre-estimate of damage. That was the core of the landmark *Dunlop* judgment, given by the House of Lords just four weeks before the outbreak of the First World War, and until recently this area of law had remained untouched by the (now) Supreme Court for over a century.

Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67 was a combined review of very different clauses. Mr El Makdessi said they were penalties in making him forfeit about $44 million and sell shares at a low revaluation for admittedly tarnishing the vital goodwill of the subject company, and Mr Beavis challenged an £85 charge for exceeding two hours of free parking. Both failed.

From the Supreme Court's long consideration of the preceding case-law, *Dunlop* and its application since, one can distil the following:

1. A reminder first to consider whether the rule applies at all. It is confined to so-called *secondary* obligations - what a party must do, or pay, or whatever else happens, following his breach of contract. It does not apply to a primary obligation i.e. what performance of the contract requires. Especially perhaps with withholding benefit, as in *Cavendish*, it may be unclear whether a clause is primary - how a party has to perform in order to receive something - or secondary, setting out what he will lose if he behaves in a contrary way;

2. The essence of *Dunlop* as summarised above is an inadequate test for a penalty, except in rudimentary cases involving damages payable on breach;

3. Instead, citing Lord Hodge, "the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach … is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract."

4. This echoes the Supreme Court's developed central theme of commercial justification of the clausing said to be penal, i.e. whether the innocent party can show a legitimate interest in protecting a business structure, or some other value, and the measures challenged are not an excessive way of achieving that;

5. A clause found to be a penalty fails completely. It cannot be applied in part.

Just over 15 months since *Cavendish* is too soon to assess its effect, but one might expect renewed focus on primary and secondary obligations, and perhaps efforts to ensure that the former cannot plausibly be presented as the latter. In some cases, insurers might want to review the wording of their cancellation clauses.

It is possible, too, that P&I Clubs may revisit their rules providing for loss of cover if calls and other sums are not paid. The familiar "FANTI" and "PADRE ISLAND" cases of 1989 were determined on other grounds, but the Court of Appeal (Bingham LJ dissenting) would if necessary have ruled that a provision forfeiting cover for the relevant year - though not imputing prior years, for which calls had been fully paid - was unenforceable as a penalty.

While not technically binding, that has been the settled position for nearly 30 years. However, it was based on habitual application of an old doctrine that has now been questioned, so a Court or Tribunal might now be persuaded to favour the Bingham LJ dissent and uphold a term removing a defaulter's current year cover.

There may also be scope in some cases to argue that:

(a) on proper analysis, the relevant provision is a primary one, as it just says what a member/other insured must do to have or maintain cover, rather than prescribe for adverse behaviour; and

(b) an insurance provider, especially a mutual one, has a legitimate business interest in garnering payment of premium or calls, and preventing payers subsidising defaulters.

The main counters are likely to be that (i) any clause that also jeopardises previous years' cover sets a secondary consequence, rather than defining primary obligations by performance (ii) notions of commonality in payment affect the paying group rather more than the business of the payee and (iii) in protecting any proven legitimate business interest, complete loss of cover for the current year, and certainly for any fully paid prior year, is too heavy-handed.

In a welcome review of a well-known rule, the Supreme Court has made a major change of emphasis, but it remains to be seen what effect this will have on familiar wording, and its interpretation.

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