Supreme Court clarifies the law on penalty clauses and the consequences for non-compete provisions

It is common for contracts, such as shareholder agreements, commercial contracts and standard terms of business, to set out specific consequences for breach. This might be, for example, a parking fine for overstaying in a car park, or a set fee for late payment of an invoice. It is a long established principle in English law that where such clauses amount to a 'penalty', they will be unenforceable. This principle has been restated and clarified by the Supreme Court in the recent cases, *Cavendish Square Holding BV v El Makdessi* and *Parking Eye Ltd v Beavis*.

Valid and enforceable clauses

In Cavendish v El Makdessi, Mr Makdessi agreed to sell to Cavendish a controlling stake in a company. The sale agreement contained a non-compete covenant which, if breached, provided that Mr Makdessi would not receive the two final instalments of the consideration and could be forced to sell his remaining shares at a reduced value. On breach of the agreement by Mr Makdessi, he argued that these provisions amounted to an unenforceable penalty.

In Parking Eye v Beavis, Mr Beavis overstayed in a car park in which there were signs stating that parking was free for two hours, but an £85 fine would be incurred thereafter. Mr Beavis argued that the fine amounted to an unenforceable penalty.

In each case the relevant clauses were upheld as valid and enforceable.

The true test

Exactly what amounts to a 'penalty clause' has been clarified. The Supreme Court rejected an earlier test which suggested that the clause would be likely to be a penalty clause if it were intended to be a 'deterrent', or enforced the payment of a sum which was not a 'genuine pre-estimate of loss'.

The true test is whether the clause in question imposes a liability on the guilty party out of all proportion to any legitimate interest of the innocent party in enforcing the core terms of the contract. The innocent party can have no proper interest in simply punishing the defaulter.

Who is impacted by this decision?

This decision affects anyone who might seek to rely on any clause which sets out a pre-determined consequence for a breach of a contract. This could relate to, for example, being forced to a pay a pre-determined amount, losing the right to receive a pre-determined amount, or being forced to transfer an asset, such as shares. Examples could include:

- additional fees charged for breach of standard terms of business;

- bad leaver provisions in a shareholder agreement (such as those forcing the sale of shares at below market value); and
- specified damages for breach of a non-competition covenant.

While these cases provide some welcome clarity regarding the law in this area and arguably bring it more into line with the commercial realities of a modern business, a key 'take away' point for contract parties is that, even where parties are of equal bargaining power, the freedom to contract is not unfettered. Where the court deems a pre-determined consequence of breach as too harsh, it can still declare it to be unenforceable. Given the subject matter of Cavendish, this point is particularly relevant to companies and individuals who are subject to, or rely on, default and non-compete provisions.

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