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Penalty Clauses and the Recent Decisions by the UK Supreme Court in *Cavendish* v. *Makdessi* & *ParkingEye* v. *Beavis*

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Abstract: The UK Supreme court recently rendered two important decisions on penalty clauses: *Cavendish* v. *Makdessi* and *ParkingEye* v. *Beavis.* The penalty clause is a controversial legal concept in Europe because it can result in high and unreasonable payment obligations. Most European legal systems agree that some form of protection against unreasonable penalty clauses is needed, but differ in the way penalty clauses are restricted. The most extreme approach is followed by English law, where a distinction is made between invalid penalty clauses and valid liquidated damages clauses. The new UK Supreme Court cases introduce new elements in English law in this respect. In this issue, the two decisions are discussed from a comparative perspective by a number of authors from different legal systems (English & Welsh, Belgian, German, Dutch, French, Italian, Swedish and Polish law).

1. The Use of Penalty Clauses

Agreed payment clauses fix in advance the amount that a non-performing party has to pay in case of non-performance. In the English legal terminology, these clauses are called penalty clauses and liquidated damages clauses. Herein, the common term 'penalty clause' refers to agreed payment clauses in general; that is, the English legal concepts of penalty *and* liquidated damages clauses.

Historically, a penalty clause may serve two functions.[1] Firstly, it may aim to ascertain in advance the amount of damages that the injured party may claim, thereby avoiding litigation for the assessment of damages. Secondly, the penalty clause may primarily provide for an incentive (or: penalty) for the other party to adequately perform his or her contractual obligations. Here, the penalty clause exceeds the likely damage or may be claimed in addition to statutory damages in order to induce the other party to perform. In some legal systems, this form of penalty clause is said to punish the non-performing party.

By contractually fixing a high payment obligation in case of non-performance, it becomes more likely that the other party will adequately perform

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1 See R. Zimmermann, *The Law of Obligations – Roman Foundations of the Civilian Tradition* (Oxford: OUP, 2nd edn 1996), pp 95–96.

his or her contractual duties. Therefore, a penalty clause aims to assist legal certainty and is widely used in legal practice.

2. Different Approaches

However, the penalty clause is a controversial legal concept because it may result in high and unreasonable payment obligations and therefore not only compensates for the damages a contracting party suffers. The question arises as to whether contractual parties are allowed to agree on any form of penalty clause or whether protection is needed. Most European legal systems agree that some form of protection against unreasonable penalty clauses is needed,[2] but differ in terms of how penalty clauses are restricted. The most extreme approach is followed by English law, which makes a distinction between penalty clauses and liquidated damages clauses. Where the latter are valid and enforceable, the former are not. Other jurisdictions, such as the Dutch, do not make a distinction between penalty and liquidated damages clauses and consider them both valid, subject to the possibility that a court reduces or supplements unfair agreed payment clauses. Other legal systems consider both penalty and liquidated damages clauses as valid, but do make a distinction between the two clauses: only penalty clauses are subject to judicial control. Due to the fact that the legal approach to penalty clauses differs throughout Europe, penalty clauses have received considerable attention in academia.[3]

3. Important Decisions by the UK Supreme Court in *Cavendish* v. *Makdessi* and *ParkingEye* v. *Beavis*

As mentioned above, the most extreme approach is to be found in the United Kingdom, where penalty clauses are not valid.[4] Parties are only allowed to make an assessment of the likely damage in advance ('a liquidated damages clause') and may not agree on payments of an amount in excess of such assessment ('penalty clause'). In order to distinguish between the two clauses, Lord Dunedin formulated

2 Even though Swedish law lacks specific provisions on penalty clauses, it restricts unreasonable penalty clauses on the basis of Swedish Contract Act s. 36 on unconscionable contracts: see Christina Ramberg in her case note from a Swedish perspective.

3 See in ERPL ('*European Review of Private Law*'), for instance, H.G. Beale, 'Penalty Clauses in English Law', 3&4. *ERPL (European Review of Private Law)* 2016, pp 353-372 and the contributions on penalty clauses under German, French, Italian, Common and European law in 3 *ERPL* 2015, pp 283-383. According to Jansen, this attention is caused by the fact that the law on penalties reveals a striking difference between common law and civil law: A. Janssen, 'Editorial: Die Vertragsstrafe im Brennpunkt der Rechtsvergleichung', 3. *ERPL* 2015, p 203.

4 In 1998 Belgian law adopted a similar approach: see H.N. Schelhaas, *Het boetebeding in het Europese contractenrecht* (Deventer: Kluwer 2004), p 156 ff.

in the Dunlop case[5] various tests 'which if applicable to the case under consideration may prove helpful, or even conclusive'. All tests boiled down to the question of whether the parties at the time of contracting made a genuine assessment of the likely damages. Lord Dunedin's tests survived and were applied for around a century, until 4 November 2015. On that date, UK Supreme Court rendered two decisions on penalty clauses (*Cavendish* v. *Makdessi* and *ParkingEye* v. *Beavis*)[6] in which the UK Supreme Court reformulated the distinction between valid liquidated damages clauses and invalid penalty clauses. The Supreme Court's press release stated the following[7]:

> *The penalty rule is an 'ancient, haphazardly constructed edifice which has not weathered well'. However, it is of long standing and a similar rule exists in all other developed systems of law. It also covers types of contract which are not regulated in any other way. It should not therefore be abolished, but neither should it be extended. The fundamental principle is that the penalty rule regulates only the contractual remedy available for the breach of primary contractual obligations, and not the fairness of those primary obligations themselves.*

And:

> *What makes a contractual provision penal? Lord Dunedin's tests (...) have too often been treated as a code (...) . The concepts of 'deterrence' and 'genuine pre-estimate of loss' are unhelpful. 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.*

This press release already indicates that both decisions are important in relation to Lord Dunedin's tests to distinguish penalty clauses from liquidated damages clauses and that they introduce new elements into the English law on penalty clauses.

4. Comparative Case Notes

Given the importance of the two recent penalty clause decisions by the UK Supreme Court, the question arises as whether these decisions bring English law closer to the other European approaches in relation to penalty clauses. It is for this

5 UKHL 1 July 1914, *Dunlop Pneumatic Tyre Co Ltd* v. *New Garage & Motor Co Ltd* http://www.bailii.org/uk/cases/UKHL/1914/1.html.

6 UKSC 4 November 2015, *Cavendish Square Holdings BV* v. *Makdessi; ParkingEye Ltd* v. *Beavis* http://www.bailii.org/uk/cases/UKSC/2015/67.html

7 https://www.supremecourt.uk/cases/uksc-2013-0280-press-summary.pdf.

reason that, in this issue of ERPL, both decisions are commented on from a comparative perspective by a number of authors from different legal systems. Each author takes both decisions of the UK Supreme Court as a starting point and comments on the cases from the perspective of its own national legal system. The author also answers the question of whether a court in a different legal system would have answered the questions that were raised in *Cavendish* v. *Makdessi* and *ParkingEye* v. *Beavis* the same, and whether English law draws nearer to the other legal systems under study.

After this short introduction of the topic, the cases are first discussed from an English and Welsh perspective by Paula Giliker. Subsequently, Françoise Auvray and Sanne Jansen discuss Belgian law, which adopts the same principles as English law in this respect. Florian Faust analyses both cases from a German perspective, after which the cases are discussed against the background of Dutch law. Michel Cannarsa deals with the French perspective, followed by Francesco Paolo Patti on Italian law. Those more traditional legal systems are supplemented with an analysis from a Swedish perspective by Christina Ramberg, and with a Polish perspective by Ewa Bagińska and Paulina Ślufińska. This rich collection of case notes will be concluded with a brief comparative analysis in which some conclusions will be drawn.