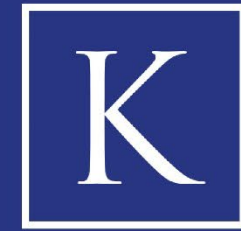


# An Introduction to Penalty Clauses

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# What is a penalty clause?

*“Where the parties to a contract agree that, in the event of a breach, the contract-breaker shall pay to the other a specified sum of money, the sum fixed may be classified by the courts as either a **penalty (which is irrecoverable)** or as **liquidated damages (which are recoverable)**”*

Chitty on Contracts 29-023

# Basic Principles

- This is a question of law
- The Court will consider the agreement at the date on which the Parties entered the contract, not the date upon which it was breached

*Cavendish Square Holdings BV v Makdessi;*  
*ParkingEye Ltd v Beavis* [2015] UKSC 67

Joint appeals heard by a seven-justice panel of the  
Supreme Court



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# *Cavendish Square Holdings BV v Makdessi*

## Facts:

- Makdessi agreed to sell Cavendish the majority of his shares in a company
- Makdessi contracted to not compete
- Contract held that if he did compete he would not be entitled to receive the final two instalments of the purchase price AND would have to transfer his remaining shares at a lower price (which excluded the value of the goodwill in the business)

# *ParkingEye Ltd v Beavis*

## Facts:

- ParkingEye run car parks which serve retail parks
- The car park had a two hour limit
- £85 fine for overstaying
- Mr Beavis argued it was a penalty clause

*“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.”*

Three stage test:

1. Secondary obligation?
2. Legitimate commercial interest in deterring the breach?
3. Is the amount extravagant or unconscionable in proportion to that interest?

# Secondary Obligations

*“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”*

*Cavendish [14]*



An example:

*“At the end of the PCP term the Customer can return the Vehicle to the Dealer or pay the Balloon Payment as specified in the Terms of this contract”*

The payment of the balloon payment can not be a penalty clause as it is not a secondary obligation.

# Legitimate Interest in Detering Breach

- Punishment is NOT a legitimate interest
- Hallmarks of a legitimate interest:
  - Difficulty in proving loss
  - Difficult in detection
  - Substitute not available
  - Loss suffered by a third party
  - Insolvency risk

# Is the amount extravagant or unconscionable in proportion to that interest?

- Case by case basis
- Must not be substantially more than is required in order to deter the defendant from breach
- If a genuine pre-estimate of loss it is unlikely that would be a penalty clause

# Examples

*“I/We understand that in the event of a cancellation I/We will be liable to a cancellation fee equivalent to 2% of the Rateable Value of the subject property/properties”*

*“In the event of a delivery being delayed by over 24 hours, the Courier shall pay the Customer a sum equivalent to 50% of the value of the Shipment”*

# Examples

*Cavendish v Makdessi*  
Clauses = enforceable

*ParkingEye v Beavis*  
Clause = enforceable

# Scope of the doctrine

- It also covers other types of clauses that had adverse consequences for that party upon its breach of the contract

*“the party in breach of this contract in any way will be precluded from recovering any of the contract sum and is required to return any monies already paid”*

# Disguised Penalties

*Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] Q.B. 433

- D hired slides
- C charges a much higher rate if the slides not returned within a fixed period
- Bingham LJ suggested there may be a category of disguised penalty clauses

*“In reaching the conclusion I have expressed I would not wish to be taken as deciding that condition 2 was not challengeable as a disguised penalty clause. This point was not argued before the judge nor raised in the notice of appeal. It was accordingly not argued before us. I have accordingly felt bound to assume, somewhat reluctantly, that condition 2 would be enforceable if fully and fairly brought to the defendants’ attention.”*

Per Bingham LJ



# Thank you

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