Penalty clauses redefined

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Many employment contracts and settlement agreements contain clauses suggesting dire consequences if they are breached. When relied upon, employees often argue that they are "penalty clauses" and therefore void. Faced with two contrasting cases on the nature of a penalty clause, the Supreme Court has provided a new test to identify those clauses which are unenforceable as penalties.

The first case concerned Mr Makdessi, the founder of a successful group of advertising companies. He and his partner

entered into an agreement to sell their majority shareholding in the group to Cavendish. The agreement imposed non-compete obligations on Mr Makdessi and his co-owner; it provided that breach of those obligations would disentitle him to two further payments and require him to sell to Cavendish his remaining shares at a default price.

The second case related to Mr Beavis, a motorist who parked his car in a car park managed by ParkingEye. Signs in the car park indicated that there was a 2-hour maximum stay and that failure to comply would result in an £85 charge. Mr Beavis overstayed the 2-hour limit by 56 minutes and was faced with an £85 fine (reduced to £50 if paid within 14 days).

Both Mr Beavis and Mr Makdessi argued that they had been subjected to penalty clauses which were unenforceable.

The Supreme Court found that the terms were not penalty clauses and could therefore be enforced. In doing so, it replaced the old test for penalty clauses, which focused in large part on whether the clause represented a genuine pre-estimate of the loss which would be caused by breach (in which case they would be enforced) or whether they were extravagant (when they would be void). Instead, it determined that there was a multi-factored test.

One criterion is whether the clause relates to something which must be done under the terms of the contract; if it does, it cannot be a penalty clause.

Another factor raised by the Supreme Court is whether the clause was freely negotiated by parties with comparable bargaining power. Whilst that may not be the case in employment relationships, save for those employees who are particularly senior, it was the case for Mr Makdessi.

Finally, the court must consider whether the provision is “unconscionable” or “extravagant”; this was not the case for Mr Beavis, as the Court held that ParkingEye’s charge was in

proportion to its legitimate interests in managing the car park.

Whilst this decision is a significant restatement of the law, in practice carefully worded clauses should be able to stay on the right side of the new penalty clause definition and remain enforceable.

Cavendish Square Holding BV v El Makdessi and ParkingEye Ltd v Beavis [2015] UKSC 67

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