**Michaelmas Term**
**[2015] UKSC 67**
*On appeal from: [2013] EWCA Civ 1539 and [2015] EWCA Civ 402*

# JUDGMENT

# Cavendish Square Holding BV (Appellant) *v* Talal El Makdessi (Respondent)

# ParkingEye Limited (Respondent) v Beavis (Appellant)

**before**

**Lord Neuberger, President**
**Lord Mance**
**Lord Clarke**
**Lord Sumption**
**Lord Carnwath**
**Lord Toulson**
**Lord Hodge**

## JUDGMENT GIVEN ON

## 4 November 2015

**Heard on 21, 22 and 23 July 2015**

*Appellant (Cavendish Square Holding BV)*
Joanna Smith QC
Richard Leiper
James McCreath
Edwin Peel
(Instructed by Squire Patton Boggs (UK) LLP)

*Appellant (Beavis)*
John de Waal QC
David Lewis
Ryan Hocking
(Instructed by Harcus Sinclair)

*Respondent (Talal El Makdessi)*
Michael Bloch QC
Camilla Bingham QC

(Instructed by Clifford Chance LLP)

*Respondent (ParkingEye Limited)*
Jonathan Kirk QC
David Altaras
Thomas Samuels
(Instructed by Cubism Law)

*Intervener (Consumers' Association)*
Christopher Butcher QC
(Instructed by Consumers' Association In-House Lawyers)

**LORD NEUBERGER AND LORD SUMPTION: (with whom Lord Clarke and Lord Carnwath agree)**

1. These two appeals raise an issue which has not been considered by the Supreme Court or by the House of Lords for a century, namely the principles underlying the law relating to contractual penalty clauses, or, as we will call it, the penalty rule. The first appeal, *Cavendish Square Holding BV v Talal El Makdessi*, raises the issue in relation to two clauses in a substantial commercial contract. The second appeal, *ParkingEye Ltd v Beavis*, raises the issue at a consumer level, and it also raises a separate issue under the Unfair Terms in Consumer Contracts Regulations 1999 (SI 1999/2083) ("the 1999 Regulations").

2. We shall start by addressing the law on the penalty rule generally, and will then discuss the two appeals in turn.

## The law in relation to penalties

3. The penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well, and which in the opinion of some should simply be demolished, and in the opinion of others should be reconstructed and extended. For many years, the courts have struggled to apply standard tests formulated more than a century ago for relatively simple transactions to altogether more complex situations. The application of the rule is often adventitious. The test for distinguishing penal from other principles is unclear. As early as 1801, in *Astley v Weldon* (1801) 2 Bos & Pul 346, 350 Lord Eldon confessed himself, not for the first time, "much embarrassed in ascertaining the principle on which [the rule was] founded". Eighty years later, in *Wallis v Smith* (1882) 21 Ch D 243, 256, Sir George Jessel MR, not a judge noted for confessing ignorance, observed that "The ground of that doctrine I do not know". In 1966 Diplock LJ, not a judge given to recognising defeat, declared that he could "make no attempt, where so many others have failed, to rationalise this common law rule": *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1446. The task is no easier today. But unless the rule is to be abolished or substantially extended, its application to any but the clearest cases requires some underlying principle to be identified.

### *Equitable origins*

4. The penalty rule originated in the equitable jurisdiction to relieve from defeasible bonds. These were promises under seal to pay a specified sum of money,

subject to a proviso that they should cease to have effect on the satisfaction of a condition, usually performance of some other ("primary") obligation. By the beginning of the 16th century, the practice had grown up of taking defeasible bonds to secure the performance obligations sounding in damages. This enabled the holder of the bond to bring his action in debt, which made it unnecessary for him to prove his loss and made it possible to stipulate for substantially more than his loss. The common law enforced the bonds according to their letter. But equity regarded the real intention of the parties as being that the bond should stand as security only, and restrained its enforcement at common law on terms that the debtor paid damages, interest and costs. The classic statement of this approach is that of Lord Thurlow LC in *Sloman v Walter* (1783) 1 Bro CC 418, 419:

> "… where a penalty is inserted merely to secure the enjoyment of a collateral object, the enjoyment of the object is considered as the principal intent of the deed, and the penalty only as accessional, and, therefore, only to secure the damage really incurred ..."

5. The essential conditions for the exercise of the jurisdiction were (i) that the penal provision was intended as a security for the recovery of the true amount of a debt or damages, and (ii) that that objective could be achieved by restraining proceedings on the bond in the courts of common law, on terms that the defendant paid damages. As Lord Macclesfield observed in *Peachy v Duke of Somerset* (1720) 1 Strange 447, 453:

> "The true ground of relief against penalties is from the original intent of the case, where the penalty is designed only to secure money, and the court gives him all that he expected or desired: but it is quite otherwise in the present case. These penalties or forfeitures were never intended by way of compensation, for there can be none."

This last reservation remained an important feature of the equitable jurisdiction to relieve. As Baggallay LJ put it in *Protector Endowment Loan and Annuity Company v Grice* (1880) 5 QBD 592, 595, "where the intent is not simply to secure a sum of money, or the enjoyment of a collateral object, equity does not relieve".

*The common law rule*

6. The process by which the equitable rule was adopted by the common law is traced by Professor Simpson in his article *The penal bond with conditional*

*defeasance* (1966) 82 LQR 392, 418-419. Towards the end of the 17th century, the courts of common law tentatively began to stay proceedings on a penal bond to secure a debt, unless the plaintiff was willing to accept a tender of the money, together with interest and costs. The rule was regularised and extended by two statutes of 1696 and 1705. Section 8 of the Administration of Justice Act 1696 (8 & 9 Will 3 c 11) is a prolix provision whose effect was that the plaintiff suing in the common law courts on a defeasible bond to secure the performance of covenants (not just debts) was permitted to plead the breaches and have his actual damages assessed. Judgment was entered on the bond, but execution was stayed upon payment of the assessed damages. The Administration of Justice Act 1705 (4 & 5 Anne c 16) allowed the defendant in an action on the bond to pay the amount of the actual loss, together with interest and costs, into court, and rely on the payment as a defence. These statutes were originally framed as facilities for plaintiffs suing on bonds. But by the end of the 18th century the common law courts had begun to treat the statutory procedures as mandatory, requiring damages to be pleaded and proved and staying all further proceedings on the bond: see *Roles v Rosewell* (1794) 5 TR 538, *Hardy v Bern* (1794) 5 TR 636. The effect of this legislation was thus to make it unnecessary to proceed separately in chancery for relief from the penalty and in the courts of common law for the true loss. As a result, the equitable jurisdiction was rarely invoked, and the further development of the penalty rule was entirely the work of the courts of common law.

7. It developed, however, on wholly different lines. The equitable jurisdiction to relieve from penalties had been closely associated with the jurisdiction to relieve from forfeitures which developed at the same time. Both were directed to contractual provisions which on their face created primary obligations, but which during the 17th and 18th centuries the courts of equity treated as secondary obligations on the ground that the real intention was that they should stand as a mere security for performance. The court then intervened to grant relief from the rigours of the secondary obligation in order to secure performance in another, less penal or (in modern language) more proportionate, way. In contrast, the penalty rule as it was developed by the common law courts in the course of the 19th and 20th centuries proceeded on the basis that although penalties were secondary obligations, the parties meant what they said. They intended the provision to be applied according to the letter with a view to penalising breach. The law relieved the contract-breaker of the consequences not because the objective could be secured in another way but because the objective was contrary to public policy and should not therefore be given effect at all. The difference in approach to penalties of the courts of equity and the common law courts is in many ways a classic example of the contrast between the flexible if sometimes unpredictable approach of equity and the clear if relatively strict approach of the common law.

8. With the gradual decline of the use of penal defeasible bonds, the common law on penalties was developed almost entirely in the context of damages clauses –

ie clauses which provided for payment of a specified sum in place of common law damages. Because they were a contractual substitute for common law damages, they could not in any meaningful sense be regarded as a mere security for their payment. If the agreed sum was a penalty, it was treated as unenforceable. Starting with the decisions in *Astley* in 1801 and *Kemble v Farren* (1829) 6 Bing 141, the common law courts introduced the now familiar distinction between a provision for the payment of a sum representing a genuine pre-estimate of damages and a penalty clause in which the sum was out of all proportion to any damages liable to be suffered. By the middle of the 19th century, this rule was well established. In *Betts v Burch* (1859) 4 H & N 506, 509, Martin B regretted that he was "bound by the cases" and prevented from holding that "parties are at liberty to enter into any bargain they please" so that "if they have made an improvident bargain they must take the consequences". But Bramwell B (at p 511) appeared to have no such reservations.

9. The distinction between a clause providing for a genuine pre-estimate of damages and a penalty clause has remained fundamental to the modern law, as it is currently understood. The question whether a damages clause is a penalty falls to be decided as a matter of construction, therefore as at the time that it is agreed: *Public Works Comr v Hills* [1906] AC 368, 376; *Webster v Bosanquet* [1912] AC 394; *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79, at pp 86-87 (Lord Dunedin); and *Cooden Engineering Co Ltd v Stanford* [1953] 1 QB 86, 94 (Somervell LJ). This is because it depends on the character of the provision, not on the circumstances in which it falls to be enforced. It is a species of agreement which the common law considers to be by its nature contrary to the policy of the law. One consequence of this is that relief from the effects of a penalty is, as Hoffmann LJ put it in *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130, 144, "mechanical in effect and involves no exercise of discretion at all." Another is that the penalty clause is wholly unenforceable: *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6, 9, 10 (Lord Halsbury LC); *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689, 698 (Lord Reid), 703 (Lord Morris of Borth-y-Gest) and 723-724 (Lord Salmon); *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana (The "Scaptrade")* [1983] 2 AC 694, 702 (Lord Diplock); *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 191-193 (Mason and Wilson JJ). Deprived of the benefit of the provision, the innocent party is left to his remedy in damages under the general law. As Lord Diplock put it in *The "Scaptrade"* at p 702:

> "The classic form of penalty clause is one which provides that upon breach of a primary obligation under the contract a secondary obligation shall arise on the part of the party in breach to pay to the other party a sum of money which does not represent a genuine pre-estimate of any loss likely to be sustained by him as the result of the breach of primary

> obligation but is substantially in excess of that sum. The classic form of relief against such a penalty clause has been to refuse to give effect to it, but to award the common law measure of damages for the breach of primary obligation instead."

10. Equity, on the other hand, relieves against forfeitures "where the primary object of the bargain is to secure a stated result which can effectively be attained when the matter comes before the court, and where the forfeiture provision is added by way of security for the production of that result": *Shiloh Spinners Ltd v Harding* [1973] AC 691, 723 (Lord Wilberforce). As Lord Wilberforce said at p 722, the paradigm cases are the jurisdiction to relieve from a right of re-entry in a lease of land and the mortgagor's equity of redemption (and the associated equitable right to redeem) in relation to mortgages. Save in relation to non-payment of rent, the power to grant relief from forfeiture to lessees is now contained in section 146 of the Law of Property Act 1925, and probably exclusively so (see *Official Custodian for Charities v Parway Estates Departments Ltd* [1985] Ch 151). Relief for mortgagors through the equitable right to redeem is (save in relation to most residential properties) largely still based on judge-made law. However, neither by statute nor on general principles of equity is a lessor's right of re-entry or a mortgagee's right of sale or foreclosure treated as being by its nature contrary to the policy of the law. What equity (and, where it applies, statute) typically considers to be contrary to the policy of the law is the enforcement of such rights in circumstances where their purpose, namely the performance of the obligations in the lease or the mortgage, can be achieved in other ways – normally by late substantive compliance and payment of appropriate compensation. The forfeiture or foreclosure/power of sale is therefore enforceable, equity intervening only to impose terms. These will generally require the lessee or mortgagor to rectify the breach and make good any loss suffered by the lessor or mortgagee. If the lessee or mortgagee cannot or will not do so, the forfeiture will be unconditionally enforced – although perhaps not invariably (see per Lord Templeman in *Associated British Ports v CH Bailey plc* [1990] 2 AC 703, 707-708 in the context of section 146, and, more generally, the judgments in *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd (No 3)* [2013] UKPC 20, [2015] 2 WLR 875).

11. The penalty rule as it has been developed by the judges gives rise to two questions, both of which have a considerable bearing on the questions which arise on these appeals. In what circumstances is the rule engaged at all? And what makes a contractual provision penal?

*In what circumstances is the penalty rule engaged?*

12. In England, it has always been considered that a provision could not be a penalty unless it provided an exorbitant alternative to common law damages. This

meant that it had to be a provision operating upon a breach of contract. In *Moss Empires Ltd v Olympia (Liverpool) Ltd* [1939] AC 544, this was taken for granted by Lord Atkin (p 551) and Lord Porter (p 558). As a matter of authority the question is settled in England by the decision of the House of Lords in *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 ("*ECGD*"). Lord Roskill, with whom the rest of the committee agreed, said at p 403:

> "[P]erhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant. But it is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an onerous or possibly even a commercially imprudent bargain."

As Lord Hodge points out in his judgment, the Scottish authorities are to the same effect.

13. This principle is worth restating at the outset of any analysis of the penalty rule, because it explains much about the way in which it has developed. There is a fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach. Leaving aside challenges going to the reality of consent, such as those based on fraud, duress or undue influence, the courts do not review the fairness of men's bargains either at law or in equity. The penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves. This was not a new concept in 1983, when *ECGD* was decided. It had been the foundation of the equitable jurisdiction, which depended on the treatment of penal defeasible bonds as secondary obligations or, as Lord Thurlow LC put it in 1783 in *Sloman* as "collateral" or "accessional" to the primary obligation. And it provided the whole basis of the classic distinction made at law between a penalty and a genuine pre-estimate of loss, the former being essentially a way of punishing the contract-breaker rather than compensating the innocent party for his breach. We shall return to that distinction below.

14. This means that in some cases the application of the penalty rule may depend on how the relevant obligation is framed in the instrument, ie whether as a conditional primary obligation or a secondary obligation providing a contractual alternative to damages at law. Thus, where a contract contains an obligation on one party to perform an act, and also provides that, if he does not perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which is capable of being a penalty; but 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.

15. However, the capricious consequences of this state of affairs are mitigated by the fact that, as the equitable jurisdiction shows, the classification of terms for the purpose of the penalty rule depends on the substance of the term and not on its form or on the label which the parties have chosen to attach to it. As Lord Radcliffe said in *Campbell Discount Co Ltd v Bridge* [1962] AC 600, 622, "[t]he intention of the parties themselves", by which he clearly meant the intention as expressed in the agreement, "is never conclusive and may be overruled or ignored if the court considers that even its clear expression does not represent 'the real nature of the transaction' or what 'in truth' it is taken to be" (and cf per Lord Templeman in *Street v Mountford* [1985] AC 809, 819). This aspect of the equitable jurisdiction was inherited by the courts of common law, and has been firmly established since the earliest common law cases.

16. Payment of a sum of money is the classic obligation under a penalty clause and, in almost every reported case involving a damages clause, the provision stipulates for the payment of money. However, it seems to us that there is no reason why an obligation to transfer assets (either for nothing or at an undervalue) should not be capable of constituting a penalty. While the penalty rule may be somewhat artificial, it would heighten its artificiality to no evident purpose if it were otherwise. Similarly, the fact that a sum is paid over by one party to the other party as a deposit, in the sense of some sort of surety for the first party's contractual performance, does not prevent the sum being a penalty, if the second party in due course forfeits the deposit in accordance with the contractual terms, following the first party's breach of contract – see the Privy Council decisions in *Public Works Comr v Hills* [1906] AC 368, 375-376, and *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573. By contrast, in *Else (1982)* at p 146, Hoffmann LJ, citing *Stockloser v Johnson* [1954] 1 QB 476 in support, said that, unlike a case where "money has been deposited as security for due performance of [a] party's obligation", "retention of instalments which have been paid under contract so as to become the absolute property of the vendor does not fall within the penalty rule", although, he added that it was "subject … to the jurisdiction for relief against forfeiture".

17. The relationship between penalty clauses and forfeiture clauses is not entirely easy. Given that they had the same origin in equity, but that the law on penalties was then developed through common law while the law on forfeitures was not, this is unsurprising. Some things appear to be clear. Where a proprietary interest or a "proprietary or possessory right" (such as a patent or a lease) is granted or transferred subject to revocation or determination on breach, the clause providing

for determination or revocation is a forfeiture and cannot be a penalty, and, while it is enforceable, relief from forfeiture may be granted: see *BICC plc v Burndy Corpn* [1985] Ch 232, 246-247 and 252 (Dillon LJ) and *The "Scaptrade"*, pp 701-703, (Lord Diplock). But this does not mean that relief from forfeiture is unavailable in cases not involving land – see *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd (No 2)* [2013] UKPC 2, [2015] 2 WLR 875, especially at paras 92-97, and the cases cited there.

18. What is less clear is whether a provision is capable of being both a penalty clause and a forfeiture clause. It is inappropriate to consider that issue in any detail in this judgment, as we have heard very little argument on forfeitures – unsurprisingly because in neither appeal has it been alleged that any provision in issue is a forfeiture from which relief could be granted. But it is right to mention the possibility that, in some circumstances, a provision could, at least potentially, be a penalty clause as well as a forfeiture clause. We see the force of the arguments to that effect advanced by Lord Mance and Lord Hodge in their judgments.

*What makes a contractual provision penal?*

19. As we have already observed, until relatively recently this question was answered almost entirely by reference to straightforward liquidated damages clauses. It was in that context that the House of Lords sought to restate the law in two seminal decisions at the beginning of the 20th century, *Clydebank* in 1904 and *Dunlop* in 1915.

20. *Clydebank* was a Scottish appeal about a shipbuilding contract with a provision (described as a "penalty") for the payment of £500 per week for delayed delivery. The provision was held to be a valid liquidated damages clause, not a penalty. Lord Halsbury (p 10) said that the distinction between the two depended on

> "whether it is, what I think gave the jurisdiction to the courts in both countries to interfere at all in an agreement between the parties, unconscionable and extravagant, and one which no court ought to allow to be enforced."

Lord Halsbury declined to lay down any "abstract rule" for determining what was unconscionable or extravagant, saying only that it must depend on "the nature of the transaction – the thing to be done, the loss likely to accrue to the person who is endeavouring to enforce the performance of the contract, and so forth". Lord Halsbury's formulation has proved influential, and the two other members of the Appellate Committee both delivered concurring judgments agreeing with it. It is,

however, worth drawing attention to an observation of Lord Robertson (pp 19-20) which points to the principle underlying the contrasting expressions "liquidated damages" and "penalty":

> "Now, all such agreements, whether the thing be called penalty or be called liquidate damage, are in intention and effect what Professor Bell calls 'instruments of restraint', and in that sense penal. But the clear presence of this does not in the least degree invalidate the stipulation. The question remains, had the respondents no interest to protect by that clause, or was that interest palpably incommensurate with the sums agreed on? It seems to me that to put this question, in the present instance, is to answer it."

21. *Dunlop* arose out of a contract for the supply of tyres, covers and tubes by a manufacturer to a garage. The contract contained a number of terms designed to protect the manufacturer's brand, including prohibitions on tampering with the marks, restrictions on the unauthorised export or exhibition of the goods, and on resales to unapproved persons. There was also a resale price maintenance clause, which would now be unlawful but was a legitimate restriction of competition according to the notions prevailing in 1914. It was this clause which the purchaser had broken. The contract provided for the payment of £5 for every tyre, cover or tube sold in breach of any provision of the agreement. Once again, the provision was held to be a valid liquidated damages clause. In his speech, Lord Dunedin formulated four tests "which, if applicable to the case under consideration, may prove helpful, or even conclusive" (p 87). They were (a) that the provision would be penal if "the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach"; (b) that the provision would be penal if the breach consisted only in the non-payment of money and it provided for the payment of a larger sum; (c) that there was "a presumption (but no more)" that it would be penal if it was payable in a number of events of varying gravity; and (d) that it would not be treated as penal by reason only of the impossibility of precisely pre-estimating the true loss.

22. Lord Dunedin's speech in *Dunlop* achieved the status of a quasi-statutory code in the subsequent case-law. Some of the many decisions on the validity of damages clauses are little more than a detailed exegesis or application of his four tests with a view to discovering whether the clause in issue can be brought within one or more of them. In our view, this is unfortunate. In the first place, Lord Dunedin proposed his four tests not as rules but only as considerations which might prove helpful or even conclusive "if applicable to the case under consideration". He did not suggest that they were applicable to every case in which the law of penalties was engaged. Second, as Lord Dunedin himself acknowledged, the essential question was whether the clause impugned was "unconscionable" or "extravagant". The four

tests are a useful tool for deciding whether these expressions can properly be applied to simple damages clauses in standard contracts. But they are not easily applied to more complex cases. To deal with those, it is necessary to consider the rationale of the penalty rule at a more fundamental level. What is it that makes a provision for the consequences of breach "unconscionable"? And by comparison with what is a penalty clause said to be "extravagant"? Third, none of the other three Law Lords expressly agreed with Lord Dunedin's reasoning, and the four tests do not all feature in any of their speeches. Indeed, it appears that, in his analysis at pp 101-102, Lord Parmoor may have taken a more restrictive view of what constituted a penalty than did Lord Dunedin. More generally, the other members of the Appellate Committee gave their own reasons for concurring in the result, and they also repay consideration. For present purposes, the most instructive is that of Lord Atkinson, who approached the matter on an altogether broader basis.

23. Lord Atkinson pointed (pp 90-91) to the critical importance to Dunlop of the protection of their brand, reputation and goodwill, and their authorised distribution network. Against this background, he observed (pp 91-92):

> "It has been urged that as the sum of £5 becomes payable on the sale of even one tube at a shilling less than the listed price, and as it was impossible that the appellant company should lose that sum on such a transaction, the sum fixed must be a penalty. In the sense of direct and immediate loss the appellants lose nothing by such a sale. It is the agent or dealer who loses by selling at a price less than that at which he buys, but the appellants have to look at their trade *in globo*, and to prevent the setting up, in reference to all their goods anywhere and everywhere, a system of injurious undercutting. The object of the appellants in making this agreement, if the substance and reality of the thing and the real nature of the transaction be looked at, would appear to be a single one, namely, to prevent the disorganization of their trading system and the consequent injury to their trade in many directions. The means of effecting this is by keeping up their price to the public to the level of their price list, this last being secured by contracting that a sum of £5 shall be paid for every one of the three classes of articles named sold or offered for sale at prices below those named on the list. The very fact that this sum is to be paid if a tyre cover or tube be merely offered for sale, though not sold, shows that it was the consequential injury to their trade due to undercutting that they had in view. They had an obvious interest to prevent this undercutting, and on the evidence it would appear to me impossible to say that that interest was incommensurate with the sum agreed to be paid."

Lord Atkinson went on to draw an analogy, which has particular resonance in the *Cavendish* appeal, with a clause dealing with damages for breach of a restrictive covenant on the canvassing of business by a former employee. In this context, he said (pp 92-93):

> "It is, I think, quite misleading to concentrate one's attention upon the particular act or acts by which, in such cases as this, the rivalry in trade is set up, and the repute acquired by the former employee that he works cheaper and charges less than his old master, and to lose sight of the risk to the latter that old customers, once tempted to leave him, may never return to deal with him, or that business that might otherwise have come to him may be captured by his rival. The consequential injuries to the trader's business arising from each breach by the employee of his covenant cannot be measured by the direct loss in a monetary point of view on the particular transaction constituting the breach."

Lord Atkinson was making substantially the same point as Lord Robertson had made in *Clydebank*. The question was: what was the nature and extent of the innocent party's interest in the performance of the relevant obligation. That interest was not necessarily limited to the mere recovery of compensation for the breach. Lord Atkinson considered that the underlying purpose of the resale price maintenance clause gave Dunlop a wider interest in enforcing the damages clause than pecuniary compensation. £5 per item was not incommensurate with that interest even if it was incommensurate with the loss occasioned by the wrongful sale of a single item.

24. Although the other members of the Appellate Committee did not express themselves in the same terms as Lord Atkinson, their approach was entirely consistent with his. Lord Parker at p 97 said that "whether the sum agreed to be paid on the breach is really a penalty must depend on the circumstances of each particular case", and at p 99, echoing Lord Atkinson's fuller treatment of the point, as just set out, he described the damage which would result from any breach as "consist[ing] in the disturbance or derangement of the system of distribution by means of which [Dunlop's] goods reach the ultimate consumer". In their speeches, Lord Dunedin (p 87), Lord Parker (p 98) and Lord Parmoor (p 103) ultimately were content to rest their decision that the £5 was not a penalty on the ground that an exact pre-estimate of loss was impossible, whereas, in the passages quoted above, Lord Atkinson analysed why that was so. It seems clear that the actual result of the case was strongly influenced by Lord Atkinson's reasoning. The clause was upheld although, on the face of it, it failed all but the last of Lord Dunedin's tests. The £5 per item applied to breaches of very variable significance and it was impossible to relate the loss attributable to the sale of that item. It was justifiable only by reference to the wider interests identified by Lord Atkinson.

25. The great majority of cases decided in England since *Dunlop* have concerned more or less standard damages clauses in consumer contracts, and Lord Dunedin's four tests have proved perfectly adequate for dealing with those. More recently, however, the courts have returned to the possibility of a broader test in less straightforward cases, in the context of the supposed "commercial justification" for clauses which might otherwise be regarded as penal. An early example is the decision of the House of Lords in *The "Scaptrade"*, where at p 702, Lord Diplock, with whom the rest of the Appellate Committee agreed, observed that a right to withdraw a time-chartered vessel for non-payment of advance hire was not a penalty because its commercial purpose was to create a fund from which the cost of providing the chartered service could be funded.

26. In *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752, Colman J was concerned with a common form provision in a syndicated loan agreement for interest to be payable at a higher rate during any period when the borrower was in default. There was authority that such provisions were penal: *Lady Holles v Wyse* (1693) 2 Vern 289; *Strode v Parker* (1694) 2 Vern 316, *Wallingford v Mutual Society* (1880) 5 App Cas 685, 702 (Lord Hatherley). But Colman J held that the clause was valid because its predominant purpose was not to deter default but to reflect the greater credit risk associated with a borrower in default. At pp 763-764, he observed that a provision for the payment of money upon breach could not be categorised as a penalty simply because it was not a genuine pre-estimate of damages, saying that there would seem to be:

> "no reason in principle why a contractual provision the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach."

27. Colman J's approach was approved by Mance LJ, delivering the leading judgment in the Court of Appeal in *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2004] 1 CLC 401, para 13. A similar view was taken by Arden LJ in *Murray v Leisureplay plc* [2005] IRLR 946, para 54, where she posed the question

> "Has the party who seeks to establish that the clause is a penalty shown that the amount payable under the clause was imposed *in terrorem*, or that it does not constitute a genuine pre-estimate of loss for the purposes of the *Dunlop* case, and, if he has shown the latter, is there some other reason which justifies the

> discrepancy between [the amount payable under the clause and the amount payable by way of damages in common law]?" (emphasis added).

She considered that the clause in question had advantages for both sides, and pointed out that no evidence had been adduced to show that the clause lacked commercial justification: see paras 70-76. But Buxton LJ put the matter on a wider basis for which Clarke LJ (para 105) expressed a preference. He referred to the speech of Lord Atkinson in *Dunlop* and suggested that the ratio of the actual decision in that case had been that "an explanation of the clause in commercial rather than deterrent terms was available". All three members of the court endorsed the approach of Colman J in *Lordsvale* and Mance LJ in *Cine Bes*.

28. Colman J in *Lordsvale* and Arden LJ in *Murray* were inclined to rationalise the introduction of commercial justification as part of the test, by treating it as evidence that the impugned clause was not intended to deter. Later decisions in which a commercial rationale has been held inconsistent with the application of the penalty rule, have tended to follow that approach: see, for example, *Euro London Appointments Ltd v Claessens International Ltd* [2006] 2 Lloyd's Rep 436, *General Trading Company (Holdings) Ltd v Richmond Corpn Ltd* [2008] 2 Lloyd's Rep 475. It had the advantage of enabling them to reconcile the concept of commercial justification with Lord Dunedin's four tests. But we have some misgivings about it. The assumption that a provision cannot have a deterrent purpose if there is a commercial justification, seems to us to be questionable. By the same token, we agree with Lord Radcliffe's observations in *Campbell Discount* at p 622, where he said:

> "… I do not myself think that it helps to identify a penalty, to describe it as in the nature of a threat 'to be enforced *in terrorem*' (to use Lord Halsbury's phrase in *Elphinstone v Monkland Iron & Coal Co Ltd* (1886) 11 App Cas 332, 348). I do not find that that description adds anything of substance to the idea conveyed by the word 'penalty' itself, and it obscures the fact that penalties may quite readily be undertaken by parties who are not in the least terrorised by the prospect of having to pay them and yet are, as I understand it, entitled to claim the protection of the court when they are called upon to make good their promises."

Moreover, the penal character of a clause depends on its purpose, which is ordinarily an inference from its effect. As we have already explained, this is a question of construction, to which evidence of the commercial background is of course relevant in the ordinary way. But, for the same reason, the answer cannot depend on evidence

of actual intention: see *Chartbrook Ltd v Persimmon Homes Ltd* [2009] AC 1101, paras 28-47 (Lord Hoffmann). However, while we have misgivings about some aspects of their reasoning, these aspects are peripheral to the essential point which Colman J and Buxton LJ were making, and we consider that their emphasis on justification provides a valuable insight into the real basis of the penalty rule. It is the same insight as that of Lord Robertson in *Clydebank* and Lord Atkinson in *Dunlop*. A damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach. This must depend on whether the innocent party has a legitimate interest in performance extending beyond the prospect of pecuniary compensation flowing directly from the breach in question.

29. The availability of remedies for a breach of duty is not simply a question of providing a financial substitute for performance. It engages broader social and economic considerations, one of which is that the law will not generally make a remedy available to a party, the adverse impact of which on the defaulter significantly exceeds any legitimate interest of the innocent party. In the famous case of *White & Carter (Councils) Ltd v McGregor* [1962] AC 413, Lord Reid observed, at p 431:

> "It may well be that, if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other party with an additional burden with no benefit to himself. If a party has no interest to enforce a stipulation, he cannot in general enforce it: so it might be said that, if a party has no interest to insist on a particular remedy, he ought not to be allowed to insist on it. And, just as a party is not allowed to enforce a penalty, so he ought not to be allowed to penalise the other party by taking one course when another is equally advantageous to him. … Here the respondent did not set out to prove that the appellants had no legitimate interest in completing the contract and claiming the contract price rather than claiming damages. … Parliament has on many occasions relieved parties from certain kinds of improvident or oppressive contracts, but the common law can only do that in very limited circumstances."

In *White & Carter* the innocent party was entitled to ignore the repudiation of the contract-breaker and proceed to perform, claiming his remuneration in debt rather than limiting himself to damages, notwithstanding that this course might be a great deal more expensive for the contract-breaker. This, according to Lord Reid (p 431), was because the contract-breaker "did not set out to prove that the appellants had no legitimate interest in completing the contract and claiming the contract price rather than claiming damages".

30. More generally, the attitude of the courts, reflecting that of the Court of Chancery, is that specific performance of contractual obligations should ordinarily be refused where damages would be an adequate remedy. This is because the minimum condition for an order of specific performance is that the innocent party should have a legitimate interest extending beyond pecuniary compensation for the breach. The paradigm case is the purchase of land or certain chattels such as ships, which the law recognises as unique. Because of their uniqueness the purchaser's interest extends beyond the mere award of damages as a substitute for performance. As Lord Hoffmann put it in addressing a very similar issue "the purpose of the law of contract is not to punish wrongdoing but to satisfy the expectations of the party entitled to performance": *Co-operative Insurance Society Ltd v Argyll Stores (Holdings) Ltd* [1998] AC 1, 15.

31. In our opinion, the law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions: between a penalty and genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent. These distinctions originate in an over-literal reading of Lord Dunedin's four tests and a tendency to treat them as almost immutable rules of general application which exhaust the field. In *Legione v Hateley* (1983) 152 CLR 406, 445, Mason and Deane JJ defined a penalty as follows:

> "A penalty, as its name suggests, is in the nature of a punishment for non-observance of a contractual stipulation; it consists of the imposition of an additional or different liability upon breach of the contractual stipulation ..."

All definition is treacherous as applied to such a protean concept. This one can fairly be said to be too wide in the sense that it appears to be apt to cover many provisions which would not be penalties (for example most, if not all, forfeiture clauses). However, in so far as it refers to "punishment" and "an additional or different liability" as opposed to "*in terrorem*" and "genuine pre-estimate of loss", this definition seems to us to get closer to the concept of a penalty than any other definition we have seen. The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not therefore, at any rate without more, mean that it is penal. To describe it as a deterrent (or, to use the Latin equivalent, *in terrorem*) does not add anything. A deterrent provision in a contract is simply one species of provision designed to influence the conduct of the party potentially affected. It is no different in this respect from a contractual inducement. Neither is it inherently penal or contrary to the policy of the law. The question whether it is enforceable should depend on whether the means by which the contracting party's conduct is to be influenced are "unconscionable" or

(which will usually amount to the same thing) "extravagant" by reference to some norm.

32. 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. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance. In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach, and we therefore expect that Lord Dunedin's four tests would usually be perfectly adequate to determine its validity. But compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations. This was recognised in the early days of the penalty rule, when it was still the creature of equity, and is reflected in Lord Macclesfield's observation in *Peachy* (quoted in para 5 above) about the application of the penalty rule to provisions which were "never intended by way of compensation", for which equity would not relieve. It was reflected in the result in *Dunlop*. And it is recognised in the more recent decisions about commercial justification. And, as Lord Hodge shows, it is the principle underlying the Scottish authorities.

33. The penalty rule is an interference with freedom of contract. It undermines the certainty which parties are entitled to expect of the law. Diplock LJ was neither the first nor the last to observe that "The court should not be astute to descry a 'penalty clause'": *Robophone* at p 1447. As Lord Woolf said, speaking for the Privy Council in *Philips Hong Kong Ltd v Attorney General of Hong Kong* (1993) 61 BLR 41, 59, "the court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld", not least because "[a]ny other approach will lead to undesirable uncertainty especially in commercial contracts".

34. Although the penalty rule originates in the concern of the courts to prevent exploitation in an age when credit was scarce and borrowers were particularly vulnerable, the modern rule is substantive, not procedural. It does not normally depend for its operation on a finding that advantage was taken of one party. As Lord Wright MR observed in *Imperial Tobacco Company (of Great Britain) and Ireland v Parslay* [1936] 2 All ER 515, 523:

> "A millionaire may enter into a contract in which he is to pay liquidated damages, or a poor man may enter into a similar contract with a millionaire, but in each case the question is exactly the same, namely, whether the sum stipulated as damages for the breach was exorbitant or extravagant ..."

35. But for all that, the circumstances in which the contract was made are not entirely irrelevant. In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach. In that connection, it is worth noting that in *Philips Hong Kong* at pp 57-59, Lord Woolf specifically referred to the possibility of taking into account the fact that "one of the parties to the contract is able to dominate the other as to the choice of the terms of a contract" when deciding whether a damages clause was a penalty. In doing so, he reflected the view expressed by Mason and Wilson JJ in *AMEV-UDC* at p 194 that the courts were thereby able to "strike a balance between the competing interests of freedom of contract and protection of weak contracting parties" (citing Atiyah, *The Rise and Fall of Freedom of Contract* (1979), Chapter 22). However, Lord Woolf was rightly at pains to point out that this did not mean that the courts could thereby adopt "some broader discretionary approach". The notion that the bargaining position of the parties may be relevant is also supported by Lord Browne-Wilkinson giving the judgment of the Privy Council in *Workers Bank*. At p 580, he rejected the notion that "the test of reasonableness [could] depend upon the practice of one class of vendor, which exercises considerable financial muscle" as it would allow such people "to evade the law against penalties by adopting practices of their own". In his judgment, he decided that, in contracts for sale of land, a clause providing for a forfeitable deposit of 10% of the purchase price was valid, although it was an anomalous exception to the penalty rule. However, he held that the clause providing for a forfeitable 25% deposit in that case was invalid because "in Jamaica, the customary deposit has been 10%" and "[a] vendor who seeks to obtain a larger amount by way of forfeitable deposit must show special circumstances which justify such a deposit", which the appellant vendor in that case failed to do.

*Should the penalty rule be abrogated?*

36. The primary case of Miss Smith QC, who appeared for Cavendish in the first appeal, was that the penalty rule should now be regarded as antiquated, anomalous and unnecessary, especially in the light of the growing importance of statutory regulation in this field. It is the creation of the judges, and, she argued, the judges should now take the opportunity to abolish it. There is a case to be made for taking this course. It was expounded with considerable forensic skill by Miss Smith, and has some powerful academic support: see Sarah Worthington, *Common Law Values: the Role of Party Autonomy in Private Law*, in *The Common Law of Obligations: Divergence and Unity* (ed A Robertson and M Tilbury (2015)), pp 18-26. We rather doubt that the courts would have invented the rule today if their predecessors had not done so three centuries ago. But this is not the way in which English law develops, and we do not consider that judicial abolition would be a proper course for this court to take.

37. The first point to be made is that the penalty rule is not only a long-standing principle of English law, but is common to almost all major systems of law, at any rate in the western world. It has existed in England since the 16th century and can be traced back to the same period in Scotland: McBryde, *The Law of Contract in Scotland*, 3rd ed (2007), paras 22-148. The researches of counsel have shown that it has been adopted with some variants in all common law jurisdictions, including those of the United States. A corresponding rule was derived from Roman law by Pothier, *Traité des Obligations*, No 346, which is to be found in the Civil Codes of France (article 1152), Germany (for non-commercial contracts only) (sections 343, 348), Switzerland (article 163.3), Belgium (article 1231) and Italy (article 1384). It is included in influential attempts to codify the law of contracts internationally, including the Unidroit *Principles of International Commercial Contracts* (2010) (article 7.4.13), and the UNCITRAL *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance* (article 6). In January 1978 the Committee of Ministers of the Council of Europe recommended a number of common principles relating to penal clauses, including (article 7) that a stipulated sum payable on breach "may be reduced by the court when it is manifestly excessive".

38. It is true that statutory regulation, which hardly existed at the time that the penalty rule was developed, is now a significant feature of the law of contract. In England, the landmark legislation was the Unfair Contract Terms Act 1977. For most purposes, the Act was superseded by the Unfair Terms in Consumer Contracts Regulations 1994 (SI 1994/3159), which was in turn replaced by the 1999 Regulations, both of which give effect to European Directives. The 1999 Regulations contain an "indicative and non-exhaustive list of the terms which may be regarded as unfair", including terms which have the object or effect of "requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation". Nonetheless, statutory regulation is very far from covering the whole field. Penalty clauses are controlled by the 1999 Regulations, but the Regulations apply only to consumer contracts and the control of unfair terms under regulations 3 and 5 is limited to those which have not been individually negotiated. There are major areas, notably non-consumer contracts, which are not regulated by statute. Some of those who enter into such contracts, for example professionals and small businesses, may share many of the characteristics of consumers which are thought to make the latter worthy of legal protection. The English Law Commission considered penalty clauses in 1975 (Working Paper No 61, *Penalty Clauses and Forfeiture of Monies Paid*, April 1975), at a time when there was no relevant statutory regulation, and the Scottish Law Commission reported on them in May 1999 (Report No 171). Neither of these Reports recommended abolition of the rule. On the contrary, both recommended legislation which would have expanded its scope.

39. Further, although there are justified criticisms that can be made of the penalty rule, it is consistent with other well-established principles which have been developed by judges (albeit mostly in the Chancery courts) and which involve the court in declining to give full force to contractual provisions, such as relief from forfeiture, the equity of redemption, and refusal to grant specific performance, as discussed in paras 10-11 and 29-30 above. Finally, the case for abolishing the rule depends heavily on anomalies in the operation of the law as it has traditionally been understood. Many, though not all of these are better addressed (i) by a realistic appraisal of the substance of contractual provisions operating upon breach, and (ii) by taking a more principled approach to the interests that may properly be protected by the terms of the parties' agreement.

*Should the penalty rule be extended?*

40. In the course of his cogent submissions, Mr Bloch QC, who appeared for Mr Makdessi on the first appeal, suggested that, as an alternative to confirming or abrogating the penalty rule, this court could extend it, so that it applied more generally. As he pointed out, this was the course taken by the High Court of Australia, and it would have the advantage of rendering the penalty rule less formalistic in its application, and, which may be putting the point in a different way, less capable of avoidance by ingenious drafting.

41. This step has recently been taken in Australia. Until recently, the law in Australia was the same as it is in England: see *IAC Leasing Ltd v Humphrey* (1972) 126 CLR 131, 143 (Walsh J); *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359, 390 (Brennan J); *AMEV-UDC* at p 184 (Mason and Wilson JJ, citing *ECGD* among other authorities), 211 (Dawson J); *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 662. However, a radical departure from the previous understanding of the law occurred with the decision of the High Court of Australia in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205. The background to this case was very similar to that in *Office of Fair Trading v Abbey National plc* [2010] 1 AC 696. It concerned the application of the penalty rule to contractual bank charges payable when the bank bounced a cheque or allowed the customer to draw in excess of his available funds or agreed overdraft limit. These might in a loose sense be regarded as banking irregularities, but they did not involve any breach of contract on the part of the customer. On that ground Andrew Smith J had held in the *Abbey National* case that the charges were incapable of being penalties: [2008] 2 All ER (Comm) 625, paras 295-299 (the point was not appealed). In *Andrews*, the High Court of Australia disagreed. They engaged in a detailed historical examination of the equitable origin of the rule and concluded that there subsisted, independently of the common law rule, an equitable jurisdiction to relieve against any sufficiently onerous provision which was conditional upon a failure to observe some other provision, whether or not that failure was a breach of contract. At para 10, they defined a penalty as follows:

> "In general terms, a stipulation prima facie imposes a penalty on a party (the first party) if, as a matter of substance, it is collateral (or accessory) to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party. In that sense, the collateral or accessory stipulation is described as being in the nature of a security for and *in terrorem* of the satisfaction of the primary stipulation. If compensation can be made to the second party for the prejudice suffered by failure of the primary stipulation, the collateral stipulation and the penalty are enforced only to the extent of that compensation. The first party is relieved to that degree from liability to satisfy the collateral stipulation."

42. Any decision of the High Court of Australia has strong persuasive force in this court. But we cannot accept that English law should take the same path, quite apart from its inconsistency with established and unchallenged House of Lords authority. In the first place, although the reasoning in *Andrews* was entirely historical, it is not in fact consistent with the equitable rule as it developed historically. The equitable jurisdiction to relieve from penalties arose wholly in the context of bonds defeasible in the event of the performance of a contractual obligation. It necessarily posited a breach of that obligation. Secondly, if there is a distinct and still subsisting equitable jurisdiction to relieve against penalties which is wider than the common law jurisdiction, with three possible exceptions it appears to have left no trace in the authorities since the fusion of law and equity in 1873. The first arguable exception is in *In re Dagenham (Thames) Dock Co; Ex p Hulse* (1873) LR 8 Ch App 1022 (followed by the Privy Council in *Kilmer v British Columbia Orchard Lands Ltd* [1913] AC 319), where the Court of Appeal granted a purchaser, who had been in possession for five years and carried out improvements, further time to pay the second and final instalment of a purchase price on the ground that the clause requiring him to vacate and to forfeit the first instalment for not having paid the second instalment on time, was a "penalty". However, James and Mellish LJJ may have been treating the clause as a forfeiture (as they both also used that expression in their brief judgments), and in any event they treated the purchaser in the same way as a mortgagor in possession asking for more time to pay. Further, as Romer LJ pointed out in *Stockloser* at pp 497-498, the decision could be justified by the fact that time had already been extended twice by agreement, and in any event there was no question of the vendor being required to repay the first instalment. The second arguable exception is no more than an unsupported throw-away line in the judgment of Diplock LJ in *Robophone* at p 1446, where he said it was "by no means clear" whether penalty clauses "are simply void", but, on analysis, he was dealing with a rather different point (namely that discussed by Lord Atkin in the passage that follows). The third exception is the unsatisfactory decision in *Jobson v Johnson* [1989] 1 WLR 1026, to which we shall return in paras

84-87 below. It is relevant to add in this connection that the law of penalties has been held to be the same in England and Scotland: Stair Memorial Encyclopaedia of the Laws of Scotland, vol 15, paras 783-801, and see *Clydebank*. Yet equity, although influential, has never been a distinct branch of Scots law. In the modern law of both countries, the penalty rule is an aspect of the law of contract. Thirdly, the High Court's redefinition of a penalty is, with respect, difficult to apply to the case to which it is supposedly directed, namely where there is no breach of contract. It treats as a potential penalty any clause which is "in the nature of a security for and *in terrorem* of the satisfaction of the primary stipulation." By a "security" it means a provision to secure "compensation … for the prejudice suffered by the failure of the primary stipulation". This analysis assumes that the "primary stipulation" is some kind of promise, in which case its failure is necessarily a breach of that promise. If, for example, there is no duty not to draw cheques against insufficient funds, it is difficult to see where compensation comes into it, or how bank charges for bouncing a cheque or allowing the customer to overdraw can be regarded as securing a right of compensation. Finally, the High Court's decision does not address the major legal and commercial implications of transforming a rule for controlling remedies for breach of contract into a jurisdiction to review the content of the substantive obligations which the parties have agreed. Modern contracts contain a very great variety of contingent obligations. Many of them are contingent on the way that the parties choose to perform the contract. There are provisions for termination upon insolvency, contractual payments due on the exercise of an option to terminate, break-fees chargeable on the early repayment of a loan or the closing out of futures contracts in the financial or commodity markets, provisions for variable payments dependent on the standard or speed of performance and "take or pay" provisions in long-term oil and gas purchase contracts, to take only some of the more familiar types of clause. The potential assimilation of all of these to clauses imposing penal remedies for breach of contract would represent the expansion of the courts' supervisory jurisdiction into a new territory of uncertain boundaries, which has hitherto been treated as wholly governed by mutual agreement.

43. We would accept that the application of the penalty rule can still turn on questions of drafting, even where a realistic approach is taken to the substance of the transaction and not just its form. But we agree with what Hoffmann LJ said in *Else (1982)* at p 145, namely that, while it is true that the question whether the penalty rule applies may sometimes turn on "somewhat formal distinction[s]", this can be justified by the fact that the rule "being an inroad upon freedom of contract which is inflexible … ought not to be extended", at least by judicial, as opposed to legislative, decision-making.

## The first appeal: Cavendish v El Makdessi

*The factual and procedural history*

44. Mr Makdessi founded a group of companies ("the Group") which by 2008 had become the largest advertising and marketing communications group in the Middle East, and operated through a network of around 20 companies with more than 30 offices in over 15 countries. At that time, Mr Makdessi was one of the most influential Lebanese business leaders, his name was closely identified with the business of the Group, and he had very strong relationships with its clients and senior employees.

45. In 2008, the holding company of the Group was Team Y & R Holdings Hong Kong Ltd ("the Company"). The Company had 1,000 issued shares, which were owned by Mr Makdessi and Mr Joseph Ghossoub, with the exception of 126 shares which were held by Young & Rubicam International Group BV ("Y & RIG"), a company in the WPP group of companies ("WPP"), the world's largest market communications services group.

46. By an agreement of 28 February 2008 ("the Agreement") Mr Makdessi and Mr Ghossoub (described as "the Sellers") agreed to sell to Y & RIG (described as "the Purchaser") 474 shares (described as "the Sale Shares") in the Company. Y & RIG then transferred those shares to Cavendish Square Holdings BV ("Cavendish"), another WPP company, and by a novation agreement of 29 February 2008, Cavendish was substituted for Y & RIG as a party to the Agreement. Thus Cavendish came to hold 60% of the Company while the Sellers retained 40%. For present purposes, Y & RIG can be ignored and the Purchaser can be treated as Cavendish.

47. The Agreement had been the subject of extensive negotiations over six months, and both sides were represented by highly experienced and respected commercial lawyers: Allen & Overy acting for Cavendish, and Lewis Silkin for the Sellers, Mr Makdessi and Mr Ghossoub.

48. By clause 3.1, the price payable by Cavendish "[i]n consideration of the sale of the Sale Shares and the obligations of the Sellers herein" (and which was to be apportioned 53.88% to Mr Makdessi and 46.12% to Mr Ghossoub) was to be paid by Cavendish in the following way:

i) A "Completion Payment" of US$34m to be paid on completion of the Agreement;

ii) A "Second Payment" of US$31.5m to be paid into escrow on completion, and to be released in four instalments, as restructuring of the Group companies took effect;

iii) An "Interim Payment", to be paid 30 days after agreement of the group operating profits ("OPAT") for 2007-2009, and to be the amount by which the product of eight, 0.474 and the average annual OPAT 2007-2009 exceeded US$63m (being the sum of the earlier payments less US$ 2.5m representing interest);

iv) A "Final Payment", to be paid 30 days after agreement of the OPAT for 2007-2011, and to be the amount by which the product of a figure between seven and ten (depending on the level of profit), 0.474 and the annual average annual OPAT for 2009-2011 exceeded the aggregate of US$63m and the Interim Payment.

Clause 6 contained provisions relating to the "calculation of OPAT and payment of the consideration".

49. Clause 3.2 of the Agreement provided that, if the Interim Payment and/or the Final Payment turned out to be a negative figure, it or they should be treated as zero, but there was to be no claw back of the earlier payments. Clause 3.3 of the Agreement provided that the maximum of all payments would be US$147.5m. By clause 9.1 of, and paragraph 2.15(c) of Schedule 7 to, the Agreement, the Sellers warranted that the Net Asset Value ("NAV") of the Company at 31 December 2007 was just over US$69.74m.

50. Clause 15 contained a put option which entitled each of the Sellers to require Cavendish, by a Notice served at any time between 1 January and 31 March in 2011 or any subsequent year (in the case of Mr Makdessi) and any time between 1 January and 31 March in 2017 or in any subsequent year (in the case of Mr Ghossoub), to buy all their remaining shares in the Company. The price payable on the exercise of this option was (subject to a cap of US$75m in the case of each Seller) to be the relevant seller's proportion of a sum eight times the average OPAT for a reference period of seven years (the year in which the notice was served, the previous year and the two subsequent years). It was to be payable by instalments.

51. Clause 11 was concerned with the "protection of goodwill". Clause 11.1 provided as follows:

> "11.1. Each Seller recognises the importance of the goodwill of the Group to [Cavendish] and the WPP Group which is reflected in the price to be paid by the Purchaser for the Sale Shares. Accordingly, each Seller commits as set out in this clause 11 to ensure that the interest of each of [Cavendish] and the WPP Group in that goodwill is properly protected."

52. Clause 11.2 provided that, in Mr Makdessi's case, until two years after he ceased to hold any shares in the Company or the date of the final instalment of any payment under clause 15, and in Mr Ghossoub's case, until two years after he ceased employment with the Company, the Sellers would not (a) carry on, or be engaged or interested in "Restricted Activities" (ie the provision of goods or services which competed with the Group companies) in "Prohibited Areas" (ie in countries in which any of the Group companies carried on business); (b) solicit or accept orders, enquiries or business in respect of Restricted Activities in the Prohibited Areas; (c) divert orders, enquiries or business from any Group company; or (d) employ or solicit any senior employee or consultant of any Group company.

53. Clause 11.7 started by recording that Cavendish "recognises the importance of the goodwill of the Group to the Sellers and to the value of the Interim Payment and the Final Payment". It then contained a covenant by Cavendish that neither it nor any other WPP company would "without the Sellers' prior written consent other than within the Group companies, trade in any of the [23 identified] countries … using [specified] names [including 'Adrenalin']".

54. Under clause 7.5, Messrs El Makdessi and Ghossoub agreed that, within four months of completion, they would dispose of any shares in Carat Middle East Sarl ("Carat"), and procure the termination of a joint venture agreement which another Carat company had entered into with a member of the Aegis group of companies. Carat describes itself on its website as "the world's leading independent media planning and buying specialist … [o]wned by global media group Aegis Group plc … [with] more than 5,000 people in 70 countries worldwide". It is a competitor of WPP, including Cavendish and the Company.

55. The two provisions of central relevance for present purposes were included in clause 5, which was headed "Default". Clauses 5.1 and 5.6 provided:

> "5.1 If a Seller becomes a Defaulting Shareholder [which is defined as including 'a Seller who is in breach of clause 11.2'] he shall not be entitled to receive the Interim Payment and/or the Final Payment which would other than for his having become a Defaulting Shareholder have been paid to him and

> [Cavendish]'s obligations to make such payment shall cease. …
>
> 5.6. Each Seller hereby grants an option to [Cavendish] pursuant to which, in the event that such Seller becomes a Defaulting Shareholder, [Cavendish] may require such Seller to sell to [Cavendish] all … of the Shares held by that Seller (the Defaulting Shareholder Shares). [Cavendish] shall buy and such Seller shall sell … the Defaulting Shareholder Shares… within 30 days of receipt by such Seller of a notice from [Cavendish] exercising such option in consideration for the payment by [Cavendish] to such Seller of the Defaulting Shareholder Option Price [defined as 'an amount equal to the [NAV] on the date that the relevant Seller becomes a Defaulting Shareholder multiplied by [the percentage which represents the proportion of the total shares the relevant Seller holds]."

56. Mr Ghossoub signed an agreement by which he agreed to remain an employee and director of the Company. During the negotiations, Mr Makdessi had made it clear that he did not wish to remain an employee. However, he signed an agreement, by which he became a non-executive director of the Company (as well as other companies in the Group) and non-executive chairman, for an initial term of 18 months which was renewable. Under this he agreed to certain specific obligations by way of ongoing support of the Company.

57. Mr Makdessi resigned as non-executive chairman of the Company in April 2009. On 1 July 2009, at the Company's request, he resigned as non-executive director of all companies in the Group, save the Company itself. He was removed from the board of the Company on 27 April 2011, after the commencement of these proceedings.

58. Mr Makdessi has been paid his share of the first two payments stipulated by clause 3.1, namely the Completion Payment and the Second Payment, together with some additional interest. However, he has not yet been paid the remaining payments under clause 3.1, namely the Interim Payment or the Final Payment, or any part thereof. His remaining shares represent just over 21.5% of the whole issued share capital of the Company.

59. By December 2010, Cavendish and the Company concluded that Mr Makdessi had acted in breach of his duties to the Company as a director and in breach of his obligations to Cavendish under clause 11.2 of the Agreement. On 13

December 2010 Cavendish gave notice of the exercise of its Call Option under clause 5.6.

60. In December 2010, these proceedings were commenced against Mr Makdessi, with Cavendish suing for breach of the Agreement, and the Company suing for breach of fiduciary duty. Their re-amended particulars allege that in breach of his fiduciary duties and the restrictive covenants Mr Makdessi had throughout 2008 and 2009 in Lebanon and Saudi Arabia (both of which were within the Prohibited Area), in breach of clause 11.2, engaged in Restricted Activities, solicited clients and employees away from Group companies and accepted orders in respect of Restricted Activities.

61. The essence of the complaints was that Mr Makdessi had (i) continued to provide services to Carat, including assisting it to generate business, diverting business to it and soliciting clients and diverting their business to it; and (ii) set up rival advertising agencies in Lebanon and Saudi Arabia with "Adrenalin" in their name and that those agencies had poached or tried to poach a number of the Company's customers and employees.

62. Mr Makdessi subsequently admitted that from February 2008 he had had an ongoing, unpaid involvement in the affairs of Carat pending the appointment of a replacement CEO and that such involvement placed him in breach of fiduciary duty to the Company with effect from 1 July 2008, and that, if the covenants in clause 11.2 were valid and enforceable (as they have been held to be) his involvement in the affairs of Carat rendered him a Defaulting Shareholder within the meaning of the Agreement. The Company's claim for breach of fiduciary duty was settled by its acceptance of a payment into court made by Mr Makdessi in the sum of US$500,000. Cavendish claimed to have suffered loss and damage in the form of a loss of value of its shareholding in the Company, but it subsequently accepted that such loss was irrecoverable as it was merely "reflective" of the loss which could be claimed, indeed had been claimed, by the Company.

63. More importantly for present purposes, Cavendish claimed that Mr Makdessi's admissions of breach of fiduciary duty demonstrated that he was in breach of clause 11.2 in relation to (at least) his continued involvement in Carat. Cavendish accordingly sought a declaration that he was a Defaulting Shareholder, was not entitled to the Interim Payment or the Final Payment as a result of clause 5.1, and was obliged, as of the date 30 days after the service of its notice exercising the Call Option, namely 14 January 2011, to sell to Cavendish all his shares in the Company at the Defaulting Shareholder Option Price, and it sought specific performance of the latter obligation.

64. The case was tried by Burton J and the appeal was heard in the Court of Appeal by Patten, Tomlinson and Christopher Clarke LJJ. The issue at both stages was the same, namely whether clauses 5.1 and 5.6 were valid and enforceable as Cavendish contended, or whether as Mr Makdessi argued they both were void and unenforceable because they constituted penalties. The courts below were naturally constrained by the perceived need to fit any analysis into the framework set by Lord Dunedin's four principles. Burton J felt able to escape those constraints, and concluded that the two provisions were valid and enforceable. However, Christopher Clarke LJ, giving the leading judgment in the Court of Appeal, held that the two provisions were unenforceable penalties under the penalty rule as traditionally understood. No short summary can do justice to Christopher Clarke LJ's thoughtful and careful analysis, but essentially he felt unable to uphold Burton J's decision because he felt bound by the traditional explanation of the rule as being directed against deterrent clauses as such: see [2012] EWHC 3582 (Comm) and [2013] EWCA Civ 1539 respectively. Cavendish now appeals to this court.

*The implications of the Agreement*

65. Clause 5 deals with the obligations of a "Defaulting Shareholder". So far as Mr Makdessi was concerned, that meant a Seller in breach of the restrictive covenants at clause 11.2. In the case of Mr Ghossoub, who remained an employee of the Company, it meant a Seller who was either in breach of the restrictive covenants or else had been summarily dismissed on any of a number of specified grounds, all of them serious and potentially discreditable to the Company.

66. The background to clause 5 is of some importance. Burton J found that the Agreement was negotiated in detail over a considerable period by parties dealing on equal terms with professional assistance of a high order. Cavendish was acquiring 47.4% of the Company so as to bring its holding up to 60%. It is common ground that a large proportion of the purchase price represented goodwill. The NAV (without goodwill) of the Company was warranted by the Sellers at over US$69.7m as at 31 December 2007, whereas the maximum consideration for 47.4% of the Company, including the profit-related element, was US$147.5m, implying a maximum value of more than US$300m for the whole Group. Clause 11.1 recorded the Sellers' recognition that the restrictive covenants reflected the importance of the goodwill, and Burton J found that its value was heavily dependent on the continuing loyalty of Mr Makdessi and Mr Ghossoub. Subject to various options, they retained a 40% shareholding between them and were expected to maintain their connection with the business for a minimum period, Mr Ghossoub as an employee and director, and Mr Makdessi as a non-executive director and chairman. The following summary in the agreed Statement of Facts and Issues is based on the unchallenged evidence given at the trial:

> "The structure of the Agreement was typical of acquisition agreements in the marketing sector. As in this case, the vendor is typically the founder or operator of the business, and has important relationships with clients and key staff. If they decide to turn against the business, its success can be significantly affected, and provisions are therefore included to protect the value of the investment, and in particular the value of the goodwill represented by the vendor's existing personal relationships. The respondent fell into that category; the importance of personal relationships with clients is even stronger in the Middle East than the UK, and he had very strong relationships with clients and senior employees, and he was such a well known figure that if he acted against the Group, it would inevitably cause it to lose value."

67. Clause 3.1 provided that the first two instalments of the purchase price amounted to US$65.5m, which would be received by the Sellers in any event. The effect of clause 5.1 was that in the event that a Seller acted in breach of the restrictive covenants, he would not be entitled to receive the last two instalments of the purchase price, the Interim Payment and the Final Payment, both of which were calculated by reference to the audited consolidated profit of the Company for years after completion of the Agreement (2007-2009 for the Interim Payment, and 2007-2011 for the Final Payment). The result of Cavendish's exercise of its rights under clause 5.1 according to its terms was to reduce the consideration for the Defaulting Shareholder's shares from his proportion of the maximum of US$147.5m to his proportion of US$65.5m. In Mr Makdessi's case, he would receive up to US$44,181,600 less.

68. Under clause 15, the Sellers had a put option to require Cavendish to buy their remaining shareholdings, which in Mr Makdessi's case was first exercisable during the first three months of 2011. The provisions determining the option price have been summarised in para 50 above. It was a multiple of average audited consolidated profit over a reference period, a formula which would reflect the value of goodwill. The effect of clause 5.6 was that if before the exercise of the clause 15 put option a Seller was in breach of the restrictive covenants, Cavendish acquired an option to acquire his retained shareholding at a lower price, namely the relevant proportion of the net asset value at the time of the default. The result of Cavendish's implementation of clause 5.6, according to its terms, was that insofar as, at the date of default, Mr Makdessi's shareholding had a value attributable to goodwill, he would not receive it and would not be able to exercise the clause 15 put option in 2011.

*Was clause 5.1 contrary to the penalty rule?*

69. Clause 5.1 disentitles a Defaulting Shareholder from receiving money which would otherwise have been due to him as his proportion of the price of the transferred shares. If this constitutes a forfeiture, it would appear that, at least on the current state of the authorities, there would be no jurisdiction to relieve against it, because a contractual right to be paid money is not a proprietary or possessory interest in property: *The "Scaptrade"* and *BICC* (see para 17 above). But there is some, albeit rather unsatisfactory, authority that such a clause may be a penalty.

70. *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689 concerned a provision in a building subcontract entitling the contractor to "suspend or withhold" the payment of money due to the subcontractor upon any breach of contract. Four members of the Appellate Committee accepted, obiter, a concession by counsel that this was a penalty: see p 698 (Lord Reid), pp 703-704 (Lord Morris of Borth-y-Gest), p 711 (Viscount Dilhorne), pp 723-724 (Lord Salmon). This was because it allowed the contractor to withhold all sums due, and not just the estimated damages flowing from the sub-contractor's breach. The result was to put intolerable pressures on the latter's cash-flow which was calculated to force him into submission.

71. The only other English decision directly in point is *Socony Mobil Oil Co Inc v West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island")* [1987] 2 Lloyd's Rep 529 (Saville J), [1989] 1 Lloyd's Rep 239 (CA); [1991] 2 AC 1, a case notable for the multiplicity of arguments and the diversity of judicial opinions. It was a claim under the Third Parties (Rights Against Insurers) Act 1930 by cargo claimants who had obtained judgment for damages against an insolvent ship owner entered with the defendant P & I Club. Saville J dismissed the claim on the ground that under the standard "pay to be paid" clause in the rules recovery from the club was conditional on the ship owner having first paid the judgment creditor. Since this had not happened there was no claim to be transferred under the 1930 Act. The Court of Appeal allowed the appeal on this point. They were wrong to do so, as the House of Lords subsequently held. But on the footing that the "pay to be paid" clause did not bar the claim, the Court of Appeal went on to consider an alternative argument on behalf of the club, based on a provision in its rules that cover should retrospectively cease upon the insured's failure to pay a call. The judgment creditor's answer to this argument was that the provision was unenforceable as a penalty. Saville J had held (i) that this last question did not arise because on the facts the retrospective cesser clause would not have applied anyway, but (ii) that the penalty rule was not engaged because it applied only to provisions which required the contract-breaker to pay money. The Court of Appeal upheld him on (i), as a result of which (ii) did not arise. But Stuart-Smith LJ considered point (ii), obiter. He thought, on the basis of *Gilbert-Ash*, that the penalty rule could apply to a provision disentitling the contract-breaker from receiving a sum of money. He

could "see no distinction between withholding or disentitling a person to a sum of money which is due to him and requiring him to pay a sum of money" (p 262). O'Connor LJ said (p 265) that if the point had arisen he would have been of the same view as Stuart-Smith LJ. Bingham LJ disagreed, and would have held that the penalty rule was not engaged.

72. These two cases thus provide some support for the contention that clause 5.1 is capable of engaging the penalty rule. On the other hand, it has been held that a clause which renders instalments irrecoverable by a defaulting purchaser is a forfeiture but not a penalty: see *Else (1982)* and *Stockloser*, cited in para 16 above. If that is so, then there is a powerful argument for saying that a clause which renders instalments of payment irrecoverable by a defaulting vendor should, by the same token, not be a penalty, but at best a forfeiture.

73. We are, however, prepared to assume, without deciding, that a contractual provision may in some circumstances be a penalty if it disentitles the contract-breaker from receiving a sum of money which would otherwise have been due to him. But even on that assumption, it will not always be a penalty. That must depend on the nature of the right of which the contract-breaker is being deprived and the basis on which he is being deprived of it. The provision thought to be penal in *Gilbert-Ash* was a good example of a secondary provision operating upon a breach of the subcontractor's primary obligations. It authorised the contractor to withhold all remuneration due to the subcontractor if the latter had committed any breach of contract until the contractor's claim had been resolved. It was a security, albeit an exorbitant one, for the contractor's claim. The retrospective cesser clause in the West of England Club's rules in *The "Padre Island"* was very different. It forfeited an accrued right to indemnity permanently. Clauses of this kind are potentially harsher than those which operate simply as a security. But they may define the primary obligations of the parties, in which case the penalty rule will not apply to them. It is not a proper function of the penalty rule to empower the courts to review the fairness of the parties' primary obligations, such as the consideration promised for a given standard of performance. For example, the consideration due to one party may be variable according to one or more contingencies, including the contingency of his breach of the contract. There is no reason in principle why a contract should not provide for a party to earn his remuneration, or part of it, by performing his obligations. If as a result his remuneration is reduced upon his non-performance, there is no reason to regard that outcome as penal. Suppose that a contract of insurance provided that it should be cancelled *ab initio* if the insured failed to pay the premium within three months of inception. The effect would be to forfeit any claim upon a casualty occurring in the first three months but it would be difficult to regard the provision as penal on that account. One reason why Bingham LJ disagreed with Stuart-Smith LJ was that he considered the retrospective cesser clause to be no different. "I do not myself think it unreasonable", he said (p 254), "that a member should lose his cover in respect of a period for which he fails to pay

his premium." He may well have been right to analyse the clause in that way, but it is a fair criticism of Stuart-Smith LJ's approach that he did not consider this aspect of the matter at all.

74. Where, against this background, does clause 5.1 stand? It is plainly not a liquidated damages clause. It is not concerned with regulating the measure of compensation for breach of the restrictive covenants. It is not a contractual alternative to damages at law. Indeed in principle a claim for common law damages remains open in addition, if any could be proved. The clause is in reality a price adjustment clause. Although the occasion for its operation is a breach of contract, it is in no sense a secondary provision. The consideration fixed by clause 3.1 is said to be payable "[i]n consideration of the sale of the Sale Shares and the obligations of the Sellers herein". Those obligations of the Sellers herein include the restrictive covenants. Clause 5.1 belongs with clauses 3 and 6, among the provisions which determine Cavendish's primary obligations, ie those which fix the price, the manner in which the price is calculated and the conditions on which different parts of the price are payable. Its effect is that the Sellers earn the consideration for their shares not only by transferring them to Cavendish, but by observing the restrictive covenants. As Burton J said at para 59 of his judgment, "[t]he juxtaposition on the one hand of substantial delayed payment for goodwill and on the other hand a series of covenants which is intended to safeguard and protect that goodwill is of particular significance".

75. Although clause 5.1 has no relationship, even approximate, with the measure of loss attributable to the breach, Cavendish had a legitimate interest in the observance of the restrictive covenants which extended beyond the recovery of that loss. It had an interest in measuring the price of the business to its value. The goodwill of this business was critical to its value to Cavendish, and the loyalty of Mr Makdessi and Mr Ghossoub was critical to the goodwill. The fact that some breaches of the restrictive covenants would cause very little in the way of recoverable loss to Cavendish is therefore beside the point. As Burton J graphically observed in para 43 of his judgment, once Cavendish could no longer trust the Sellers to observe the restrictive covenants, "the wolf was in the fold". Loyalty is indivisible. Its absence in a business like this introduces a very significant business risk whose impact cannot be measured simply by reference to the known and provable consequences of particular breaches. It is clear that this business was worth considerably less to Cavendish if that risk existed than if it did not. How much less? There are no juridical standards by which to answer that question satisfactorily. We cannot know what Cavendish would have paid without the assurance of the Sellers' loyalty, even assuming that they would have bought the business at all. We cannot know whether the basic price or the maximum price fixed by clause 3.1 would have been the same if they were not adjustable in the event of breach of the restrictive covenants. We cannot know what other provisions of the agreement would have been different, or what additional provisions would have been included on that

hypothesis. These are matters for negotiation, not forensic assessment (save in the rare cases where the contract or the law requires it). They were matters for the parties, who were, on both sides, sophisticated, successful and experienced commercial people bargaining on equal terms over a long period with expert legal advice and were the best judges of the degree to which each of them should recognise the proper commercial interests of the other.

76. We have already drawn attention to the fact that damages are in principle recoverable in addition to the price reduction achieved by clause 5.1. In this case, the Company recovered US$500,000 from Mr Makdessi. Cavendish has abandoned any claim of their own for damages, because any loss of theirs would simply reflect the Company's loss. But it would not always be so. There are hypotheses, for example that the restrictive covenants had been broken after he ceased to be a director, in which Cavendish's loss by his breach of the restrictive covenants would not have been reflective and might in principle have been recovered in addition to the reduction of the price under clause 5.1. Does any of this matter? We do not think so. Clause 5.1 is not concerned with the measure of compensation for the breach. It cannot be regarded as penal simply because damages are recoverable in addition. The real question is whether any damages have been suffered on account of the breach in circumstances where the price has been adjusted downwards on account of the same breach. As between Mr Makdessi and the Company, the right of Cavendish to a price reduction cannot affect the measure or recoverability of the Company's loss. It is *res inter alios acta*. It is an open question whether the right to a price reduction would go to abate any loss recoverable by Cavendish themselves if they had suffered any. We do not propose to resolve it on this appeal: the issue does not arise and was not argued. It is enough to note that if Cavendish's loss is not abated, that would be because the law regards Cavendish as having suffered it notwithstanding its right to the reduction. That can hardly make clause 5.1 a penalty.

77. We do not doubt that price adjustment clauses are open to abuse, and if clause 5.1 were a disguised punishment for the Sellers' breach, it would make no difference that it was expressed as part of the formula for determining the consideration. But before a court can reach that conclusion, it must have some reason to do so. In this case, there is none. On the contrary, all the considerations summarised above point the other way.

78. We conclude, in agreement with Burton J, that clause 5.1 was not a penalty.

*Was clause 5.6 contrary to the penalty rule?*

79. Clause 5.6 gives rise to more difficult questions, but the analysis is essentially the same.

80. The purpose of requiring a Defaulting Shareholder to sell his retained shares was to sever the connection between the Company and a major shareholder if he were to compete against it (and also, in the case of Mr Ghossoub, if he were to be dismissed for discreditable conduct). The severance of the connection is completed by clause 14.2, which provides that upon ceasing to be a shareholder he will no longer be entitled to a seat on the board or to appoint a nominee in his place. In itself, this is not said to be objectionable. The objection is to the formula which excludes the value of goodwill from the calculation of the price. It is not and could not be suggested that the exclusion of goodwill serves to compensate for the estimated loss attributable to the breach. Any recoverable damages for the breach of the restrictive covenants will be recoverable on top of the forced sale of the Defaulting Shareholder's retained shares. Indeed, the effect of excluding the value of goodwill is to achieve what Mr Bloch called a "reverse sliding scale". The more trivial the effect of the breach on the value of the goodwill, the greater will be the Defaulting Shareholder's loss in being deprived of any goodwill element in the price.

81. The logic of the price formula for the sale of the retained shares under clause 5.6 is similar to that of the price adjustment achieved by clause 5.1 for the sale of the transferred shares. It reflects the reduced price which Cavendish was prepared to pay for the acquisition of the business in circumstances where it could not count on the loyalty of Mr Makdessi and/or Mr Ghossoub. We have dealt with this point in the context of clause 5.1. It also reflects the fact that with the severance of the connection between the Defaulting Shareholder and the Company, no goodwill will in future be attributable to his role in the business. Indeed, the assumption must be that a Seller in breach of the restrictive covenants may be actively engaged in undermining the goodwill attributable to his former role in the business. It is true that the severance of the connection between a Defaulting Shareholder and the Group will not necessarily destroy the whole of the goodwill of the business which was sold to Cavendish, especially if the other Seller remains loyal. But so far as the Group is able to retain some or all of the goodwill built up by the Defaulting Shareholder in the past, that will presumably be due to the efforts of others.

82. In our view, the same legitimate interest which justifies clause 5.1 justifies clause 5.6 also. It was an interest in matching the price of the retained shares to the value that the Sellers were contributing to the business. There is a perfectly respectable commercial case for saying that Cavendish should not be required to pay the value of goodwill in circumstances where the Defaulting Shareholder's efforts and connections are no longer available to the Company, and indeed are being deployed to the benefit of the Company's competitors, and where goodwill going forward would be attributable to the efforts and connections of others. It seems likely that clause 5.6 was expected to influence the conduct of the Sellers after Cavendish's acquisition of control in a way that would benefit the Company's business and its proprietors during the period when they were yoked together. To that extent it may be described as a deterrent. But that is only objectionable if it is penal, ie if the object

was to punish. But the price formula in clause 5.6 had a legitimate function which had nothing to do with punishment and everything to do with achieving Cavendish's commercial objective in acquiring the business. And, like clause 5.1, it was part of a carefully constructed contract which had been the subject of detailed negotiations over many months between two sophisticated commercial parties, dealing with each other on an equal basis with specialist, experienced and expert legal advice.

83. More fundamentally, a contractual provision conferring an option to acquire shares, not by way of compensation for a breach of contract but for distinct commercial reasons, belongs as it seems to us among the parties' primary obligations, even if the occasion for its operation is a breach of contract. This may be tested by asking how the penalty rule could be applied to it without making a new contract for the parties. The Court of Appeal simply treated clause 5.6 as unenforceable, and declared that Mr Makdessi was not obliged to sell his shares whether at the specified price or at all. That cannot be right, since the severance of the shareholding connection was in itself entirely legitimate, and indeed commercially sensible. If the option to acquire the retained shares is to stand, the price formula cannot be excised without substituting something else. Yet there is no juridical basis on which a different pricing formula can be imposed. There is no fall-back position at common law, as there is in the case of a damages clause.

84. Mr Bloch argued that this difficulty can be surmounted by granting Mr Makdessi a remedy corresponding to the one ordered by the Court of Appeal in *Jobson v Johnson*. We do not accept this. *Jobson* arose out of a contract for the sale of a substantial shareholding in a football club for a consideration payable by instalments. The contract provided that in the event of default in the payment of any instalment, the purchaser would be obliged to transfer the shareholding back to the vendors at a price which was said to represent a substantial undervalue. This was a forfeiture. The purchaser would have been entitled to relief in equity if he had been in a position to pay, albeit late. The purchaser had in fact counterclaimed for such relief, but the counterclaim had been struck out on account of his failure to comply with his disclosure obligations. That left only a contention, advanced by way of defence, that the obligation to transfer back the shares was also a penalty. As briefly discussed in para 17 above, that may or may not have been an argument which was open to him, and it is unnecessary to decide that issue on this appeal. The Court of Appeal accepted the argument and held that the penalty rule could apply not only to an obligation to pay money upon a breach of contract, but also to an obligation to transfer assets in that event. This gives rise to no difficulty at least in principle, in a case where the court could simply decline to enforce the penalty, leaving the innocent party to his ordinary remedies at law. That was the position in *Jobson*, because the Court of Appeal construed the share transfer clause as a purely secondary obligation which was intended simply to secure the payment of the price: see pp 1031-1032, 1037 (Dillon LJ), pp 1043-1044, 1045 (Nicholls LJ). On that basis, Mr Johnson could in theory have been left to obtain judgment for the amount

of the outstanding instalments and if necessary levy execution against the shares. However, we are bound to observe that this would appear to be a somewhat peculiar outcome. If the purchaser had been able to argue that he was entitled to relief from forfeiture, the court would presumably have dealt with his case on that basis and would not have considered the penalty argument at all. Accordingly, on the Court of Appeal's reasoning, as a result of his default in giving disclosure, he was able to achieve a better result than he would have done if he had given disclosure and been able to seek relief from forfeiture.

85. In terms of achieving a fair commercial result, it is perhaps understandable that the Court of Appeal took the course that they did. Rather than applying the well-established principles relating to penalties, they invoked the authorities on relief from forfeiture, which Mr Johnson had been prevented from claiming, and applied them to the penalty rule. They held that in equity a penalty was enforceable *pro tanto*, or on what Nicholls LJ called a "scaled down" basis, ie only to the extent of any actual loss suffered by the breach. The court achieved this by offering the vendor the choice of (i) taking an order for specific performance of the retransfer, conditional upon its being ascertained that this would not overcompensate him for the non-payment of the outstanding instalments, or (ii) taking an order for the sale of the shares by the court, the outstanding instalment and interest to be paid to him out of the proceeds and the balance to be paid to the defaulting purchaser. A somewhat similar approach was later taken by the High Court of Australia in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, which also adopted the concept of partial enforcement.

86. The difficulty about this approach was pointed out by Mason and Wilson JJ in the High Court of Australia in *AMEV-UDC* at pp 192-193:

> "At least since the advent of the Judicature system a penalty provision has been regarded as unenforceable or, perhaps void, ab initio: *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1. In all that time it has been thought that no action could be brought on such a clause, no doubt because the courts should not lend their aid to the enforcement in any way of a provision which is oppressive. However, this is not the only reason why the courts would refuse to lend their aid. In the majority of cases involving penalties, the courts, if called upon to assist in partial enforcement of the kind suggested by the appellant, would be required to undertake an unfamiliar role. They would need to rewrite the clause so as to permit the plaintiff to recover the loss he has actually sustained. Penalty clauses are not, generally speaking, so expressed as to entitle the plaintiff to recover his actual loss. Instead they prescribe the payment of a sum which is exorbitant or a sum to be ascertained by reference

> to a formula which is not an acceptable pre-estimate of damage. In either case the court, if it were to enforce the clause, would be performing a function very different from that which it undertakes when it severs or reads down an unenforceable covenant, such as a covenant in restraint of trade. In the ultimate analysis, in whatever form it be expressed, the appellant's argument amounts to an invitation to the court to develop a new law of compensation, distinct from common law damages, which would govern the entitlement of plaintiffs who insist on the inclusion of penalty clauses in their contracts."

87. Even if the course taken by the Court of Appeal in *Jobson* had been right, it would not be available to Mr Makdessi because clause 5.6 cannot sensibly be analysed as a mere security for the performance of the restrictive covenants. But in our opinion the analysis of Mason and Wilson JJ was correct, and so far as it related to the form of relief, *Jobson* was wrongly decided. In the first place, the treatment of a penalty clause as partly enforceable, although supported by some turns of phrase in old cases concerned with other issues, is contrary to consistent modern authority. So, with respect, is the treatment of its enforcement as discretionary according to the circumstances at the time of the breach. If, as the authorities show, the penal consequences of a contractual provision fall to be determined as at the time of the agreement, and a provision found to be a penalty is unenforceable, it is impossible to see how it can be enforceable on terms. Secondly, the Court of Appeal accepted that the court could not rewrite the parties' contract by specifically enforcing the retransfer of the shares to the vendors at a higher price or enforcing the retransfer of some only of the shares: see p 1037 (Dillon LJ), p 1042 (Nicholls LJ). Yet that is in reality what they did, by refusing to enforce the retransfer unless the vendor agreed to vary its effect. Third, the Court of Appeal interpreted the provision for the retransfer of the shares as a "security" for the payment of the outstanding instalments. They placed the word "security" in inverted commas because the obligation was purely personal. But the Court of Appeal's order treated it as if it was an equitable mortgage of the shares, which it manifestly was not. It appears to us that the Court of Appeal were, as a matter of legal analysis, treating the clause in question as a forfeiture and not a penalty, and granting relief from forfeiture on appropriate terms, although in doing so they purported to be treating it as a penalty clause, because they were constrained to do so in the light of the pleadings. So far as the relief granted in *Jobson* is concerned, the decision was entirely orthodox if it is treated as a forfeiture case, but it was wrong in principle if it is treated as a penalty case.

88. The Court of Appeal in this case thought clauses 5.1 and 5.6 should both be treated in the same way when it came to applying the penalty rule, and we take the same view, but, in agreement with Burton J at first instance, we consider that neither clause is avoided by the penalty rule.

## The second appeal: ParkingEye v Beavis

*The factual and procedural history*

89. British Airways Pension Fund ("the Fund") owns the Riverside Retail Park in Chelmsford. The Fund leases sites on the Retail Park to various multiple retailers, but retains overall control of the site. There is a car park located at the Retail Park, and, on 25 August 2011, the Fund entered into a contract with ParkingEye Ltd in respect of management services at that car park.

90. At all material times since then, ParkingEye has displayed about 20 signs at the entrance to the car park and at frequent intervals throughout it. The signs are large, prominent and legible, so that any reasonable user of the car park would be aware of their existence and nature, and would have a fair opportunity to read them if he or she wished to do so.

91. The upper 80% or so of the signs are worded and laid out substantially as follows (mostly in black print on an orange background):

"**ParkingEye**
car park management

**2 hour max stay**

Customer only car park

4 hour maximum stay for Fitness Centre Members

Failure to comply with the following
will result in a Parking Charge of **£85**

- Parking limited to 2 hours (no return within 1 hour)
- Park only within marked bays
- Blue badge holders only in marked bays".

Below this main part of the signs in small, but legible black print on the same orange background is the following information:

> "ParkingEye Ltd is solely engaged to provide a traffic space maximisation scheme. We are not responsible for the car park surface, other motor vehicles, damage or loss to or from motor vehicles or user's safety. The parking regulations for this car

> park apply 24 hours a day, all year round, irrespective of the site opening hours. Parking is at the absolute discretion of the site. By parking within the car park, motorists agree to comply with the car park regulations. Should a motorist fail to comply with the car park regulations, the motorist accepts that they are liable to pay a Parking Charge and that their name and address will be requested from the DVLA.
>
> Parking charge Information: A reduction of the Parking Charge is available for a period, as detailed in the Parking Charge Notice. The reduced amount payable will not exceed £75, and the overall amount will not exceed £150 prior to any court action, after which additional costs will be incurred."

Below that information, in somewhat larger print are the words: "This car park is private property". At the very bottom of the signs on a black background is ParkingEye's name, telephone number and address in orange, and a drawing of a padlock, a drawing of a surveillance camera with the words "car park monitored by ANPR systems" in small letters underneath, and two logos recording that ParkingEye was a member of the British Parking Association ("BPA") and that it was a BPA "approved operator".

92. At 2.29 on the afternoon of 15 April 2013, Mr Beavis drove his motor car into the car park and parked it there. He did not leave until two hours 56 minutes later, thereby overstaying the two-hour limit by nearly an hour. ParkingEye obtained Mr Beavis's name and address from the Driver and Vehicle Licensing Agency ("DVLA"), and sent him a standard "First Parking Charge Notice" which demanded that he pay the £85 charge within 28 days, but stated that, if he paid within 14 days, the charge would be reduced to £50. The Notice also informed him of an appeals procedure. Mr Beavis ignored this demand, as well as a subsequent standard form reminder notice and warning letter. ParkingEye then began proceedings in the County Court to recover the £85 alleged to be due. A claim of this size would normally have been dealt with by a District Judge under the small claims procedure, but it was recognised that the case raised some points of principle which were likely to affect many other similar claims, so it was heard by the Designated Civil Judge for East Anglia.

93. Before Judge Moloney QC and before the Court of Appeal, Mr Beavis raised two arguments as to why he should not have to pay the £85 charge, namely that it was (i) unenforceable at common law because it is a penalty, and/or (ii) unfair and therefore unenforceable by virtue of the 1999 Regulations. The Court of Appeal (Moore-Bick and Patten LJJ and Sir Timothy Lloyd) upheld Judge Moloney QC's

decision rejecting each of his arguments – see [2015] EWCA Civ 402. Mr Beavis now appeals to this court, maintaining both his arguments.

*Introductory*

94. It was common ground before the Court of Appeal, and is common ground in this court, that on the facts which we have just summarised there was a contract between Mr Beavis and ParkingEye. Mr Beavis had a contractual licence to park his car in the retail park on the terms of the notice posted at the entrance, which he accepted by entering the site. Those terms were that he would stay for not more than two hours, that he would park only within the marked bays, that he would not park in bays reserved for blue badge holders, and that on breach of any of those terms he would pay £85. Moore-Bick LJ in the Court of Appeal was inclined to doubt this analysis, and at one stage so were we. But, on reflection, we think that it is correct. The £85 is described in the notice as a "parking charge", but no one suggests that that label is conclusive. In our view it was not, as a matter of contractual analysis, a charge for the right to park, nor was it a charge for the right to overstay the two-hour limit. Not only is the £85 payable upon certain breaches which may occur within the two-hour free parking period, but there is no fixed period of time for which the motorist is permitted to stay after the two hours have expired, for which the £85 could be regarded as consideration. The licence having been terminated under its terms after two hours, the presence of the car would have constituted a trespass from that point on. In the circumstances, the £85 can only be regarded as a charge for contravening the terms of the contractual licence.

95. Schemes of this kind (including a significant discount on prompt payment after the first demand) are common in the United Kingdom. Some are operated by private landowners, some by parking management companies like ParkingEye, and some by local authorities. They are subject to a measure of indirect regulation. Under section 54 of the Protection of Freedoms Act 2012, parked cars may not be immobilised or towed away by a private operator, but section 56 and Schedule 4 provide for the recovery of parking charges. Where a motorist becomes liable by contract for a "sum in the nature of a fee or charge" or in tort for a "sum in the nature of damages", there is a right under certain conditions to recover it: Schedule 4, paragraph 4. One of those conditions is that the keeper's details must have been supplied by the Secretary of State in response to an application for the information: *ibid*, para 11. The Secretary of State's functions in relation to the provision of this information are performed by the DVLA. Under article 27(1)(e) of the Road Vehicles (Registration and Licensing) Regulations 2002 (SI 2002/2742), the Secretary of State is empowered to make available particulars in the vehicle register to anyone who "has reasonable cause for wanting the particulars to be made available to him". Since 2007, the policy of the Secretary of State has been to disclose the information for parking enforcement purposes only to members of an accredited trade association. The criteria for accreditation were stated in Parliament

to include the existence of "a clear and enforced code of conduct (for example relating to conduct, parking charge signage, charge levels, appeals procedure, approval of ticket wording and appropriate pursuit of penalties" (Hansard (HC Debates), 24 July 2006, col 95WS).

96. As at April 2013, there was only one relevant accredited trade association, the BPA, to which reference was made on the Notice, and to which ParkingEye still belongs. The BPA Code of Practice is a detailed code of regulation governing signs, charges and enforcement procedures. Clause 13 deals with grace periods. Clause 13.4 provides:

> "13.4 You should allow the driver a reasonable period to leave the private car park after the parking contract has ended, before you take enforcement action."

Clause 19 provides:

> "19.5 If the parking charge that the driver is being asked to pay is for a breach of contract or act of trespass, this charge must be based on the genuine pre-estimate of loss that you suffer. We would not expect this amount to be more than £100. If the charge is more than this, operators must be able to justify the amount in advance.
>
> 19.6 If your parking charge is based on a contractually agreed sum, that charge cannot be punitive or unreasonable. If it is more than the recommended amount in 19.5 and is not justified in advance, it could lead to an investigation by the Office of Fair Trading."

The maximum of £100 recommended by the BPA may be compared with the penalties charged by local authorities, which are regulated by statute. The Civil Enforcement of Parking Contraventions (Guidelines on Levels of Charges) (England) Order 2007 (SI 2007/3487) lays down guidelines for the level of penalties outside Greater London. For "higher level contraventions" (essentially unauthorised on-street parking), the recommended penalty is capped at £70 and for other contraventions at £50. The corresponding figures for Greater London are £130 and £80.

*Parking charges and the penalty rule*

97. ParkingEye concedes that the £85 is payable upon a breach of contract, and that it is not a pre-estimate of damages. As it was not the owner of the car park, ParkingEye could not recover damages, unless it was in possession, in which case it may be able to recover a small amount of damages for trespass. This is because it lost nothing by the unauthorised use resulting from Mr Beavis overstaying. On the contrary, at least if the £85 is payable, it gains by the unauthorised use, since its revenues are wholly derived from the charges for breach of the terms. The notice at the entrance describes ParkingEye as being engaged to provide a "traffic space maximisation scheme", which is an exact description of its function. In the agreed Statement of Facts and Issues, the parties state that "the predominant purpose of the parking charge was to deter motorists from overstaying", and that the landowner's objectives include the following:

> "a. The need to provide parking spaces for their commercial tenants' prospective customers;
>
> b. The desirability of that parking being free so as to attract customers;
>
> c. The need to ensure a reasonable turnover of that parking so as to increase the potential number of such customers;
>
> d. The related need to prevent 'misuse' of the parking for purposes unconnected with the tenants' business, for example by commuters going to work or shoppers going to off-park premises; and
>
> e. The desirability of running that parking scheme at no cost, or ideally some profit, to themselves."

98. Against this background, it can be seen that the £85 charge had two main objects. One was to manage the efficient use of parking space in the interests of the retail outlets, and of the users of those outlets who wish to find spaces in which to park their cars. This was to be achieved by deterring commuters or other long-stay motorists from occupying parking spaces for long periods or engaging in other inconsiderate parking practices, thereby reducing the space available to other members of the public, in particular the customers of the retail outlets. The other purpose was to provide an income stream to enable ParkingEye to meet the costs of operating the scheme and make a profit from its services, without which those

services would not be available. These two objectives appear to us to be perfectly reasonable in themselves. Subject to the penalty rule and the Regulations, the imposition of a charge to deter overstayers is a reasonable mode of achieving them. Indeed, once it is resolved to allow up to two hours free parking, it is difficult to see how else those objectives could be achieved.

99. In our opinion, while the penalty rule is plainly engaged, the £85 charge is not a penalty. The reason is that although ParkingEye was not liable to suffer loss as a result of overstaying motorists, it had a legitimate interest in charging them which extended beyond the recovery of any loss. The scheme in operation here (and in many similar car parks) is that the landowner authorises ParkingEye to control access to the car park and to impose the agreed charges, with a view to managing the car park in the interests of the retail outlets, their customers and the public at large. That is an interest of the landowners because (i) they receive a fee from ParkingEye for the right to operate the scheme, and (ii) they lease sites on the retail park to various retailers, for whom the availability of customer parking was a valuable facility. It is an interest of ParkingEye, because it sells its services as the managers of such schemes and meets the costs of doing so from charges for breach of the terms (and if the scheme was run directly by the landowners, the analysis would be no different). As we have pointed out, deterrence is not penal if there is a legitimate interest in influencing the conduct of the contracting party which is not satisfied by the mere right to recover damages for breach of contract. Mr Butcher QC, who appeared for the Consumers' Association (interveners), submitted that because ParkingEye was the contracting party its interest was the only one which could count. For the reason which we have given, ParkingEye had a sufficient interest even if that submission be correct. But in our opinion it is not correct. The penal character of this scheme cannot depend on whether the landowner operates it himself or employs a contractor like ParkingEye to operate it. The motorist would not know or care what if any interest the operator has in the land, or what relationship it has with the landowner if it has no interest. This conclusion is reinforced when one bears in mind that the question whether a contractual provision is a penalty turns on the construction of the contract, which cannot normally turn on facts not recorded in the contract unless they are known, or could reasonably be known, to both parties.

100. None of this means that ParkingEye could charge overstayers whatever it liked. It could not charge a sum which would be out of all proportion to its interest or that of the landowner for whom it is providing the service. But there is no reason to suppose that £85 is out of all proportion to its interests. The trial judge, Judge Moloney QC, found that the £85 charge was neither extravagant nor unconscionable having regard to the level of charges imposed by local authorities for overstaying in car parks on public land. The Court of Appeal agreed and so do we. It is higher than the penalty that a motorist would have had to pay for overstaying in an on-street parking space or a local authority car park. But a local authority would not necessarily allow two hours of free parking, and in any event the difference is not

substantial. The charge is less than the maximum above which members of the BPA must justify their charges under their code of practice. The charge is prominently displayed in large letters at the entrance to the car park and at frequent intervals within it. The mere fact that many motorists regularly use the car park knowing of the charge is some evidence of its reasonableness. They are not constrained to use this car park as opposed to other parking facilities provided by local authorities, Network Rail, commercial car park contractors or other private landowners. They must regard the risk of having to pay £85 for overstaying as an acceptable price for the convenience of parking there. The observations of Lord Browne-Wilkinson in *Workers Bank* at p 580 referred to in para 35 above are in point. While not necessarily conclusive, the fact that ParkingEye's payment structure in its car parks (free for two hours and then a relatively substantial sum for overstaying) and the actual level of charge for overstaying (£85) are common in the UK provides support for the proposition that the charge in question is not a penalty. No other evidence was furnished by Mr Beavis to show that the charge was excessive.

101. We conclude, in agreement with the courts below, that the charge imposed on Mr Beavis was not a penalty.

*Parking charges and the Unfair Terms in Consumer Contracts Regulations 1999*

102. The 1999 Regulations subject the terms of consumer contracts to a fairness test. An unfair term is not binding on a consumer: regulation 8(1). The fairness test is not applicable to all terms in consumer contracts. It does not apply to certain core terms, namely those which define the "main subject matter of the contract" nor to the adequacy of the price or remuneration for the goods or services supplied: regulation 6(2). But it follows from the fact that the £85 charge is a charge for acting in breach of the primary terms that it is not excluded from the fairness test under either of these heads. The issue is therefore whether the test is satisfied.

103. Under regulation 5(1), a contractual term which has not been individually negotiated

> "shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer."

Regulation 6(1) provides that

> "the unfairness of a contractual term shall be assessed, taking into account the nature of the goods or services for which the contract was concluded and by referring, at the time of conclusion of the contract, to all the circumstances attending the conclusion of the contract and to all the other terms of the contract or of another contract on which it is dependent."

An "indicative and non-exhaustive" list of terms which "may" be regarded as unfair by this test is contained in Schedule 2. This includes at paragraph 1(e) a term "requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation".

104. In our opinion, the same considerations which show that the £85 charge is not a penalty, demonstrate that it is not unfair for the purpose of the Regulations.

105. The reason is that although it arguably falls within the illustrative description of potentially unfair terms at paragraph 1(e) of Schedule 2 to the Regulations, it is not within the basic test for unfairness in regulations 5(1) and 6(1). The Regulations give effect to Council Directive 93/13/EEC on unfair terms in consumer contracts, and these rather opaque provisions are lifted word for word from articles 3 and 4 of the Directive. The effect of the Regulations was considered by the House of Lords in *Director General of Fair Trading v First National Bank plc* [2001] 1 AC 481. But it is sufficient now to refer to *Aziz v Caixa d'Estalvis de Catalunya, Tarragona i Manresa* (Case C-415/11) [2013] 3 CMLR 89, which is the leading case on the topic in the Court of Justice of the European Union. *Aziz* was a reference from a Spanish court seeking guidance on the criteria for determining the fairness of three provisions in a loan agreement. They provided for (i) the acceleration of the repayment schedule in the event of the borrower's default, (ii) the charging of default interest, and (iii) the unilateral certification by the lender of the amount due for the purpose of legal proceedings. The judgment of the Court of Justice is authority for the following propositions:

1) The test of "significant imbalance" and "good faith" in article 3 of the Directive (regulation 5(1) of the 1999 Regulations) "merely defines in a general way the factors that render unfair a contractual term that has not been individually negotiated" (para 67). A significant element of judgment is left to the national court, to exercise in the light of the circumstances of each case.

2) The question whether there is a "significant imbalance in the parties' rights" depends mainly on whether the consumer is being deprived of an advantage which he would enjoy under national law in the absence

of the contractual provision (paras 68, 75). In other words, this element of the test is concerned with provisions derogating from the legal position of the consumer under national law.

3) However, a provision derogating from the legal position of the consumer under national law will not necessarily be treated as unfair. The imbalance must arise "contrary to the requirements of good faith". That will depend on "whether the seller or supplier, dealing fairly and equitably with the consumer, could reasonably assume that the consumer would have agreed to such a term in individual contract negotiations" (para 69).

4) The national court is required by article 4 of the Directive (regulation 6(1) of the 1999 Regulations) to take account of, among other things, the nature of the goods or services supplied under the contract. This includes the significance, purpose and practical effect of the term in question, and whether it is "appropriate for securing the attainment of the objectives pursued by it in the member state concerned and does not go beyond what is necessary to achieve them" (paras 71-74). In the case of a provision whose operation is conditional upon the consumer's breach of another term of the contract, it is necessary to assess the importance of the latter term in the contractual relationship.

106. In its judgment, the Court of Justice drew heavily on the opinion of Advocate General Kokott, specifically endorsing her analysis at a number of points. That analysis, which is in the nature of things more expansive than the court's, repays careful study. In the Advocate General's view, the requirement that the "significant imbalance" should be contrary to good faith was included in order to limit the Directive's inroads into the principle of freedom of contract. "[I]t is recognised," she said, "that in many cases parties have a legitimate interest in organising their contractual relations in a manner which derogates from the [rules of national law]" (para AG73). In determining whether the seller could reasonably assume that the consumer would have agreed to the relevant term in a negotiation, it is important to consider a number of matters. These include

> "whether such contractual terms are common, that is to say they are used regularly in legal relations in similar contracts, or are surprising, whether there is an objective reason for the term and whether, despite the shift in the contractual balance in favour of the user of the term in relation to the substance of the term in question, the consumer is not left without protection" (para AG75).

Advocate General Kokott returned to the question of legitimate interest when addressing default interest. She observed that a provision requiring the payment upon default of a sum exceeding the damage caused, may be justified if it serves to encourage compliance with the borrower's obligations:

> "If default interest is intended merely as flat-rate compensation for damage caused by default, a default interest rate will be substantially excessive if it is much higher than the accepted actual damage caused by default. It is clear, however, that a high default interest rate motivates the debtor not to default on his contractual obligations and to rectify quickly any default which has already occurred. If default interest under national law is intended to encourage observance of the agreement and thus the maintenance of payment behaviour, it should be regarded as unfair only if it is much higher than is necessary to achieve that aim" (para AG87).

Finally, the Advocate General observes that the impact of a term alleged to be unfair must be examined broadly and from both sides. Provisions favouring the lender may indirectly serve the interest of the borrower also, for example by making loans more readily available (para AG94).

107. In our opinion the term imposing the £85 charge was not unfair. The term does not exclude any right which the consumer may be said to enjoy under the general law or by statute. But it may fairly be said that in the absence of agreement on the charge, Mr Beavis would not have been liable to ParkingEye. He would have been liable to the landowner in tort for trespass, but that liability would have been limited to the occupation value of the parking space. To that extent there was an imbalance in the parties' rights. But it did not arise "contrary to the requirement of good faith", because ParkingEye and the landlord to whom ParkingEye was providing the service had a legitimate interest in imposing a liability on Mr Beavis in excess of the damages that would have been recoverable at common law. ParkingEye had an interest in inducing him to observe the two-hour limit in order to enable customers of the retail outlets and other members of the public to use the available parking space. To echo the observations of the Advocate General at para AG94 of her opinion, charging overstayers £85 underpinned a business model which enabled members of the public to park free of charge for two hours. This was fundamental to the contractual relationship created by Mr Beavis's acceptance of the terms of the notice, whose whole object was the efficient management of the car park. It was an interest of exactly the kind envisaged by the Advocate General at para AG87 of her opinion and by the Court of Justice at para 74 of the judgment. There is no reason to regard the amount of the charge as any higher than was necessary to achieve that objective.

108. Could ParkingEye, "dealing fairly and equitably with the consumer, … reasonably assume that the consumer would have agreed to such a term in individual contract negotiations"? The concept of a negotiated agreement to enter a car park is somewhat artificial, but it is perfectly workable provided that one bears in mind that the test, as Advocate General Kokott pointed out in *Aziz* at para AG75, is objective. The question is not whether Mr Beavis himself would in fact have agreed to the term imposing the £85 charge in a negotiation, but whether a reasonable motorist in his position would have done so. In our view a reasonable motorist would have agreed. In the first place, motorists generally and Mr Beavis in particular did accept it. In the case of non-negotiated standard terms that would not ordinarily be entitled to much weight. But although the terms, like all standard contracts, were presented to motorists on a take it or leave it basis, they could not have been briefer, simpler or more prominently proclaimed. If you park here and stay more than two hours, you will pay £85. Motorists could hardly avoid reading the notice and were under no pressure to accept its terms.

109. Objectively, they had every reason to do so. They were being allowed two hours of free parking. In return they had to accept the risk of being charged £85 if they overstayed. Overstaying penalties are, as we have mentioned, both a normal feature of parking contracts on public and on private land, and important for the efficient management of the space in the interests of the general body of users and the neighbouring outlets which they may frequent. They are beneficial not just to ParkingEye, the landowner and the retail outlets, but to the motorists themselves, because they make parking space available to them which might otherwise be clogged up with commuters and other long-stay users. The amount of the charge was not exorbitant in comparison to the general level of penalties imposed for parking infractions. Nor is there any reason to think that it was higher than necessary to ensure considerate use by motorists of the available space. And, while we accept Mr Butcher's submission that the fact that the £85 charge is broadly comparable to charges levied by local authorities for parking in public car parks is not enough to show that it was levied in good faith, it is nonetheless a factor which assists ParkingEye in that connection. The risk of having to pay it was wholly under the motorist's own control. All that he needed was a watch. In our opinion, a hypothetical reasonable motorist would have agreed to objectively reasonable terms, and these terms are objectively reasonable.

110. It is right to mention three further arguments which were raised by Mr de Waal QC on behalf of Mr Beavis to support his case that the £85 charge was unfair, and which we have not so far specifically addressed.

111. First, Mr de Waal relied on the fact that it was payable by a motorist who overstayed even by a minute. The Consumers' Association expanded on this point by observing that there are many reasons why a motorist may overstay, some of which may be due to unforeseen circumstances. We cannot accept this.

ParkingEye's business model could have had a graduated charge for overstayers based on how long they overstayed, but the fact that it did not do so does not render it unfair. Even if it had done, it would presumably have involved a specific sum for each hour or part of an hour, in which case the same complaint could be made. More fundamentally, as we have explained, the £85 charge for overstayers was not a payment for being permitted to park after the two hours had expired: it was a sum imposed for staying for more than two hours. The notion of a single sum between £50 and £100 for overstaying even by a minute, appears to be a very common practice, in that it is adopted by many, probably the majority of, public and private car park operators. As for the suggestion that the overstay may have arisen from unforeseen circumstances, we find it hard to regard that as relevant. The object of the £85 charge is simply to influence the behaviour of motorists by causing them to leave within two hours. It is reasonable that the risk of exceeding it should rest with the motorist, who is in a position to organise his time as he sees fit. There are many circumstances in life when the only way of being on time is to allow for contingency and arrive early. This is accepted by every motorist who uses metered on-street parking while shopping. The legal basis on which he is made liable for overstaying penalties is of course different in that case. It is statutory and not contractual. But the underlying rationale and justification is precisely the same, namely to ration scarce parking space. It is right to add that, as communicated to any overstayer from whom the charge is demanded, ParkingEye has an appeals procedure, and the BPA Code of Practice provides at paragraph 13.4 for a reasonable grace period after the expiry of the fixed parking period. The appeals procedure provides a degree of protection for any overstayer, who would be able to cite any special circumstances as a reason for avoiding the charge. And, while the Code of Practice is not a contractual document, it is in practice binding on the operator since its existence and observance is a condition of his ability to obtain details of the registered keeper from the DVLA. In assessing the fairness of a term, it cannot be right to ignore the regulatory framework which determines how and in what circumstances it may be enforced.

112. The second argument which should be mentioned is that the £85 charge for overstayers "takes advantage of the consumer's requirement to park in that particular place to shop or visit a particular location". If this car park is unusually attractively located for shoppers and others, the evidence shows that the £85 charge has not been fixed at a particularly high level to reflect that fact. Further, as Mr Kirk QC pointed out on behalf of ParkingEye, it is equally true that the consumer gets the benefit of free parking in that unusually attractively located car park for two hours, and, save in unusual circumstances, it is entirely within his or her control whether the two-hour limit is exceeded. And if the consumer considers that the circumstances are unusual, he or she can invoke the appeals procedure.

113. Finally, Mr de Waal submitted that it was unfair to make the minority who contravene the parking rules bear the whole cost of running the car park. In our view,

if the £85 charge is itself such as a reasonable motorist would accept, the mere imbalance between the position of those who comply and those who do not cannot possibly make the charge unfair. It arises only because both categories are allowed two hours of free parking, and because the great majority of users of the car park (more than 99.5%, we were told) observe the rules.

114. Accordingly, we agree with the courts below that the £85 charge in this case does not infringe the 1999 Regulations.

**Conclusion on the two appeals**

115. For these reasons, we would allow the appeal in *Cavendish v El Makdessi* and dismiss the appeal in *ParkingEye v Beavis*, and we would declare that none of the terms impugned on the two appeals contravenes the penalty rule, and that the charge in issue in *ParkingEye v Beavis* does not infringe the 1999 Regulations.

**LORD MANCE:**

*Introduction*

116. These two appeals raise wide-ranging and difficult questions about the current law governing contractual penalties. The cases lie at opposite ends of a financial spectrum. In the first, the appellant, Cavendish Square Holding BV ("Cavendish"), is part of the world's leading marketing communications group ("WPP"), while the respondent, Mr Talal El Makdessi, was co-founder and co-owner with Mr Joseph Ghossoub of the Middle East's largest advertising and marketing communications group ("the Group"). Prior to 2008 WPP held 12.6% of the shares of the Group. In 2008 Mr El Makdessi and Mr Ghoussoub agreed to sell to Cavendish a further 47.4% of the Group's shares (in the form of an interest in Team Y & R Holdings Hong Kong Ltd ("Team"), a holding company set up to facilitate the transaction).

117. The transaction was effected by a sale and purchase agreement dated 28 February 2008, whereby Mr El Makdessi and Mr Ghoussoub agreed to make the 47.4% shareholding available in the ratio of 53.88% to 46.12%. The price was payable in stages: US$65.5m (Mr El Makdessi's share being 53.88%) was payable on completion of the sale and Group reorganisation. Thereafter, there were to be Interim and Final Payments derived from a multiple of the Group's audited consolidated operating profit ("OPAT") between respectively 2007 and 2009 and 2007 and 2011. Clause 11.2 was a clause prohibiting Mr El Makdessi from various competitive or potentially competitive activity. Clauses 5.1 and 5.6 provided that, if

he breached clause 11.2, he would not be entitled to receive the Interim and/or Final Payments, and could be required to sell Cavendish the rest of his shares at a "Defaulting Shareholder Option Price", based on asset value and so ignoring any goodwill value. Mr El Makdessi also became non-executive chair of Team with a service agreement binding him to remain in position for at least 18 months.

118. It is accepted by Mr El Makdessi that he did subsequently breach clause 11.2, and was thereby also in breach of fiduciary duty towards Team. The present proceedings were initiated by both Cavendish and Team. Team's claim was settled in October 2012 when it accepted a Part 36 payment of US$500,000 made by Mr El Makdessi. Cavendish's claim is for declarations that Mr El Makdessi's breach of clause 11.2 means that clauses 5.1 and 5.6 now have the effect stated in the previous paragraph. Mr El Makdessi maintains that they are unenforceable penalty clauses.

119. In the second case, the appellant, Mr Beavis, was the owner and driver of a vehicle which he parked in a retail shopping car park adjacent to Chelmsford railway station. The owner of the retail site and car park, British Airways Pension Fund ("BAPF"), had engaged ParkingEye Ltd, the respondent, to provide "a traffic space maximisation scheme". The scheme involved the erection at the entrance to and throughout the car part of prominent notices, including the injunctions "2 hour max stay" and "Parking limited to 2 hours", coupled with the further notice "Failure to comply … will result in a Parking Charge of £85". Underneath, it also stated: "By parking within the car park, motorists agree to comply with the car park regulations". Mr Beavis left his car parked for 56 minutes over a permitted two-hour period. He maintains that the £85 charge demanded of him by ParkingEye (reducible to £50 if he had paid within 14 days) is an unenforceable penalty. Further or alternatively, he maintains that it is unfair and invalid within the meaning of the Unfair Terms in Consumer Contracts Regulations 1999.

120. Cavendish succeeded before Burton J on 14 December 2012, although only on condition that it agreed to credit Mr El Makdessi with the US$500,000 recovered from him by Team. The Court of Appeal (Patten, Tomlinson and Christopher Clarke LJJ), [2013] EWCA Civ 1539, over-ruled Burton J, [2012] EWHC 3582 (Comm), on 26 November 2013, holding both clauses to be unenforceable penalties. The court held however that the judge had had, on his view of the case, no basis to impose a condition that Cavendish agree to credit Mr El Makdessi with the US$500,000 (and the contrary has not been suggested before the Supreme Court). Mr Beavis has so far failed at both instances, before Judge Moloney QC on 19 May 2014 and the Court of Appeal (Moore-Bick and Patten LJJ and Sir Timothy Lloyd) on 23 April 2015, [2015] EWCA Civ 402. The appellants in both cases now appeal with the permission of the Supreme Court in the case of Mr El Makdessi and of the Court of Appeal in the case of Mr Beavis.

*Cavendish v Mr El Makdessi – facts*

121. I can summarise and take the relevant terms of the sale and purchase agreement to which Cavendish and Mr El Makdessi were parties from the agreed Statement of Facts and Issues ("SFI"):

> "10. By clause 2.1 of the Agreement, Joe and the respondent (defined as 'the Sellers') agreed to sell 47.4% of the shareholding in the Company. Clause 3 set out the consideration for that sale, which pursuant to Schedule 1 was to be shared between the respondent and Joe in shares of 53.88% and 46.12% respectively. The consideration, payment of which was not expressed to be subject to any condition, was as follows:
>
> (1) A payment of US$34,000,000 on completion;
>
> (2) A second payment of US$31,500,000 to be paid into escrow on completion and released to Joe and the respondent in accordance with clauses 3.6 to 3.12 (which in short provided for the sum to become payable in stages as the various restructurings provided for in the Agreement took effect).
>
> (3) A further payment ('**the Interim Payment**') was to become payable on its 'Due Date' and was to be calculated as follows:
>
> 8 x Average 2007-2009 'OPAT' x 47.4% minus US$63,000,000
>
> (4) A final payment ('**the Final Payment**') was to become payable on its 'Due Date', and was to be calculated as follows:
>
> > 'M' x Average 2007-2011 'OPAT' x 47.4% minus US$63,000,000 and the Interim Payment.
>
> 11. 'OPAT' was defined in Schedule 12 as meaning the audited consolidated operating profit of the Group, and 'Due Date' was defined as meaning 30 days after the relevant OPAT was

agreed or determined. The figure 'M' in the definition of Final Payment was a figure varying between seven and ten depending on the growth of OPAT over the period 2007 to 2011.

12. Thus the Interim and Final Payments in essence obliged the purchaser to make further payments to Joe and the respondent calculated by reference to the Group's profitability in the years 2007 to 2011.

13. Clause 3.2 provided that if the calculation of the Interim Payment or the Final Payment resulted in a negative figure, it was to be treated as zero and Joe and the respondent would not be required to repay any sum already paid.

14. Clause 3.3 capped the total amount of all payments at US$147,500,000.

15. By clause 9.1, paragraph 2.15 of Schedule 7, and Schedule 11, Joe and the respondent warranted that the net assets of the entire Group, not just their share, as at 31 December 2007 were US$69,744,340.

16. Under the Agreement, therefore, a substantial part of the purchase consideration comprised goodwill:

a. The Completion and Second Payments totalled $65.5m and were for 47.4% of the equity (47.4% of the warranted 2007 NAV being $33,058,817);

b. At its highest (assuming no decrease in NAV) some US$114.44m would be payable for goodwill ($147,500,000 - $33,058,817), representing 77% of the aggregate purchase consideration.

17. Clause 11 was entitled 'Protection of Goodwill', and provided that:

*'11 PROTECTION OF GOODWILL*

*11.1 Each Seller recognises the importance of the goodwill of the Group to the Purchaser and the WPP Group which is reflected in the price to be paid by the Purchaser for [the shares]. Accordingly, each Seller commits as set out in this clause 11 to ensure that the interest of each of the Purchaser and the WPP Group in that goodwill is properly protected.'*

18. Clause 11.2 then set out various restrictive covenants ('the Restrictive Covenants') entered into by Joe and the respondent:

*'11.2 Until the date 24 months after the Relevant Date, no Seller will directly or indirectly without the Purchaser's prior consent:*

*(a) carry on or be engaged, concerned, or interested, in competition with the Group, in the Restricted Activities within the Prohibited Area;*

*(b) solicit or knowingly accept any orders, enquiries or business in respect of the Restricted Activities in the Prohibited Area from any Client;*

*(c) divert away from any Group Company any orders, enquiries or business in respect of the Restricted Activities from any Client; or*

*(d) employ, solicit or entice away from or endeavour to employ, solicit, or entice away from any Group Company any senior employee or consultant employed or engaged by that Group Company.'*

19. By virtue of the definitions in Schedule 12 of the Agreement, 'Restricted Activities' meant the provision of products and/or services of a competitive nature to those being provided by the Group, 'Prohibited Area' meant any countries in which the Group carried on the business of marketing communications and ancillary services, and 'Client' meant any client or potential client of the Group who had placed an order

with the Group during the past 12 months or been in discussions with the Group during that period.

20. As to the several covenants:-

> (a) the effect of any breach of the covenant against employing or soliciting senior employees could be less than a breach of the covenants against competitive activity; the respondent's position is that it was likely, in many circumstances, to be markedly less; and
>
> (b) Losses attributable to breaches of the covenant against solicitation could vary, the respondent says were likely to vary widely, according to the nature, extent, duration and success of the solicitation.

21. By clause 7.5, the respondent agreed that within four months after completion he would dispose of any shares held by him in Carat Middle East Sarl ('Carat') and procure that a joint venture agreement of 19 December 2003 to which Group Carat (Nederland) BV and Aegis International BV, on the one hand, and the respondent, on the other, were parties, would be terminated.

22. By the time of trial, the respondent had conceded that (if the Restrictive Covenants were enforceable) he was in breach thereof by reason of his ongoing, unpaid involvement in the affairs of Carat ('the Breach').

23. It is the provisions providing for the consequences of breach which are in issue in this appeal. By reason of the Breach, the respondent became a 'Defaulting Shareholder' within the meaning of the definition in Schedule 12. Clause 5.1 is headed 'DEFAULT' and includes two relevant provisions.

24. First, clause 5.1 provides that on becoming a Defaulting Shareholder, the respondent would not be entitled to receive the Interim Payment or the Final Payment:

> *'If a Seller becomes a Defaulting Shareholder he shall not be entitled to receive the Interim Payment and/or the Final Payment which would other than for his having become a Defaulting Shareholder have been paid to him and the Purchaser's obligation to make such payments shall cease.'*

25. In money terms, the effect of this provision is that in the event of a default by the respondent, he could receive up to $44,181,600 less than would have been the case had he not acted in breach. If both Sellers were to default, they could lose up to US$82m ($147.5-$65.5) between them.

26. Second, clause 5.6 grants an option over the respondent's remaining shares in the Group whereby in the event that he became a Defaulting Shareholder, the appellant could require him to sell those remaining shares:

> *'Each Seller hereby grants an option to the Purchaser pursuant to which, in the event that such Seller becomes a Defaulting Shareholder, the Purchaser may require such Seller to sell to the Purchaser (or its nominee) all (and not some only) of the Shares held by that Seller (the Defaulting Shareholder Shares). The Purchaser (or its nominee) shall buy and such Seller shall sell with full title guarantee the Defaulting Shareholder Shares ... within 30 days of receipt by such Seller of a notice from the Purchaser exercising such option in consideration for the payment by the Purchaser to such Seller of the Defaulting Shareholder Option Price.'*

27. The 'Defaulting Shareholder Option Price' is defined in Schedule 12 as meaning the proportion of the Net Asset Value of the company equal to the proportion of shares sold by the Defaulting Shareholder, a formula which excludes the value of goodwill. By clause 5.7, this could be satisfied either in cash or by issuing shares in WPP, at the absolute discretion of the appellant.

28. Clause 15.1 granted the Sellers a put option by which they could require the appellant to purchase all their remaining shares in the Company:

> *'Each Seller is hereby granted an option by the Purchaser pursuant to which such Seller may, subject to clause 15.2, by service of an Option Notice in the form set out in Schedule 10 (the Option Notice) require the Purchaser (or its nominee) to purchase from him all (and not some only) of the Shares held by that Seller (the Option Shares). The Purchaser (or its nominee) shall buy and the Seller shall sell with full title guarantee the Option Shares ... within 30 days of receipt of the Option Notice in consideration for the payment when due of the price determined in accordance with clause 15.3 (the Option Price).'*

29. In money terms, the effect of clause 5.6 is that insofar as the retained shares of a Defaulting Shareholder have, at the date when he becomes a Defaulting Shareholder, a value which is attributable to goodwill, he will not receive it. He will not be able to exercise the put option otherwise available in 2011 and subsequent years, which would give him a price, not exceeding $75m, which reflected goodwill.

30. As of the date of the Agreement, the respondent was, and was bound to remain, a director for at least 18 months and was entitled to remain thereafter as long as he was a shareholder unless Cavendish considered that his outside business interests were likely to result in a material ongoing conflict with his duties as a director. For so long as he did remain a director, any breach of clause 11.2 would give rise to a cause of action for breach of fiduciary duty to the Company.

31. The Agreement contained no provision which precluded the Company from bringing a claim for damages for conduct rendering the respondent a Defaulting Shareholder.

32. As with the agreement as a whole, these provisions were subject to negotiation and amendment between the parties. …

33. The structure of the Agreement was typical of acquisition agreements in the marketing sector. As in this case, the vendor is typically the founder or operator of the business, and has important relationships with clients and key staff. If they decide to turn against the business, its success can be significantly

> affected, and provisions are therefore included to protect the value of the investment, and in particular the value of the goodwill represented by the vendor's existing personal relationships. The respondent fell into that category; the importance of personal relationships with clients is even stronger in the Middle East than the UK, and he had very strong relationships with clients and senior employees, and he was such a well known figure that if he acted against the Group, it would inevitably cause it to lose value. …"

122. Paragraphs 25 and 29 of this agreed summary outline the effect of clauses 5.1 and 5.6 of the sale and purchase agreement, on which Cavendish relies but which Mr El Makdessi submits to be penal and unenforceable. Since clauses 5.1 and 5.6 operate because Mr El Makdessi became a Defaulting Shareholder by reason of breach of clause 11.2, both clauses need to be considered with reference to the nature, scope and duration of the restrictive covenants in favour of Cavendish which clause 11.2 contains. As para 33 of the agreed summary records, the restrictive covenants represented very significant protections of the value of the goodwill which Cavendish was to acquire. Clause 11.2 provides for such protection to continue until 24 months after the "Relevant Date". By Schedule 12:

> "Relevant Date means in respect of a Seller the later of the date of termination of his employment by the Group, the date that he no longer holds any Shares or the date of payment of the final instalment of the Option Price pursuant to clause 15.5(b)."

Clause 16.1 provided that:

> "Save as otherwise expressly provided by this agreement no Seller shall transfer, sell, charge, Encumber or otherwise dispose of all or part of his interest in any Shares."

The put option referred to in para 28 of the agreed summary was only exercisable by Mr El Makdessi by option notice served "at any time between 1 January and 31 March in 2011 or in any subsequent year" (clause 15.2). Upon its exercise, the Option Price was payable in two instalments, the second or final instalment being due "within 30 days of the agreement or final determination of OPAT for N+2" (clause 15.5(b)). OPAT means under Schedule 12 "the audited consolidated operating profit … in any 12-month accounting period ending 31 December". N means "the financial year in which the Option Notice is served" (clause 15.3). N+2 thus means the year 2013, and the earliest date of full payment of any Option Price under clause 15 would be some date in 2014, once the OPAT for N+2 was agreed

or finally determined. That would be the (earliest) Relevant Date, assuming that Mr El Makdessi had previously determined his employment by the Group which he was only committed to maintain for 18 months from the date of the agreement (para 30 of the agreed summary). Under the terms of the sale and purchase agreement dated 28 February 2008, Mr El Makdessi was bound by the restrictive covenants for a further 24 months, ie until a date in 2016, some eight years after the sale and purchase agreement. There has been no challenge in this court to the reasonableness of this lengthy restriction, and it underlines the importance of goodwill to the agreement and to the buyers, Cavendish, in particular.

*ParkingEye Limited v Beavis - facts*

123. The signs exhibited at the entrance and throughout the car park are large, prominent and legible. They are worded as follows (the words down to "marked bays" all being given especial prominence):

> "*ParkingEye*
> car park management
> *2 hour max stay*
> *Customer only car park*
> *4 hour maximum stay for Fitness Centre Members*
> *Failure to comply with the following will result in a Parking Charge of: £85*
> Parking limited to 2 hours
> (no return within 1 hour)
> Park only within marked bays
> Blue badge holders only in marked bays
>
> ParkingEye Ltd is solely engaged to provide a traffic space maximisation scheme. We are not responsible for the car park surface, other motor vehicles, damage or loss to or from motor vehicles or user's safety. The parking regulations for this car park apply 24 hours a day, all year round, irrespective of the site opening hours. Parking is at the absolute discretion of the site. By parking within the car park, motorists agree to comply with the car park regulations. Should a motorist fail to comply with the car park regulations, the motorist accepts that they are liable to pay a Parking Charge and that their name and address will be requested from the DVLA. Parking charge Information: A reduction of the Parking Charge is available for a period, as detailed in the Parking Charge Notice. The reduced amount payable will not exceed £75, and the overall amount will not exceed £150 prior to any court action, after which additional costs will be incurred.

This car park is private property."

124. ParkingEye operated the arrangements at the Chelmsford car park under a "Supply Agreement for Car Park Management" made with BAPF on 25 August 2011. ParkingEye guarantees BAPF an undisclosed minimum weekly amount for the privilege, for which it appears, in practice, to have been paying BAPF about £1,000 per week. Neither BAPF nor ParkingEye makes any charge for parking by motorists who comply with the two-hour maximum stay and other regulations. So ParkingEye's only income is from those required to pay the £85 (or reduced) charge. ParkingEye operates a number of other car parks on a similar basis. Its annual accounts for the year ended 31 August 2013 show an operating profit of over £1.6m, and a net profit after tax of about £1m, on a turnover of over £14m.

125. Parking at the site is monitored by ParkingEye by automatic number plate recognition cameras to monitor the entry into and departure of vehicles from the car park. The cameras showed Mr Beavis's vehicle driving into the car park at 14.29 pm on 15 April 2013 and leaving at 17.26 pm, a stay of two hours and 56 minutes. Mr Beavis admits having been the driver. ParkingEye obtained the vehicle's registered keeper's details from the DVLA, and sent a First Parking Charge Notice which included statements to the effect that the parking charge of £85 was payable within 28 days of the date of the notice, but would be discounted to £50 if paid within 14 days, and that there was an appeals procedure (which did not however include any power to grant discretionary relief). Mr Beavis did not pay or appeal, and the present proceedings were begun against him.

*The issues*

126. This section of the judgment concerns the doctrine of penalties. I deal later with the issues arising under the Unfair Terms in Consumer Contracts Regulations 1999: see paras 200-213 below. Miss Joanna Smith QC for Cavendish invites the Supreme Court to undertake a fundamental review of the law regarding penalties. In her submission it is outdated, incoherent and unnecessary, and should be abolished. Alternatively, it should have no place in relation to "commercial" contracts, by which I understand her to mean contracts at arm's length between equally balanced parties, like Cavendish and Mr El Makdessi. In the further alternative, she submits that it is or should be held to be inapplicable to any clauses other than those requiring payment of money on breach, and/or to clauses not aimed at compensating for the breach, but for which some other valid commercial reason exists.

127. Mr Bloch QC for Mr El Makdessi resists these submissions. In his submission, the doctrine fulfils a tried and well-established role, there is no impetus, let alone one based on any research or review, for its abolition or restriction and it

is, on principle and authority, applicable to the types of clause in issue in this case. He submits that the law governing penalties enables and requires account to be taken of the interests intended to be protected by the relevant clause – a proposition that Miss Smith was in reply at first inclined to dispute, but after questioning and reflection later herself endorsed. But protection of such interests is, in Mr Bloch's submission, subject to the over-riding control that it must not be extravagant, oppressive or manifestly excessive. In his submission the present clauses are precisely that, since their effect is in the case of clause 5.1 to deprive Mr El Makdessi of part of the agreed consideration, and to do so in a way which bears no resemblance to any loss which his breach may have caused Cavendish or the Group. On the contrary, the smaller the loss it has caused, the larger the penalty effect, and vice versa. As to clause 5.6, its effect is to give Cavendish a right on any default by Mr El Makdessi to force him to part with his remaining shareholding, at a price likely to be well below its actual value, again in circumstances where the difference in value in no way reflects any loss which the default may have caused Cavendish or the Group, and where the smaller the loss caused to the Group, the larger the difference in value of which Mr El Makdessi is deprived.

128. Mr John de Waal QC for Mr Beavis, and Mr Christopher Butcher QC for the Consumers' Association, interveners, submit that there is a dichotomy between a genuine pre-estimate and a deterrent clause, that the focus must be on the particular contractual relationship in issue, and general commercial or other considerations cannot detract from that focus or justify what would otherwise amount to a penalty. Mr Jonathan Kirk QC for ParkingEye does not challenge the existing law of penalties, but, like Miss Smith, submits that it is inapplicable to clauses not aimed at compensating for the breach, but for which some other valid (not necessarily commercial) reason exists. That, he submits, is the present case.

129. The law of penalties in this jurisdiction currently applies to contractual clauses operating on a breach of contract by the other party to the contract: see the statements to that effect by Lord Roskill in *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 at pp 402H and 404C (although the facts of that case were quite special). This limitation has on occasion been seen as a weakness or even as an indication of inherent fragility in the doctrine's underpinning. The High Court of Australia has quite recently addressed this aspect head-on, holding that breach is not an essential aspect of the doctrine; the essential question is whether the contract imposes a restriction from doing the particular act, reserving a payment if it is done, or whether it confers a right to do the act in return for payment of an equivalent: *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, 247 CLR 205, *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50, para 95.

130. The present appeals do not raise for consideration whether there should be any such extension of the doctrine, but rather whether it should be abolished or

restricted, in English law. For my part, if the doctrine survives in English law, I do not see the distinction between situations of breach and non-breach as being without rational or logical underpinning. It is true that clever drafting may create apparent incongruities in particular cases. But in most cases parties know and reflect in their contracts a real distinction, legal and psychological, between what, on the one hand, a party can permissibly do and what, on the other hand, constitutes a breach and may attract a liability to damages for - or even to an injunction to restrain - the breach. In Mr Beavis's appeal, Mr de Waal also suggested that ParkingEye could have economic reasons for formulating the liability to pay £85 (or a reduced £50) as a liability for breach, rather than as a consideration payable for parking for longer than two hours. As a consideration, he suggested, it would have attracted VAT and ParkingEye could furthermore have incurred liability for rates as a person in beneficial occupation of the car park.

*The concept of a penalty*

131. The doctrine of penalties is commonly expressed as involving a dichotomy between compensatory and deterrent clauses. In *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1446H-1447A, Diplock LJ even expressed the doctrine in terms of a rule of public policy that did not "permit a party to a contract to recover in an action a sum greater than the measure of damages to which he would be entitled at common law". All three of the early 20th century decisions of highest jurisdictions which together constitute the origin of the modern doctrine contain dicta suggestive of a mutually exclusive dichotomy. But all three show that there is no requirement that the measure of damages at common law should be ascertainable - indeed that an inability to ascertain this can justify an agreement to pay a fixed sum on breach. In this connection, they point to a broad understanding of the interests which can justify such an agreement. All three decisions must also be read in context, which involved interests different from those relevant on the present appeals.

132. In the first decision, the Scottish appeal of *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6, the House was concerned with an expressed "penalty" of £500 per week for late delivery of four torpedo boats to the Spanish Government. The Earl of Halsbury LC distinguished at p 10 between an agreed sum for damages and a penalty to be held over the other party *in terrorem* and Lord Davey at p 15 between a clause providing for liquidate damages or for a punishment irrespective of the damage caused. But the Earl of Halsbury went on to stress how "extremely complex, difficult, and expensive" any proof of damages would have been, how it would involve "before one's mind the whole administration of the Spanish Navy" and how "absolutely idle and impossible [it would be] to enter into a question of that sort unless you had some kind of agreement between the parties as to what was the real measure of damages which ought to be applied" (pp 11-12). He also rejected out of hand submissions that a warship has no value at all, and that, had the torpedo boats been delivered on

time, they would have been sunk, like much else of the Spanish fleet, in the Spanish-American war (of 1898, after the United States intervened in support of Cuban independence).

133. Lord Davey and Lord Robertson indicated that they saw the ultimate question as being whether the shipbuilders had shown that the clause was exorbitant, extravagant or unconscionable to the point where it could not be regarded as commensurate with the interest protected: see pp 16 and 20. Lord Robertson encapsulated his view of the issue as follows:

> "The question remains, had the respondents no interest to protect by that clause, or was that interest palpably incommensurate with the sums agreed on? It seems to me that to put this question, in the present instance, is to answer it. Unless injury to a state is as matter of law inexpressible in money, Spain was or might be deeply interested in the early delivery of these ships and deeply injured by delay.
>
> To my thinking, Lord Moncreiff has, in two sentences, admirably stated the case: 'The subject-matter of the contracts, and the purposes for which the torpedo-boat destroyers were required, make it extremely improbable that the Spanish Government ever intended or would have agreed that there should be inquiry into, and detailed proof of, damage resulting from delay in delivery. The loss sustained by a belligerent, or an intending belligerent, owing to a contractor's failure to furnish timeously warships or munitions of war, does not admit of precise proof or calculation; and it would be preposterous to expect that conflicting evidence of naval or military experts should be taken as to the probable effect on the suppression of the rebellion in Cuba or on the war with America of the defenders' delay in completing and delivering those torpedo-boat destroyers.'"

At p 19, Lord Robertson also described a penalty as a sum "merely stipulated *in terrorem* [which] could not possibly have formed … a genuine pre-estimate of the creditor's probable or possible interest in the due performance of the principal obligation".

134. Lord Robertson's last words were quoted by the Judicial Committee of the Privy Council (which included the Lord Chancellor, Lord Davy and Lord Dunedin) in the second decision, *Public Works Comr v Hills* [1906] AC 368, 375-376. The

Board's advice was that the clause in that case was a penalty. The clause, contained in one railway construction contract, provided for the forfeiture, on non-completion of the railway within the stipulated time, of whatever retention moneys were held as a result of two separate railway construction contracts together with a further £10,000. The "determining factor" was in the Board's advice that the sum was not a "definite sum, but is liable to great fluctuation in amount dependent on events not connected with the fulfilment of this contract" (p 376).

135. The third decision is the English appeal in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79. Under Dunlop's standard terms, distributors undertook not to sell or offer the goods to any private customers or to any co-operative society at less than Dunlop's current list prices, not to sell to persons whose supplies Dunlop had decided to suspend, and not to exhibit or export without Dunlop's consent. The terms stipulated for payment of £5 for every tyre, cover, or tube sold or offered in breach of such undertakings. Dunlop's unchallenged evidence was price cutting would indirectly damage their business as a whole (p 88). On this basis the House held that the stipulation was not a penalty.

136. Lord Dunedin said:

> "But though damage as a whole from such a practice would be certain, yet damage from any one sale would be impossible to forecast. It is just, therefore, one of those cases where it seems quite reasonable for parties to contract that they should estimate that damage at a certain figure, and provided that figure is not extravagant there would seem no reason to suspect that it is not truly a bargain to assess damages, but rather a penalty to be held *in terrorem*."

137. Lord Atkinson spelled the point out at pp 91-93 (italics added):

> "In the sense of direct and immediate loss the appellants lose nothing by such a sale. It is the agent or dealer who loses by selling at a price less than that at which he buys, but the appellants have to look at their trade in globo, and to prevent the setting up, in reference to all their goods anywhere and everywhere, a system of injurious undercutting. *The object of the appellants in making this agreement, if the substance and reality of the thing and the real nature of the transaction be looked at, would appear to be a single one, namely, to prevent the disorganization of their trading system and the consequent injury to their trade in many directions.* The means of effecting

> this is by keeping up their price to the public to the level of their price list, this last being secured by contracting that a sum of 5l shall be paid for every one of the three classes of articles named sold or offered for sale at prices below those named on the list. The very fact that this sum is to be paid if a tyre cover or tube be merely offered for sale, though not sold, shows that it was the consequential injury to their trade due to undercutting that they had in view. *They had an obvious interest to prevent this undercutting, and on the evidence it would appear to me impossible to say that that interest was incommensurate with the sum agreed to be paid.*
>
> Their object is akin in some respects to that which a trader has in binding a former employee not to set up, or carry on, a rival business within a certain area. The trader's object is to prevent competition, and especially to prevent his old customers whom the employee knows from being enticed away from him. If one takes for example the case of a plumber, the carrying on of the trade of a plumber may mean anything from mending gas pipes for a few pence apiece up to doing all the plumbing work of a big hotel. If the employee should mend one hundred of such pipes for twenty old customers at 6d apiece, for which the employer would charge 1s apiece, could it possibly be contended that the trader's loss was only one hundred sixpences, 21 10s? It is, I think, quite misleading to concentrate one's attention upon the particular act or acts by which, in such cases as this, the rivalry in trade is set up, and the repute acquired by the former employee that he works cheaper and charges less than his old master, and to lose sight of the risk to the latter that old customers, once tempted to leave him, may never return to deal with him, or that business that might otherwise have come to him may be captured by his rival. The consequential injuries to the trader's business arising from each breach by the employee of his covenant cannot be measured by the direct loss in a monetary point of view on the particular transaction constituting the breach. An old customer may be as effectively enticed away from him through the medium of a 10s job done at a cheap rate as by a 50l job done at a cheap rate, or a reputation for cheap workmanship may be acquired possibly as effectively in one case as in the other."

138. Lord Parker was to like effect. After concluding that the damage likely to accrue from the breach of every stipulation to which the clause applied was the same in kind, he said (p 99):

> "Such damage will in every case consist in the disturbance or derangement of the system of distribution by means of which the appellants' goods reach the ultimate consumer."

139. Lord Dunedin's is the first and most cited speech in *Dunlop*. But Miss Smith is right to emphasise the importance of the other speeches. The second of four main propositions which Lord Dunedin thought deducible from authoritative decisions was that:

> "2. The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage (*Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6)."

140. Later authority has found the phrase *in terrorem* to be unhelpful. Lord Radcliffe commented in *Campbell Discount Co Ltd v Bridge* [1962] AC 600, 622:

> "I do not find that that description adds anything of substance to the idea conveyed by the word 'penalty' itself, and it obscures the fact that penalties may quite readily be undertaken by parties who are not in the least terrorised by the prospect of having to pay them ..."

141. Lord Radcliffe's comment has been quoted with approval in the Court of Appeal in *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2004] 1 CLC 401 and again in *Murray v Leisureplay plc* [2005] EWCA Civ 963, [2005] IRLR 946, paras 47 and 109, per Arden LJ and Buxton LJ. In *Cine Bes*, para 13, I regarded as a "more accessible paraphrase of the concept of penalty" that adopted by Colman J in *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752, 762G. Colman J there said that the *Dunlop Pneumatic Tyre* case showed that:

> "whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach. That the contractual function is deterrent rather than compensatory can be deduced by comparing the amount that would be payable on breach with the loss that might be sustained if breach occurred."

142. Lord Dunedin's first and third propositions were that, while the language used may be a prima facie indication as to whether a sum stipulated is a penalty, it is not conclusive; the question is one of "construction" to be decided "upon the terms and inherent circumstances of each particular contract, judged of as at the time of [its] making". His fourth proposition had four sub-heads, identifying various tests which have been suggested to assist this task of construction and which "may prove helpful, or even conclusive". Briefly summarised, the tests were:

a. A sum is a penalty if "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach".

b. If the breach consists only in not paying a sum of money, a sum stipulated as payable on the breach greater than any that ought to have been paid will be a penalty.

c. There is a presumption (but no more) that it is penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage".

d. On the other hand, it is "no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties (*Clydebank Case*, Lord Halsbury, at p 11)".

143. It is clear from these three decisions that a concern can protect a system which it operates across its whole business by imposing an undertaking on all its counterparties to respect the system, coupled with a provision requiring payment of an agreed sum in the event of any breach of such undertaking. The impossibility of measuring loss from any particular breach is a reason for upholding, not for striking down, such a provision. The qualification and safeguard is that the agreed sum must not have been extravagant, unconscionable or incommensurate with any possible interest in the maintenance of the system, this being for the party in breach to show.

144. In 1986 the High Court of Australia thought, when examining recent English authority, that the underlying test of extravagance, exorbitance or unconscionability to be derived from the *Clydebank Engineering* and *Dunlop* cases had been eroded by decisions in which the focus had been more narrowly on a comparison between

the agreed sum and any possible loss which could be awarded for the breach of contract in question: *AMEV-UDC Finance Ltd v Austin* [1986] HCA 63, 162 CLR 170, 190. It advocated a return to the original concept. This was taken up by the Privy Council in *Philips Hong Kong Ltd v Attorney General of Hong Kong* (1993) 61 BLR 41, where Lord Woolf emphasised the interest that parties have in being able to know with a reasonable degree of certainty the extent of their liability and the risks that they run (p 54). But both these cases accept a basic dichotomy between penal and compensatory provisions.

145. More recent authority suggests that this dichotomy may not be exclusive and that there may be clauses which operate on breach and which are commercially justifiable although they fall into neither category. In short, commercial interests may justify the imposition upon a breach of contract of a financial burden which cannot either be related directly to loss caused by the breach or justified by reference to the impossibility of assessing such loss.

146. In *Lordsvale Finance* Colman J was concerned with a loan agreement providing that the rate of interest would increase prospectively from the time of default in payment. He noted, at pp 763-764 (italics added):

> "… the borrower in default is not the same credit risk as the prospective borrower with whom the loan agreement was first negotiated. Merely for the pre-existing rate of interest to continue to accrue on the outstanding amount of the debt would not reflect the fact that the borrower no longer has a clean record. Given that money is more expensive for a less good credit risk than for a good credit risk, there would in principle seem to be no reason to deduce that a small rateable increase in interest charged prospectively upon default would have the dominant purpose of deterring default. *That is not because there is in any real sense a genuine pre-estimate of loss, but because there is a good commercial reason for deducing that deterrence of breach is not the dominant contractual purpose of the term.*
>
> It is perfectly true that for upwards of a century the courts have been at pains to define penalties by means of distinguishing them for liquidated damages clauses. The question that has always had to be addressed is therefore whether the alleged penalty clause can pass muster as a genuine pre-estimate of loss. That is because the payment of liquidated damages is the most prevalent purpose for which an additional payment on breach might be required under a contract. However, the

> jurisdiction in relation to penalty clauses is concerned not primarily with the enforcement of inoffensive liquidated damages clauses but rather with protection against the effect of penalty clauses. *There would therefore seem to be no reason in principle why a contractual provision the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach.*"

147. In a whole series of cases across the world, courts have taken their cue from *Lordsvale* and held that provisions in loan agreements for uplifting the interest rate for the future after a default should not be regarded as penalties, save where the uplift is evidently extravagant: see eg *Hong Leuong Finance Ltd v Tan Gin Huay* [1999] 2 SLR 153, *Beil v Mansell (No 2)* (2006) 2 Qd R 499, *PSAL Ltd v Kellas-Sharpe* [2012] QSC 31, *Elberg v Fraval* [2012] VSC 342, *Place Concorde East Ltd Partnership v Shelter Corp of Canada Ltd* (2003) 43 BLR (3d) 54 and *In re Mandarin Container* [2004] 3 HKLRD 554.

148. The rationale of these cases is that the default bears on the credit risk (and, as *Beil v Mansell* identifies, may also bear on the cost of administering the loan). The uplift is conditioned on the breach, but the breach reflects directly upon the continuing appropriateness of the originally agreed interest terms. In substance, the uplift amounts to a variation of the original terms. If on the other hand, it is evident from the size of the uplift that it is in its nature a punishment for or deterrent to breach, rather than an ordinary commercial re-rating to reflect a change in risk (or administration cost), then it will still be disallowed as a penalty – as the actual decisions in *Hong Leuong*, *Beil v Mansell* and *Elberg v Fraval* illustrate.

149. In *Cine Bes* the Court of Appeal was concerned, inter alia, with an agreement settling litigation and granting a new licence on terms that, if the new licence was subsequently terminated for breach by the licensee, the licensor would be entitled, inter alia, to recover the costs incurred in the litigation. The court held that this was not penal. It was an "understandable and reasonable commercial condition upon which [the licensor] was prepared to dispose of the prior litigation and to enter into the fresh licence" (para 33). If that licence had to be terminated for breach, there was, in short, no reason why the settlement terms should not be revisited. In the course of my judgment, I said (para 15):

> "I have also found valuable Colman J's further observation[s] in *Lordsvale* at pp 763g-764a, which indicate that a dichotomy

> between a genuine pre-estimate of damages and a penalty does not necessarily cover all the possibilities. There are clauses which may operate on breach, but which fall into neither category, and they may be commercially perfectly justifiable."

150. In *Murray v Leisureplay plc* [2005] EWCA Civ 963, [2005] IRLR 946, a later Court of Appeal (Arden, Clarke and Buxton LJJ) agreed with the approach taken in *Lordsvale* and *Cine Bes*, with Clarke and Buxton LJJ stressing the importance of the commercial context, even in cases where there would be no difficulty about assessing damages (at respectively paras 105 and 118). The case concerned a clause in a chief executive's employment contract entitling him to payment of a year's gross salary in the event of wrongful termination of his employment without a year's notice.

151. The dicta in para 15 in *Cine Bes* were considered recently by the Federal Court of Australia in *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50, at para 99. The case concerned fees charged by banks for late payment, for honour and over-limit payments and for non-payments. Allsop CJ thought that any difficulties about accepting a dichotomy could be avoided by a different analysis, which he expressed at para 103 as follows:

> "The object and purpose of the doctrine of penalties is vindicated if one considers whether the agreed sum is commensurate with the interest protected by the bargain: *Andrews (HC)* at para 75; *Dunlop* at pp 91-93; *Clydebank* at pp 15-17, 19 and 20; *Public Works Comr v Hills* at pp 375-376. This is not to say that the inquiry is unconnected with recoverable damages, but the question of extravagance and unconscionability by reference, as Lord Dunedin said in *Dunlop*, to the greatest loss that could conceivably be proved to have followed from the breach, is to be understood as reflecting the obligee's interest in the due performance of the obligation: *Public Works Comr v Hills* at pp 375-376. One only needs to reflect on the facts of *Dunlop* and the justification for the payment that was found to be legitimate to appreciate these matters."

152. In my opinion, the development of the law indicated by the authorities discussed in paras 145 to 151 above is a sound one. It is most easily explained on the basis that the dichotomy between the compensatory and the penal is not exclusive. There may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden. The maintenance of a system of trade, which only functions if all trading partners adhere to it

(*Dunlop*), may itself be viewed in this light; so can terms of settlement which provide on default for payment of costs which a party was prepared to forego if the settlement was honoured (*Cine Bes*); likewise, also the revision of financial terms to match circumstances disclosed or brought about by a breach (*Lordsvale* and other cases). What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable. In judging what is extravagant, exorbitant or unconscionable, I consider (despite contrary expressions of view) that the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor.

153. The Federal Court of Australia in *Paciocco* (para 151 above) preferred to maintain the dichotomy between the penal and compensatory, while at the same time focusing on the "interest protected by the bargain" or the "interest in the due performance of the obligation" and on whether the sum stipulated as payable on breach is commensurate with, or extravagant or unconscionable by reference to, that interest. Provided that "interest" protected or "in due performance" is understood widely enough to cover an interest in renegotiating the original contractual bargain in the light of the situation after or revealed by the breach, that formulation would appear to lead to the same result as reached in the cases discussed in paras 145 to 151.

*Can the penalty doctrine apply to clauses withholding payments?*

154. In the cases so far discussed, the provision in issue required payment of money. A number of authorities have considered whether and how far the doctrine extends beyond provisions for payment of money. First, the penalty doctrine has been applied to provisions not requiring the payment of money by, but authorising the withholding of moneys otherwise due to, the party in breach. Although the point was apparently conceded (p 693H), several members of the House accepted this in *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689. The clause there provided that, in the event that a sub-contractor failed "to comply with any of the provisions of this sub-contract", the contractor might "suspend or withhold payment of any moneys due". Lord Reid said (p 698C-F) that, read literally, this would entitle the contractor to withhold sums far in excess of any fair estimate of the value of his claims and was an unenforceable penalty, and Lord Morris, Viscount Dilhorne and Lord Salmon spoke to similar effect (pp 703G, 711D and 723H). Hunter J adopted and applied their statements in Hong Kong in the building contract case of *Hsin Chong Construction Co Ltd v Hong Kong and Kowloon Wharf and Godown Co Ltd* [1984] HKCFI 212, paras 22-23.

155. In *Firma C-Trade SA v Newcastle Protection and Indemnity Association (The "Fanti" and The "Padre Island") (No 2)* [1989] 1 Lloyd's Rep 239, the majority (O'Connor and Stuart-Smith LJJ; Bingham LJ dissenting) would have held that, if (contrary to their holding) the mutual association's membership rules had provided for retrospective cesser of cover on non-payment of a release call, they would have involved an unenforceable penalty. Bingham LJ's reasoning does not rest unequivocally on a view that a withholding clause cannot constitute a penalty. He invoked considerations special to membership of a mutual insurer, namely that any loss of cover was for a period in respect of which the member was failing to pay the premium, so casting the burden of indemnity on other members (p 254). While he also relied on *Daff v Midland Colliery Owners' Mutual Indemnity Co Ltd* (1913) 109 LT 418, the question whether a similar clause could, if retroactive, be invalid as a penalty was not apparently addressed by anyone in that case, and it can in those circumstances hardly suggest that the deliberate statements in *Gilbert-Ash* were per incuriam.

156. In *Public Works Comr v Hills* the Privy Council applied the penalty doctrine to a clause forfeiting, on a termination for non-completion of works, sums lodged by a contractor with the Cape Agent-General as security for its performance and for release back to it in three stages as it progressed the works. Since the sums were only lodged by way of security and were to be returned if the works progressed, the contractor could be seen to have a continuing interest in them, which the clause forfeited. More recently in *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573, the Privy Council treated *Public Works Comr v Hills* as authority that the doctrine applies to the forfeiture of a deposit exceeding the sum of 10% of the contract price customarily paid in respect of the sale of land. It left open the unresolved question discussed in *Stockloser v Johnson* [1954] 1 QB 476, whether the doctrine applies, or the court has any other equitable power, to address a situation where a party is given possession of property on terms that he will pay for property by instalments, in default of which he will forfeit any interest in the property and the instalments already paid. However, still more recently, Eder J in *Cadogan Petroleum Holdings Ltd v Global Process Systems LLC* [2013] 2 Lloyd's Rep 26 held the doctrine inapplicable to forfeiture of prepayments made towards the acquisition of property in the form of two gas plants. The contract provided for a series of such pre-payments, not all of which GPS completed making. It never therefore acquired the gas plants, and Cadogan relied on a contractual clause forfeiting all pre-payments which GPS had made. It appears that there may be Scots authority to like effect: see *Zemhunt (Holdings) Ltd v Control Securities* [1991] Scot CS CSIH 6, 1992 SC 58, 1992 SCLR 151, although that case itself only concerned a 10% deposit.

*Can the penalty doctrine apply to transfers of money's worth?*

157. Second, the doctrine has been applied to provisions requiring the transfer, upon a breach, of money "or money's worth" in the form of property belonging to the party in breach. In *Watson v Noble* (1885) 13 R 347, a ship owner sold seven shares in a trawler to its master for £100, and agreed to hold them on trust for him, but only for so long as he fulfil obligations as skipper which included being sober and attentive to his duties. The master was later dismissed for alleged drunkenness, the owner refused to transfer the shares and the master sued to recover their price. The master succeeded on the basis that the provision for forfeiture of the shares was an unenforceable penalty. In *Jobson v Johnson* [1989] 1 WLR 1026 the English Court of Appeal reached the same conclusion, where shares in Southend United Football Club were transferred with part of the price payable by deferred instalments and the contract provided for their retransfer in the event of a failure to pay any instalment for a sum equivalent only to the first instalment, however many and whatever the value of the instalments in fact paid. Evans LJ also accepted the application of the penalty doctrine to transfers of property in *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130, 138e-f.

158. There is substantial Australian authority in the same sense. In *Bysouth v Shire of Blackburn and Mitcham (No 2)* [1928] VLR 562, Irvine CJ held at pp 574-575 with Mann and Lowe JJ agreeing at p 579 that a provision for forfeiture by the council of its contractors' property in and upon the works in the event of breach was penal. In *Forestry Commission of New South Wales v Stefanetto* (1976) 133 CLR 507, Mason and Jacobs JJ took the same view in the High Court. In *Wollondilly Shire Council v Picton Power Lines Pty Ltd* (1994) 33 NSWLR 551, 555G, the doctrine was applied to a provision requiring the defaulting contractor to sell back property to the council at its original sale price, with Handley JA observing that, since equity looks to substance not form, the doctrine must apply to the transfer of money's worth as well as money. In *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, the High Court of Australia cited *Jobson v Johnson* for the same proposition in relation to a clause requiring a petrol station to be sold back to BP at a price excluding goodwill. The argument failed on the facts, because of expert evidence, which the trial judge accepted, that in the context of this particular station there was no monetary value attaching to any goodwill. Finally, the High Court in *Andrews* again cited *Jobson v Johnson* for the proposition that the doctrine applied to the transfer of property.

159. In *Else* (para 157 above), the Court of Appeal was however concerned with a contract under which the seller retained the shares agreed to be sold in Sheffield United Football Club and the terms of which permitted the seller to retain half of any instalments already paid in the event that the contract was terminated for failure to pay any instalment. The court, distinguishing *Jobson v Johnson* as a case where property in the shares had passed, refused to extend the penalty doctrine to cover the

situation before it. There would have been discretion to relieve against forfeiture in equity, but this too was refused on the ground that it was not unconscionable in the circumstances for the seller to insist on the strict terms: the purchaser had under the contract in fact already enjoyed two years as club chairman and the agreement was itself a compromise to avoid argument whether the terms of the agreement which it replaced constituted a penalty.

*The relationship between the penalty doctrine and relief against forfeiture*

160. *Jobson v Johnson* proceeds on the basis that a case may raise for consideration both the penalty doctrine and the power of the court to relieve against forfeiture. In my opinion, that is both logical and correct in principle under the current law. A penalty clause imposes a sanction for breach which is extravagant to the point where the court will in no circumstances enforce it according to its terms. The power to relieve against forfeiture relates to clauses which do not have that character, but which nonetheless operate on breach to deprive a party of an interest in a manner which would not be penal. That it would not be penal is evident from the fact that the court will only grant relief on the basis that the breach is rectified by performance. "[I]n the ordinary course", as the Privy Council said in *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd* [2013] UKPC 20, [2015] 2 WLR 875, para 13, "relief in equity will only be granted on the basis of conditions requiring performance, albeit late, of the contract in accordance with its terms as to principal, interest and costs: see eg per Lord Parker of Waddington in *Kreglinger v New Patagonia Meat and Cold Storage Co Ltd* [1914] AC 25, at pp 49-50 and per Lord Wilberforce in *Shiloh Spinners Ltd v Harding* [1973] AC 691, at pp 722C and 723H". The two doctrines, both originating in equity, therefore operate at different points and with different effects. Consideration whether a clause is penal occurs necessarily as a preliminary to considering whether it should be enforced, or whether relief should be granted against forfeiture.

161. This same inter-relationship between the penalty doctrine and relief against forfeiture was also assumed in *BICC plc v Burndy Corpn* [1985] Ch 232, where Dillon LJ, with whom Ackner LJ agreed, considered first whether the clause was a penalty, before moving to the issue of relief against forfeiture. The clause was a provision in an agreement dissolving a joint relationship, whereby certain joint patent rights would continue to be held by BICC, with Burndy paying its share of the costs of their maintenance and processing by BICC, and with a clause providing that, if either party failed to fulfil its obligations in that regard, the party not in default could require an assignment of the guilty party's interests in the joint rights. Burndy failed to meet certain costs due, BICC claimed an assignment of Burndy's share in the joint rights, to which Burndy's first response was that the clause was in the nature of a penalty, since the value of Burndy's share would be worth many times more than the sums unpaid or any actual loss to BICC (pp 236H-237C). The submission failed on the basis that it was "commercial sense" or a "sensible purpose" that a

party failing to pay its share of the costs of processing or keeping alive a patent may be required to give up its interest (pp 246G and 247C), and that the clause was "no more a penalty clause than is the ordinary power of re-entry in a lease or the ordinary provision in a patent licence to enable the patentee to determine the licence, however valuable, in the event of non-payment of royalties" (p 247C-D). The reasoning has some of the flavour of Bingham LJ's observations in *The Fanti* about the mutuality existing between members of a mutual insurance association. But how far the analogies on which Dillon LJ relied are reliable in a context of forced transfer of property is a question for another case. The position regarding re-entry under a lease has long been regulated by statute, and a contractual licence raises different considerations to a requirement to transfer a proprietary share in joint rights. Be that as it may be, the case does not suggest that a forced transfer of property rights can never attract the operation of the penalty doctrine. It turned on the existence of joint rights, in the maintenance and processing of which both parties agreed to play their part.

*Should the penalty doctrine be abolished or restricted?*

162. This being the current state of authority, I come to Cavendish's primary and secondary cases, that the penalty doctrine should be abolished, or, that failing, that it should be restricted to non-commercial cases or to cases involving payment of money. I am unable to accept either proposition. As to abolition, there would have to be shown the strongest reasons for so radical a reversal of jurisprudence which goes back over a century in its current definition and much longer in its antecedents. It has long been recognised that the situations in which the doctrine may and may not apply can involve making distinctions which can appear narrow and which follow lines which can be difficult to define. But that has never hitherto been regarded as a reason for abandoning the whole doctrine, which in its core exists to restrain exorbitant or unconscionable consequences following from breach. In 1966 Diplock LJ, after referring in *Robophone* to the public policy behind the rule in the passage which I have already quoted (para 131 above), said that "in these days when so often one party cannot satisfy his contractual hunger à la carte but only at the table d'hôte of a standard printed contract, it has certainly not outlived its usefulness".

163. In 1975 the Law Commission in its Working Paper No 61, *Penalty Clauses and Forfeiture of Monies Paid*, far from suggesting abolition proposed that the doctrine should be expanded, along lines now accepted in Australia by *Andrews*, to cover any situation where the object of the disputed contractual obligation is to secure the act or result which is the true result of the contract (pp 18-19). In 1999, the Scottish Law Commission in its *Report on Penalty Clauses* (Scot Law Com No 171) recommended that there should continue to be judicial control over contractual penalties, whatever form they take – whether payment of money or forfeiture of money or transfer or forfeiture of property. It suggested as the criterion for such

control whether the penalty was "manifestly excessive" in all the circumstances when the contract was entered into. It further recommended a test of substance for determining whether a clause was a penalty and an extension along the same lines as the English Law Commission recommended in 1975. Cavendish's submission that this court should abolish or rewrite radically the penalty doctrine is made without the benefit of the sort of research into the consequences and merits of such a step, which the Law Commission or Parliament would undertake before venturing upon it.

164. There is therefore an unpromising background to Cavendish's submission that the doctrine should be either abolished or restricted. Further, the Scottish Law Commission pointed out (para 1.8) that there has been a general convergence of approaches in European civil codes and soft law proposals towards a recognition of the utility and desirability of judicial control of disproportionately, excessively, manifestly or grossly high or unreasonable penalties. The Council of Europe's Resolution 78(3) of 20 January 1978 on Penal Clauses in Civil Law (article 7), the Principles of European Contract Law (article 9:509), the Uncitral Texts on Liquidated Damages and Penalty Clauses (article 8) and the Unidroit Principles of International Commercial Contracts (article 7.4.13) all contain provisions for such control along such lines.

165. I note in parenthesis that many national European legal systems already appear to contain similar provisions, even if only introduced legislatively as appears to be the case in France by laws of 9 July 1975 and 11 October 1985 amending article 1152 of the Code civil (and reversing the effect of the Cour de cassation decision in *Paris frères c Dame Juillard* Civ 14 February 1866). Germany in contrast takes a broad view of the interests which may be protected by a clause imposing a financial liability on breach (*vertragsstrafe*), including among them not merely compensation, but also deterrence. But in non-business cases, the court has the power to reduce any penalty to an appropriate level under BGB (the Civil Code), section 343. However, HGB (the Commercial Code) para 248 exempts contracts between businessmen from the scope of BGB section 343, although such contracts appear still to be susceptible to control if they are standard form contracts (not the case with that between Cavendish and Mr El Makdessi) or in terms so abusive as to infringe other principles applicable generally, although only in extreme cases, such as those governing Guten Sitten, Wucher or Treu und Glauben (BGB sections 138 and 242).

166. At the court's request, Cavendish also included as an appendix to its case a valuable examination of the law of, and relevant academic commentary from, other common law countries: Australia, Canada, New York and other United States' states and sources, Scotland, New Zealand, Singapore and Hong Kong. It is sufficient to say that all these countries retain a doctrine broadly on the same lines as the current English doctrine. In both Australia and Canada, emphasis has been placed on the

root principles of extravagance, exorbitance or unconscionability, to be found in the *Clydebank Engineering* and *Dunlop* cases: *AMEV-UDC Finance Ltd v Austin* [1986] HCA 63, 162 CLR 170 and *Elsley v J G Collins Insurance Agencies Ltd* [1978] 2 SCR 916 and Waddams, *The Law of Damages* (Nov 2014), para 8-340. In Australia, the doctrine has been extended, as I have noted, to cover situations falling short of breach: *Andrews*. In both Singapore and Hong Kong, the approach in *Philips Hong Kong* has been followed. In Australia, it is established that the penalty doctrine applies to clauses calling for the transfer of property (para 158 above) as well as to the withholding of sums due, and there is also Hong Kong authority for the latter (para 154 above). Waddams, *The Law of Contracts*, 6th ed (2010), para 461 cites *Jobson v Johnson* for the proposition that it applies to clauses requiring transfer of property at an undervalue in Canada, and there is no suggestion of disagreement on either of these points in any other common law country. It would be odd, to say the least, if the United Kingdom separated itself from so general a consensus.

167. It is true that, in a European Union context measures now exist which carry some of the burden which might previously have been borne by the penalty doctrine: the Unfair Terms in Consumer Contracts Regulations 1999, giving effect to Directive 93/13/EEC, and the Consumer Protection from Unfair Trading Regulations 2008, giving effect to Directive 2005/29/EC. These are confined to consumer situations, and in the case of the former at present to contract terms which are not individually negotiated. That limitation has disappeared, with the coming into force of the Consumer Rights Act 2015 on 1 October 2015 to replace the Unfair Terms in Consumer Contracts Regulations 1999, the Unfair Contract Terms Act 1977 (in relation to consumer contracts), most of the Sale of Goods Act 1979, and the Supply of Goods and Services Act 1982 (in relation to consumer contracts). It would be unsafe to assume that any of these measures makes or will make the penalty doctrine redundant. The fact that Parliament has not sought to abolish or amend the doctrine, despite their existence, is just as capable of being invoked in its favour. In any event, the doctrine protects businesses, including small businesses, which may well have a need for it.

168. I would reject Miss Smith's submission that the doctrine should be limited so as not to apply to "commercial" cases for similar reasons. There is no basis in authority or principle for such a limitation. It would strike at an existing protection in an area where the doctrine has been frequently invoked, including in the cases on exorbitant uplifts of loan interest upon breach of loan agreements. The concept of a commercial case is also undefined and obscure, in the absence of any applicable statutory definition.

169. Miss Smith's further submission that the doctrine should be limited by confining unconscionability to circumstances of procedural misconduct, involving duress, undue influence, misrepresentation, or something similar would appear

effectively to deprive the doctrine of any role at all, and again has no basis in authority or principle.

170. I am equally unable to accept that the doctrine should be confined to cases of payment of money. It would be absurd to draw a rigid distinction between a requirement to transfer money and property. It would also be absurd to draw such a distinction between them and the withholding of moneys due. Such uncertainties as may exist regarding the doctrine's applicability to deposits or to clauses forfeiting pre-payments must await decision in due course.

*Application of the penalty doctrine - Cavendish*

171. The relevant trigger to the operation of both clauses 5.1 and 5.6 is the definition of "Defaulting Shareholder", to include "a Seller who is in breach of clause 11.2 hereof". Clause 11.2 contains various restrictive covenants. It is common ground (SFI para 20: para 121 above) that the breach of the covenant against employing or soliciting senior employees could be less than a breach of the covenants against competitive activity, and that losses from breaches of the covenant against solicitation could vary, according to the nature, extent, duration and success of the solicitation. Mr El Makdessi would say "markedly" less and vary "widely".

172. Two points may be made here. First, the covenants must be seen as a package designed to protect against activities, all of them aimed at competitive activity and all of them likely to be conducted in a manner difficult to detect and to be, if detected, difficult to evaluate with regard to their extent or impact. In this situation, Lord Atkinson's words in *Dunlop* appear to me to have resonance here:

> "The object of the appellants in making this agreement, if the substance and reality of the thing and the real nature of the transaction be looked at, would appear to be a single one, namely, to prevent the disorganization of their trading system and the consequent injury to their trade in many directions.
>
> …
>
> It is, I think, quite misleading to concentrate one's attention upon the particular act or acts by which, in such cases as this, the rivalry in trade is set up, … The consequential injuries to the trader's business arising from each breach by the employee of his covenant cannot be measured by the direct loss in a

> monetary point of view on the particular transaction constituting the breach."

This was said in a context where Dunlop was protecting the whole of its business, involving many actual and potential transactions with many different purchasers, by imposing trading restrictions on every purchaser. In the present case, Cavendish is protecting the whole of the business, of which it was to be majority shareholder, involving many actual and potential transactions with many different customers, by imposing a competitive restriction on the sellers from whom it was buying the majority control. In each case, the focus should be on the overall picture, not on the individual breaches.

173. Second, so far as it is said, obviously correctly, that breach of clause 11.2(d) may have consequences different from those of clauses 11.2(a) to (c), the speeches in *Dunlop* may be seen as open to different interpretations. On the one hand, the situation may be argued to fall within Lord Dunedin's fourth proposition, para (c). On the other hand, the whole of clause 11.2 may be regarded as doing (in Lord Atkinson's further words at p 93) "little, if anything, more than impose a single obligation" - here refraining from any potentially competitive activity. Lord Parker exposed the problems in this area to particularly detailed examination at p 98, when he described the position as

> "more complicated when the stipulation, though still a single stipulation, is capable of being broken more than once, and in more ways than one, such as a stipulation not to solicit the customers of a firm. A solicitation which is unsuccessful, can give rise to only nominal damages, and even if it be successful the actual damage may vary greatly according to the value of the custom which is thereby directly or indirectly lost to the firm. Still, whatever damage there is must be the same in kind for every possible breach, and the fact that it may vary in amount for each particular breach has never been held to raise any presumption or inference that the sum agreed to be paid is a penalty, at any rate in cases where the parties have referred to it as agreed or liquidated damages.
>
> The question becomes still more complicated where a single sum is agreed to be paid on the breach of a number of stipulations of varying importance. It is said that in such a case there arises an inference or presumption against the sum in question being in the nature of agreed damages, even though the parties have referred to it as such. My Lords, in this respect I think a distinction should be drawn between cases in which

> the damage likely to accrue from each stipulation is the same in kind and cases in which the damage likely to accrue varies in kind with each stipulation. Cases of the former class seem to me to be completely analogous to those of a single stipulation, which can be broken in various ways and with varying damage; but probably it would be difficult for the court to hold that the parties had pre-estimated the damage if they have referred to the sum payable as a penalty.
>
> In cases, however, of the latter class, I am inclined to think that the prima facie presumption or inference is against the parties having pre-estimated the damage, even though the sum payable is referred to as agreed or liquidated damages. The damage likely to accrue from breaches of the various stipulations being in kind different, a separate pre-estimate in the case of each stipulation would be necessary, and it would not be very likely that the same result would be arrived at in respect of each kind of damage."

174. Applying this passage, on the assumption that clause 11.2 should be regarded as containing, in Lord Parker's words, "a number of stipulations of varying importance" I would consider that the damage likely to accrue from each such stipulation was the same in kind - being damage from competitive activity. On that basis, Lord Parker's approach would lead to the conclusion that there was no penal presumption.

175. It is submitted, however, by Mr Bloch that clause 5.1 is penal for a different reason, because of the size and haphazard nature of its potential impact in forfeiting entitlement to receive the Interim and/or Final Payments, so far as not yet paid at the time of its breach. Taking the size of impact, it is common ground that a substantial part of the purchase price comprised goodwill (SFI, para 16). This is clear from the terms of the agreement alone (especially clauses 11.1 and 11.7), but is further confirmed by the evidence of Mr Scott for Cavendish and by the figures alone. The net assets of the entire Group were, by the terms of the sale and purchase agreement, warranted by Mr El Makdessi to be US$69.7m as at 31 December 2007. That indicates that in broad terms around US$33m of the US$65.5m paid to Mr El Makdessi and Mr Ghoussoub by way of Completion and Second Payments was seen as attributable to the Group's net asset value. Their total entitlement was capped under clause 3.3 at US$147.5m. Deducting the net asset value element of the Completion and Second Payments, the anticipated goodwill value must have been up to US$114.5m, of which US$32.5m (about 26%) was covered by the Completion and Second Payments, meaning that up to US$82m was anticipated to come by way of the Interim and Final Payments, of which Mr El Makdessi's 53.88% share would be some US$44m. On Cavendish's case, Mr El Makdessi's breach of clause 11.2

deprives him of any claim to this or any other goodwill element of the value of his shares over and above that already covered by the Completion and Second Payments.

176. Mr Bloch submits that this arrangement self-evidently lacks any rational connection between the severity of the breach or of its consequences and the impact of clause 5.1. A partial response to this submission is that there may be a connection as a result of the timing of the Interim and/or Final Payments. Clause 5.1 will only result in the loss of either Payment, if the breach occurs before the payment is due. The Due Date for each such Payment is 30 days after determination of the relevant OPAT for all financial periods to which the Payment relates. That would normally mean at some point in the first half of 2010 in the case of the Interim Period, and in the first half of 2012 in the case of the Final Payment. The later the breach in time, the less its impact on the Group and the less likely that it would occur in time for clause 5.1 to bite.

177. That, however, amounts to a very crude link, at best. And it means that clause 5.1 is only capable of operating as any form of protection for Cavendish against breaches occurring for something over four years from the date of agreement, while clause 11.2 is capable of continuing and being broken for a much longer period of years (24 months after the Relevant Date, itself potentially postponed until whenever Mr El Makdessi exercises the put option provided by clause 15).

178. Further, Mr Bloch can point to a respect in which the mechanism of clause 5.1 is likely to work in a quite opposite direction to any that would be expected: that is, in inverse ratio to any loss caused to the Group by the breach. The earlier and greater the breach, the more likely that Mr El Makdessi would be profiting by it at the expense of the Group, in a way affecting the Group's OPAT and so reducing the Interim and Final Payments and the impact of their loss under clause 5.1. In contrast, a small breach with small consequences for the Group at an early stage would leave the Group's OPAT unaffected, and would mean that clause 5.1 had the maximum possible impact on Mr El Makdessi.

179. Cavendish's response to such points is in essence that they focus too narrowly on the consequences of breach. In line with Lord Atkinson's approach in *Dunlop* (paras 142 and 172 above), the focus should be not on any particular possible breach or its timing or consequences, but on the general interest being protected, and the question whether the protection which the parties agreed can be condemned as unconscionable or manifestly excessive. In this connection, Miss Smith submits that what was in substance agreed was a price formula, which reverted, understandably, in the event of breach of clause 11.2 to a basis of valuation omitting any further goodwill element. In this connection, Miss Smith drew attention to the provision in clause 3.1 stating that the agreed payments were all in consideration of "the sale of

the Sale Shares and the obligations of the Sellers herein". However, I do not regard that as assisting the argument. The same could be said of any obligation triggering a penalty clause, and one might add that neither the Interim nor the Final Payment is expressly tied to clause 11.2, although each is expressly made "subject to the provisions of clause 6", dealing with "Calculation of OPAT and payment of the consideration".

180. Cavendish's general response nonetheless appears to me to have substantial force. The essence of what the parties were agreeing was that goodwill was crucial, and that there could be no further question of paying for any goodwill element of Mr El Makdessi's shares if he committed a breach of his non-competitive obligations under clause 11.2. It is true that, in the circumstances existing for at least the first 18 months after the agreement, any such breach would be actionable in damages by Team, with the result that Cavendish's loss would in theory be made good and it could itself have had no contractual claim for damages because of the rule precluding recovery of reflective loss. But after 18 months this would not necessarily be the case, and even during the 18-month period, it is understandable that Cavendish should no longer be prepared to pay any further goodwill element, once competitive activity by Mr El Makdessi had cast a doubt over the current and future value of the Group's goodwill. As with a bank loan, so here, on a much larger scale, it can be said that any such breach could and would change in a fundamental respect the risk element involved in Cavendish's purchase of a large block of shares in the Group.

181. On this basis, the question still remains whether clause 5.1 can and should be condemned as penal, on the grounds that it is extravagant, exorbitant or unconscionable in its nature and impact. Not without initial hesitation, and despite the powerful points made by Mr Bloch, I have come to the conclusion that, in this particular agreement made deliberately and advisedly between informed and sophisticated parties, the court should answer this question in the negative, and hold that clause 5.1 is enforceable. Its effect was to revise the basic price calculation for the shares which had been agreed to be sold, and, so viewed in the context of a carefully negotiated agreement between informed and legally advised parties at arm's length, I do not consider it can or should be regarded as extravagant, exorbitant or unconscionable.

182. I turn to clause 5.6. This raises somewhat different considerations. It is a provision requiring Mr El Makdessi as the party in breach to transfer property in his remaining shares against his will at a price based on net asset value alone. It is explained in terms of a desire to sever all interest from someone who has breached his contract. But it does so, first by imposing on the contract-breaker a forced deprivation of property which was not otherwise agreed to be sold under the contract broken, and second by doing this at a price which (unlike clause 5.1 which leaves the contract-breaker with a substantial element of goodwill value, under the

Completion and Second Payments) deprives him of the whole of any goodwill value attaching to such property.

183. I accept that a forced transfer for no consideration or for a consideration which does not reflect the value of the asset transferred may constitute a penalty within the scope of the penalty doctrine. But clause 5.6 must be viewed in nature and impact as a composite whole as well as in context. It operates as an element in a mechanism provided by clauses 5 and 11.2 for bringing to an end the continuing relationship between WPP and a defaulting shareholder. Although triggered by default, it amounts, like clause 5.1, to a reshaping of the parties' primary relationship. Had their relationship as common shareholders in the Group continued, Mr El Makdessi would have continued to be bound by the restrictions contained in clause 11.2, until 2016 (para 122 above), and would have had the benefit of the put option contained in clause 15. The Relevant Option Price which Mr El Makdessi could receive upon his exercise of the Put Option provided by clause 15 would have been based again on eight times average OPAT over four years (starting with the year preceding the exercise of the Option) capped at US$75m. As with the price of the shares which Mr El Makdessi agreed to sell, so with the Option Price, the parties clearly envisaged that a price calculated on such a basis would exceed by a multiple a net asset based price. Clause 5.6 would not have made any real sense otherwise.

184. However, once Mr El Makdessi breached clause 11.2, the position changed radically. It is accepted that, once such a breach occurred, it was in principle understandable that he should be required to sever any shareholding relationship completely by selling his remaining shares. But that would at the same time release him from his restrictive covenants, in view of the definition of the "Relevant Date", set out in para 122 above. The Group without the protective benefit of the restrictive covenants would be vulnerable (potentially for many years during which it could legitimately have expected to be protected by the covenants) in a way which would clearly justify revisiting the basis on which any price for the purchase of Mr El Makdessi's remaining shareholding was set. What the fortunes of the Group would be, following premature severance of relations, in circumstances where it was now open to Mr El Makdessi to compete as much as he wished, would be difficult, if not impossible, to predict.

185. Again, Mr Bloch submits that the clause is likely to operate in a highly random manner. A small breach committed at an early stage but of little consequence for the Group's OPAT will deprive the Defaulting Shareholder of a large goodwill value; a large breach committed at an early stage to the Defaulting Shareholder's benefit will depress the goodwill value of the Option Shares, and cost the Defaulting Shareholder less. But the ultimate question is in my view whether this carefully negotiated clause, attributing a nil value to goodwill on a forced severance of shareholding relationships triggered by a breach of basic restrictive covenants, can be regarded as exorbitant or unconscionable, having regard to the

completely new scenario created by any breach of the restrictive covenants. Once it is accepted, I think inevitably, that complete severance of relationships was a natural provision to include as a consequence of any such breach, I do not consider that an agreement that this should take place on a basis ignoring any goodwill which might subsist can or should be regarded as being either exorbitant or unconscionable.

186. That makes it unnecessary to consider Mr Bloch's further submissions that, if clause 5.6 was a penalty but it was in principle understandable that the parties should have agreed on severance of their shareholding relationship, Cavendish could have invited, but has not invited, any offer of the type which Dillon and Nicholls LJJ in *Jobson v Johnson* considered that a contract-breaker such as Mr El Makdessi could be required to make. In the present case, that would (presumably) be an offer to sell the remaining shares at a fair or market price. That would go further than anything that Dillon and Nicholls LJJ specifically endorsed in that case. It is unnecessary to say more about this aspect of the decision in *Jobson v Johnson*, on which I would in an appropriate case have wished to hear further and fuller submissions.

187. It follows that I would allow the appeal in respect of both clauses 5.1 and 5.6.

*Application of the penalty doctrine - ParkingEye Limited v Beavis*

188. There is common ground between all before the court that the relationship between ParkingEye and Mr Beavis was a contractual relationship, whereby Mr Beavis undertook not to park for more two hours and, upon any breach of that obligation, incurred a liability of £85, reducible, in this case, to £50 if he had paid within 14 days of ParkingEye's demand.

189. The Court of Appeal raised a question about this analysis, which the Supreme Court also took up. But I am satisfied that it is correct in law. The terms of the signs which Mr Beavis must be taken to have accepted by conduct in entering and parking in the car park are to that effect. Mr Beavis thereby expressly agreed to stay for two hours maximum, and to comply with the other parking restrictions, such as parking within a marked bay and not using a blue badge holder's bay, and to pay the stipulated sum if he failed so to comply.

190. It may be suggested that Mr Beavis thereby promised nothing which can in law constitute valuable consideration. He was being given a licence, on conditions, and he would have been a trespasser if he overstayed or failed to comply with its other conditions. But ParkingEye was not in possession of the car park, or capable of bringing proceedings in trespass. It had a mere right to control parking at the site

- the right to permit or refuse others to park there on such conditions as it might stipulate. By promising ParkingEye not to overstay and to comply with its other conditions, Mr Beavis gave ParkingEye a right, which it would not otherwise have had, to enforce such conditions against him in contract. Even if no Parking Charge had been stipulated, enforcement would still have been possible in law, even if a claim for damages or for an injunction might not in practice have been likely. With the stipulated Parking Charge, the nature of the intended contract is even clearer, although the question arises whether the Parking Charge is an unenforceable penalty. The quid pro quo provided by ParkingEye in return for Mr Beavis's promise was the grant of permission to park for up to two hours in its discretion free of charge, on conditions. Each party thus gave the other valuable consideration.

191. ParkingEye argued that Parliament has, by the Protection of Freedoms Act 2012, effectively recognised the legitimacy of a scheme such as theirs, in a way precluding or at least militating against any application of the penalty doctrine. The judge and Court of Appeal (para 28) also found some support in this Act for the view that charges of this kind are not to be regarded as unenforceable. In my view, that is a misreading of the Act. The Act merely "makes provision for the recovery of unpaid parking charges from the keeper or hirer of a vehicle" (section 56), in circumstances "where (a) the driver of a vehicle is required by virtue of a relevant obligation to pay parking charges in respect of the parking of the vehicle on relevant land; and (b) those charges have not been paid in full" (Schedule 4, paragraph 1). The reference to a relevant "obligation" does not exclude the penalty doctrine. On the contrary, if a charge stipulated contractually is a penalty, there will be no obligation.

192. There is nothing in the detailed definitions to affect this straightforward conclusion. Schedule 4, paragraph 2(1) provides that: "'parking charge' - (a) in the case of a relevant obligation arising under the terms of a relevant contract, means a sum in the nature of a fee or charge, and (b) in the case of a relevant obligation arising as a result of a trespass or other tort, means a sum in the nature of damages". "Relevant contract" is defined in wide terms including a contract which arises only on parking and is made either with the owner or occupier of the land or with someone like ParkingEye authorised by the owner or occupier to enter into a contract requiring the payment of parking charges: Schedule 4, paragraph 2(1). "Relevant obligation" means (a) an obligation arising under the terms of a relevant contract or, (b) where there is no relevant contract, as a result of a trespass or other tort committed by the parking: Schedule 4, paragraph 2(1). The reference to a "sum in the nature of damages is to a sum of which adequate notice was given to drivers of vehicles (when the vehicle was parked …)": Schedule 4, paragraph 2(2). The position in tort may one day merit closer examination, since it is not clear to me on what basis, other than contractual, the driver of a vehicle can incur any obligation to pay a sum in the nature of damages as a result of a trespass or other tort, however much notice was given to him or her when the vehicle was parked. If there is such a

basis, however, I have little doubt that the law would also extend the penalty doctrine to cover it.

193. The penalty doctrine is therefore potentially applicable to the present scheme. It is necessary to identify the interests which it serves. They are in my view clear. Mr Beavis obtained an (admittedly revocable) permission to park and, importantly, agreement that if and so far as he took advantage of this it would be free of charge. ParkingEye was able to fulfil its role of providing a traffic management maximisation scheme for BAPF. The scheme met, so far as appears, BAPF's aim of providing its retail park lessees with spaces in which their customers could park. All three conditions imposed were directed to this aim, and all were on their face reasonable. (The only comment that one might make, is that, although the signs made clear that it was a "Customer only car park", the Parking Charge of £85 did not apply to this limitation, which might be important in central Chelmsford. The explanation is, no doubt, that, unlike a barrier operated scheme where exit can be made conditional upon showing or using a ticket or bill obtained from a local shop, a camera operated scheme allows no such control.) The scheme gave BAPF through ParkingEye's weekly payments some income to cover the costs of providing and maintaining the car park. Judging by ParkingEye's accounts, and unless the Chelmsford car park was out of the ordinary, the scheme also covered ParkingEye's costs of operation and gave their shareholders a healthy annual profit.

194. Mr de Waal for Mr Beavis and Mr Butcher for the Consumers' Association submit that this is to look at matters too broadly and that the focus should be on the individual contract. They also submit that it is imbalanced and unfair in its operation as regards Mr Beavis or any other individual user of the car park. Mr de Waal goes so far as to suggest that the scheme contains a "concealed pitfall", since it actually operates not by reference to length of time spent parking, but by length of time spent between entry into and exit from the car park. That to my mind is an a-contextual understanding of the signs. Whether or not ParkingEye's cameras at the entry and exit are clearly visible, I do not believe that customers think that individual car parking spaces are monitored or a period spent driving around such a car park looking for a space is likely to fall outside the "2 hour max stay" or period of "Parking limited to 2 hours" specified in the signs.

195. More significantly, Mr de Waal and Mr Butcher observe that the scheme only works by taking advantage of human fallibility or unforeseen circumstances. Deliberate overstayers can leave their cars for days and only pay £85 (or the reduced sum if they pay promptly on demand). That is evidently not a problem or the scheme would provide for some form of gradated payment. Other shoppers believe that they will complete their shopping expedition within two hours and intend to do so. The scheme therefore relies on human (over)optimism, that the relevant shopping expedition will be over within two hours, or that the shopper will not find him or herself detained in a queue at the last minute in the last shop. Those who overstay

do not incur the £85 or reduced liability in any real sense by agreement, but by misfortune.

196. Mr de Waal and Mr Butcher point out that the sum of £85 or £50 could well represent a large part of a car driver's or owner's weekly income, eg in the case of a pensioner, and that, even adjacently to Chelmsford Station it is likely well to exceed any sum that would be payable for parking for say three hours in a car park charging according to time stayed. They also submit that ParkingEye's level of charging compares unfavourably with that authorised under the Civil Enforcement of Parking Contraventions (England) General Regulations 2007 (SI 2007/3483) and the Civil Enforcement of Parking Contraventions (Guidelines on Levels of Charges) (England) Order (SI 2007/3487). These authorise a penalty charge of £50, reducible, if paid within 21 days, to £25 for parking in contravention of one of the statutory or regulatory provisions listed in Schedule 7, paragraph 4 of the Traffic Management Act 2004. But a scheme relating to the enforcement of parking and parking charges by public authorities in public places is in no way analogous to that in issue on this appeal. Further, merely because statute sets a lower level does not mean that a higher level would not have been reasonable.

197. In judging whether ParkingEye's parking charges fall foul of the penalty doctrine, the scheme it operates has to be seen as a whole, bearing in mind all the interests obviously involved. This follows from what I have said in earlier parts of this judgment in relation to the penalty doctrine generally and in relation to its application to clause 5.1 of the agreement in the Cavendish appeal in particular. A useful starting point is that BAPF might have decided to operate such a scheme itself. In that case, its interest in providing for its retail lessees' requirements for parking for their customers would be both clear and clearly relevant. It does not cease to be relevant, because BAPF chose to contract out the operation of the scheme to ParkingEye. The signs disclose that ParkingEye has been engaged as car park manager to provide a traffic space maximisation scheme. The provision of free parking for up to two hours is an obvious benefit and attraction for customers and so also for retail lessees and for BAPF, which has a clear interest in the retail park's success.

198. The £85 charge for overstaying is certainly set at a level which no ordinary customer (as opposed to someone deliberately overstaying for days) would wish to incur. It has to have, and is intended to have, a deterrent element, as Judge Moloney QC recognised in his careful judgment (para 7.14). Otherwise, a significant number of customers could all too easily decide to overstay, limiting the shopping possibilities of other customers. Turnover of customers is obviously important for a retail park. A scheme which imposed a much smaller charge for short overstaying or operated with fine gradations according to the period of overstay would be likely to be unenforceable and ineffective. It would also not be worth taking customers to court for a few pounds. But the scheme is transparent, and the risk which the

customer accepts is clear. The fact that, human nature being what it is, some customers under-estimate or over-look the time required or taken for shopping, a break or whatever else they may do, does not make the scheme excessive or unconscionable. The charge has to be and is set at a level which enables the managers to recover the costs of operating the scheme. It is here also set at a level enabling ParkingEye to make a profit. Unless BAPF was itself prepared to pay ParkingEye, which would have meant, in effect, that it was subsidising customers to park on its own site, this was inevitable. If BAPF had attempted itself to operate such a scheme, one may speculate that the charge might even have had to be set at a higher level to cover its costs without profit, since ParkingEye is evidently a specialist in the area.

199. In these circumstances, the fact that no individual episode of overstaying, or of mis-parking, could be said to involve ParkingEye or BAPF in any ascertainable damage is irrelevant. What matters is that a charge of the order of £85 (reducible on prompt payment) is an understandable ingredient of a scheme serving legitimate interests. Customers using the car park agree to the scheme by doing so. The position was well summed-up by Judge Moloney QC (para 7.16), when he said that:

> "although there is a sense in which this contractual parking charge has the characteristics of a deterrent penalty, it is neither improper in its purpose nor manifestly excessive in its amount. It is commercially justifiable, not only from the viewpoints of the landowner and ParkingEye, but also from that of the great majority of motorists who enjoy the benefit of free parking at the site, effectively paid for by the minority of defaulters, who have been given clear notice of the consequences of overstaying."

*ParkingEye Limited v Beavis - Unfair Terms in Consumer Contracts Regulations 1999*

200. The 1999 Regulations address the problem of unfair terms in contracts concluded between a seller or supplier and a consumer. They implement Directive 93/13/EEC. By virtue of regulation 3(1) (Interpretation), ParkingEye is a supplier and Mr Beavis a consumer. Regulation 8(1) provides that "An unfair term in a contract concluded with a consumer by a seller or supplier shall not be binding on the consumer".

201. Regulation 5(1) specifies what is to be understood by an unfair term. It provides that:

> "A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer."

This repeats, exactly, the terms of article 3(1) of the Directive. The terms of the parking contract made between ParkingEye and Mr Beavis were not of course individually negotiated.

202. Regulation 6 provides:

> "(l) Without prejudice to regulation 12, the unfairness of a contractual term shall be assessed, taking into account the nature of the goods or services for which the contract was concluded and by referring, at the time of conclusion of the contract, to all the circumstances attending the conclusion of the contract and to all the other terms of the contract or of another contract on which it is dependent.
>
> (2) In so far as it is in plain intelligible language, the assessment of fairness of a term shall not relate -
>
> > (a) to the definition of the main subject matter of the contract, or
> >
> > (b) to the adequacy of the price or remuneration, as against the goods or services supplied in exchange."

This, although subsection (2) is differently worded, gives effect to article 4 of the Directive. It is not suggested in the present case that the term requiring payment of £85 (reducible) in the event of non-compliance with ParkingEye's regulations falls within either limb of regulation 6(2).

203. Directive 93/13/EEC indicates in its 16th preamble that:

> "the assessment, according to the general criteria chosen, of the unfair character of terms … must be supplemented by a means of making an overall evaluation of the different interests

> involved; whereas this constitutes the requirement of good faith; whereas, in making an assessment of good faith, particular regard shall be had to the strength of the bargaining positions of the parties, whether the consumer had an inducement to agree to the term and whether the goods or services were sold or supplied to the special order of the consumer; whereas the requirement of good faith may be satisfied by the seller or supplier where he deals fairly and equitably with the other party whose legitimate interests he has to take into account."

204. The Court of Justice has in *Mohamed Aziz v Caixa d'Estalvis de Catalunya, Tarragona i Manresa (Catalunyacaixa)* (Case C-415/11) given guidance as to article 3(1) of the Directive, holding that:

> "Article 3(1) of Directive 93/13 must be interpreted as meaning that:
>
> - the concept of 'significant imbalance' to the detriment of the consumer must be assessed in the light of an analysis of the rules of national law applicable in the absence of any agreement between the parties, in order to determine whether, and if so to what extent, the contract places the consumer in a less favourable legal situation than that provided for by the national law in force. To that end, an assessment of the legal situation of that consumer having regard to the means at his disposal, under national law, to prevent continued use of unfair terms, should also be carried out;
>
> - in order to assess whether the imbalance arises 'contrary to the requirement of good faith', it must be determined whether the seller or supplier, dealing fairly and equitably with the consumer, could reasonably assume that the consumer would have agreed to the term concerned in individual contract negotiations."

205. Domestically, the position was considered by the House of Lords in *Director General of Fair Trading v First National Bank plc* [2002] 1 AC 481 where Lord Bingham said (para 17) that:

> "The requirement of significant imbalance is met if a term is so weighted in favour of the supplier as to tilt the parties' rights and obligations under the contract significantly in his favour. This may be by the granting to the supplier of a beneficial option or discretion or power, or by the imposing on the consumer of a disadvantageous burden or risk or duty. The illustrative terms set out in Schedule 3 to the Regulations provide very good examples of terms which may be regarded as unfair; whether a given term is or is not to be so regarded depends on whether it causes a significant imbalance in the parties' rights and obligations under the contract. This involves looking at the contract as a whole. But the imbalance must be to the detriment of the consumer; … The requirement of good faith in this context is one of fair and open dealing. Openness requires that the terms should be expressed fully, clearly and legibly, containing no concealed pitfalls or traps. Appropriate prominence should be given to terms which might operate disadvantageously to the customer. Fair dealing requires that a supplier should not, whether deliberately or unconsciously, take advantage of the consumer's necessity, indigence, lack of experience, unfamiliarity with the subject matter of the contract, weak bargaining position or any other factor listed in or analogous to those listed in Schedule 2 to the Regulations. Good faith in this context is not an artificial or technical concept; nor, since Lord Mansfield was its champion, is it a concept wholly unfamiliar to British lawyers. It looks to good standards of commercial morality and practice. Regulation 4(1) lays down a composite test, covering both the making and the substance of the contract, and must be applied bearing clearly in mind the objective which the Regulations are designed to promote."

206. In the same case, Lord Millett said of regulation 5(1) (para 54):

> "There can be no one single test of this. It is obviously useful to assess the impact of an impugned term on the parties' rights and obligations by comparing the effect of the contract with the term and the effect it would have without it. But the inquiry cannot stop there. It may also be necessary to consider the effect of the inclusion of the term on the substance or core of the transaction; whether if it were drawn to his attention the consumer would be likely to be surprised by it; whether the term is a standard term, not merely in similar non-negotiable consumer contracts, but in commercial contracts freely

> negotiated between parties acting on level terms and at arms' length; and whether, in such cases, the party adversely affected by the inclusion of the term or his lawyer might reasonably be expected to object to its inclusion and press for its deletion. The list is not necessarily exhaustive; other approaches may sometimes be more appropriate."

207. Many of the submissions under the 1999 Regulations overlap as a matter of fact with submissions already considered in the context of the penalty doctrine. The legal test is of course different. It is however relevant and necessary in the present context as in relation to the penalty doctrine to consider "the different interests involved" (16th recital to the Directive), which brings in all the factors discussed in paras 193-199 above. Again, reliance is placed on the fact that the charge of £85 (reducible) is incurred by overstaying for the shortest of periods, and does not vary according to the length of overstay. But that, for reasons already indicated, is an integral element of the scheme.

208. Reliance is also placed on the Court of Justice's emphasis in *Aziz* on the need to consider, first, what the position would have been under national law apart from the challenged term and, second, on whether the supplier could reasonably assume that the consumer would have agreed such a term in individual contract negotiations. Bearing in mind the need under the Directive and Regulations to consider all the circumstances, the Court of Justice cannot be taken to have been identifying considerations that would by themselves be conclusive, rather than relevant. That also reflects what Lord Millett said in the passage just quoted. It is clear that, but for the agreement made when parking, Mr Beavis would not have had any right to park at all, and would have been liable to damages in trespass, for which it would, almost certainly, not have been worth BAPF's while to pursue him. That would not have achieved any of BAPF's aims, and cannot here be an appropriate comparator when assessing the legitimacy or fairness of the scheme put in place by BAPF and ParkingEye. In reality, BAPF would have had to make some entirely different arrangement, involving perhaps barriers with either machines to take payments or a car park attendant to cater for overstayers. But that would not mean that BAPF or ParkingEye could or would have lowered the charge for overstaying, which, as stated, had to be set at a deterrent level if their aim of encouraging a regular turnover of customers was to be achieved.

209. The submission that ParkingEye could not reasonably assume that customers in Mr Beavis's position would have agreed to the scheme in individual contract negotiations is less easy to address. A customer in Mr Beavis's position, if asked about the terms on which he would wish to park, would no doubt have been very satisfied with a proposal of two hours free parking, but would very probably have asked for some form of gradated payment in the event of overstaying. Confronted with the other interests involved and the considerations making that unacceptable

from BAPF's and ParkingEye's viewpoint, I am not at all confident that he or she would have refused to accept the risk of having to pay £85 (reducible on prompt payment) in the event of overstaying.

210. Mr de Waal and Mr Butcher submit that this would only have been because the customer would have under-estimated the risk, and, at this point, again suggest that the scheme trades off the weakness of well-meaning customers. They point to *Office of Fair Trading v Ashbourne Management Services Ltd* [2011] EWHC 1237 (Ch), [2011] CTLC 237, where Kitchin J held that the minimum membership term provisions in a number of standard form gym membership contracts were unfair and invalid, because:

> "The defendants' business model was designed and calculated to take advantage of the naivety and inexperience of the average consumer using gym and health clubs at the lower end of the market. The defendants knew that the average consumer overestimates the use he will make of the gym and health clubs and exploited this fact."

The problem in this respect was that the defendants, who operated gym membership schemes, themselves accepted that it was "a notorious fact that many people join such gym clubs having resolved to exercise regularly but fail to attend at all after two or three months".

211. A reading of Kitchin J's judgment indicates how fact sensitive his conclusions were, differing according to his analysis of the particular terms of different contracts before him. In particular, because contracts 11 to 13 before him allowed early termination in a wider range of circumstances (eg medical, change of employment or a move of more than 15 miles: para 50), he was prepared to accept a minimum term not exceeding 12 months – this, even though the identified problem related to members joining enthusiastically without thinking that they might well be leaving after only two or three months; and he added that he might well have been prepared to accept up to 24 or 36 months, had the contracts given an option to terminate after 12 months, coupled with a requirement to reimburse the differential between the agreed subscription and a shorter term subscription in respect of the period up to termination (para 174). There was therefore a balancing of all the interests involved at each stage.

212. Although the submissions that the scheme was unfair within the meaning of the 1999 Regulations were forcefully presented, I cannot ultimately accept them. Judge Moloney QC summarised his conclusions as follows (para 7.18):

> "a. It is difficult to categorise as not in good faith a simple and familiar provision of this sort of which very clear notice was given to the consumer in advance.
>
> b. There is not a significant imbalance between the parties' rights and obligations, when the motorist is given a valuable privilege (two hours free parking) in return for a promise to pay a specified sum in the event of overstaying, provided that sum is not disproportionately high.
>
> c. The charge in question is not disproportionately high, and insofar as it exceeds compensation its amount is justifiable, and not in bad faith or detrimental to the consumer."

213. I agree with the way Judge Moloney QC put it, as did the Court of Appeal. In the result, I would dismiss Mr Beavis's appeal.

*Conclusion*

214. It follows that in the Cavendish case, I would allow Cavendish's appeal in relation to both clause 5.1 and clause 5.6; and that I would also dismiss Mr Beavis's appeal in the second case brought by ParkingEye.

**LORD HODGE:**

215. I adopt with gratitude the summary of the facts and the procedural history of the two appeals in the joint judgment of Lord Neuberger and Lord Sumption (at paras 44-68 in relation to the Cavendish appeal and paras 89-96 in relation to Mr Beavis's appeal). Like them, I would allow the Cavendish appeal and dismiss the appeal by Mr Beavis.

216. Cavendish's primary submission was that this court should abolish the rule that the courts do not enforce penalty clauses. This issue affects Scots law as well as English law as the rule is essentially the same in each jurisdiction, although the Scottish courts have in certain circumstances a power to abate the penalty which the English courts do not. Scots law has used English authorities in its development – see Bell's *Principles of the Law of Scotland* (10th ed) section 34 – and has, through the case of *Clydebank Engineering and Shipbuilding Co Ltd v Castaneda* [1905] AC 6, (1905) 7 F (HL) 77, had a significant influence on the development of English

law. I therefore focus on authorities from both jurisdictions in this judgment but also refer to authorities from other common law jurisdictions.

217. The Cavendish appeal raises three principal issues:

i) What is the scope of the rule against penalties?

ii) Whether that rule should be abrogated or at least altered so as not to apply in commercial transactions where the contracting parties are of equal bargaining power and each acts on skilled legal advice? And if not,

iii) Whether and, if so, how the rule should be applied in the circumstances of the appeal?

218. I have come to the conclusion that the rule, which in each jurisdiction is now a rule of the law of contract, should not be abrogated. I have also concluded that its application in the circumstances of the Cavendish contract does not require the court to refuse to give effect to the parties' agreement. I set out my reasoning below before turning more briefly to Mr Beavis's appeal.

*The scope of the rule against penalties*

219. The modern law in relation to penalty clauses was laid down by the House of Lords and the Judicial Committee of the Privy Council in a quartet of cases over 100 years ago. First, the House of Lords examined a liquidated damages clause in the *Clydebank Engineering* case in 1904. Then the Privy Council applied the decision in *Clydebank* to a retention clause in *Public Works Comr v Hills* [1906] AC 368 and to a liquidated damages clause in *Webster v Bosanquet* [1912] AC 394. Finally, in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79, which again concerned a liquidated damages clause, the House of Lords, in the speech of Lord Dunedin, set out an approach to the rule which has dominated judicial discussion ever since.

220. In that case at pp 86-88 Lord Dunedin drew various propositions of law from the earlier three cases of the quartet. To assist later discussion I set out those propositions so far as necessary:

> "1. Though the parties to a contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed

to mean what they say, yet the expression used is not conclusive. The court must find out whether the payment stipulated is in truth a penalty or liquidated damages. This doctrine may be said to be found passim in nearly every case.

2. The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage (*Clydebank Engineering …*).

3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach (*Public Works Comr v Hills* and *Webster v Bosanquet*).

4. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:

> (a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach. (Illustration given by Lord Halsbury in *Clydebank* case.)
>
> (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid (*Kemble v Farren* 6 Bing 141). This though one of the most ancient instances is truly a corollary to the last test. …
>
> (c) There is a presumption (but no more) that it is a penalty when 'a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage' (Lord Watson in *Elphinstone v Monkland Iron and Coal* Co 11 App Cas 332).

On the other hand:

> (d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties (*Clydebank Case*, Lord Halsbury at p 11; *Webster v Bosanquet*, Lord Mersey at p 398)."

221. I observe that Lord Dunedin stated the first three propositions without qualification. The first and the third have caused no difficulty: the court looks to the substance of the transaction and approaches the matter as a question of construing the particular contract at the time when it was made. The second has caused difficulty when it has been treated as creating in all cases a dichotomy between a genuine pre-estimate of damage on the one hand and a deterrent against breach on the other, if the former is understood to be a calculation of what common law damages would be. Indeed, in the *Dunlop* case itself the clause was upheld not because an individual discounted sale would cause loss of the stipulated magnitude but because of the danger of repeated undercutting of the appellant's prices for their products, which would disrupt their trading system - see in particular Lord Atkinson at pp 92-93. I will return to that proposition. Lord Dunedin prefaced the tests in the fourth proposition with a recognition that they might be neither helpful nor conclusive in a particular case. That is important, but, as I shall seek to explain, I take issue with that approach in relation to proposition 4(a), which in my view contains the essence of the test, where the contractual provisions seek to fix a sum payable as damages, and an adapted form of that test applies where the clause is protecting other interests of the innocent party.

*(a) The clauses to which the rule against penalties applies*

222. One of the reasons for the problem with the second proposition has been that the penalty doctrine applies not only to clauses which seek to set the damages to be paid on breach of contract but also to clauses which set out other consequences of a breach of contract. Thus in *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752 Colman J, in a celebrated judgment dealing with a contractual provision to increase the rate of interest on a loan during a period of default, did not ask himself whether the provision was a genuine pre-estimate of damage. He considered whether it was commercially justifiable to increase the consideration payable under an executory contract upon the happening of default. He concluded that the 1% prospective increase in the interest rate was commercially justifiable so long as the dominant

purpose was not to deter the borrower from breach. In my view, that decision was clearly correct as a default affected the credit risk that the lender undertook.

223. The Court of Appeal in *Cine Bes Filmcilik Ve Yapimcilik v United International Pictures* [2004] 1 CLC 401 supported Colman J's approach. Mance LJ, who produced the leading judgment, recognised (at para 15) that there were clauses which might operate on breach and which were commercially justifiable but which did not fall into either category of a dichotomy between a genuine pre-estimate of damages and a penalty. In that case UIP had granted a licence to Cine Bes to show films on its movie channel. There were disputes over the licence agreement which resulted in litigation which the parties compromised in an agreement to grant a fresh licence. UIP later terminated the fresh licence on the ground of Cine Bes's breach of contract. One of the provisions that Cine Bes challenged as a penalty was that it should pay to UIP not only its enforcement costs for the default on the fresh licence but also its litigation costs in the prior litigation. The Court of Appeal rejected this challenge, Mance LJ stating (at para 33):

> "The agreement regarding past litigation costs was understandable in the overall context of the settlement of the prior litigation. It would be wrong to treat it as if it were there to deter [Cine Bes] from, or to penalise or punish [Cine Bes] for, any default. It was an understandable and reasonable commercial condition upon which UIP was prepared to dispose of the prior litigation, and to enter into the fresh licence."

Mance LJ, drawing on Colman J's analysis, drew a distinction between a reasonable commercial condition on the one hand and a punishment on the other. As I shall seek to show, there is support for this dichotomy in the older case law.

224. The Court of Appeal again considered the penalty doctrine in *Murray v Leisureplay plc* [2005] IRLR 946, which concerned a provision in the employment contract of a chief executive that entitled him to one year's gross salary in the event of the termination of his employment without one year's notice. The company challenged this entitlement as a penalty because common law damages would have given the director a sum after deduction of tax and national insurance contributions and he would have been under an obligation to mitigate his loss. The court rejected this challenge, accepting that the provision, which provided the director with generous reassurance against dismissal and could result in greater recovery than the amount of his actual loss which he could recover at common law, was commercially justified.

225. In my view, this broader approach of Colman J and the Court of Appeal involves a correct analysis of the law and escapes the straightjacket into which the law risked being placed by an over-rigorous emphasis on a dichotomy between a genuine pre-estimate of damages on the one hand and a penalty on the other. To justify that view I will have to look briefly at the law before *Dunlop*. Before doing so, it is necessary to look at other provisions relating to breach of contract to which the rule against penalties has been applied or may apply and in particular (i) clauses withholding payments which were otherwise due, (ii) clauses requiring the party in breach to transfer property to the innocent party and (iii) clauses providing for the payment of a non-refundable deposit in a contract of sale.

226. *Clauses withholding payments on breach*: I see no principled reason why the law on penalties should be confined to clauses that require the contract-breaker to pay money in the event of breach and not extend to clauses that in the same circumstance allow the innocent party to withhold moneys which are otherwise due. Indeed, there is ample authority to support the view that clauses which allow the innocent party to withhold payments on breach may be unenforceable as penalties where the sums retained are, or may be, wholly disproportionate to the loss suffered by the withholding party. One of the quartet of cases to which I referred in para 219 above - *Public Works Comr v Hills* – is an example of the application of the rule against penalties to a clause seeking in the event of a breach of contract to withhold money otherwise due to a contractor. In English law the House of Lords in *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689 considered a clause in a construction sub-contract that allowed the main contractor to suspend or withhold payment of any moneys due to the sub-contractor if the sub-contractor failed to comply with any of its conditions. While the contractor conceded that this part of the contractual clause was a penalty, it is clear from the speeches of their Lordships that they agreed with the concession: see Lord Reid at p 698D-F, Lord Morris of Borth-y-Gest at p 703G, Viscount Dilhorne at p 711D and Lord Salmon at p 723H. The majority of the Court of Appeal (Stuart-Smith and O'Connor LJJ) followed that approach in *The Fanti and the Padre Island (No 2)* [1989] 1 Lloyd's Rep 239.

227. Cavendish has argued that such clauses should be seen as forfeiture clauses to which the law of penalties should not apply. Ms Smith urged that it would be a recipe for confusion if a single clause were to be classified in two different ways. I disagree. There is no reason in principle why a contractual provision, which involves forfeiture of sums otherwise due, should not be subjected to the rule against penalties, if the forfeiture is wholly disproportionate either to the loss suffered by the innocent party or to another justifiable commercial interest which that party has sought to protect by the clause. If the forfeiture is not so exorbitant and therefore is enforceable under the rule against penalties, the court can then consider whether under English law it should grant equitable relief from forfeiture, looking at the position of the parties after the breach and the circumstances in which the contract

was broken. This was the approach which Dillon LJ adopted in *BICC plc v Burndy Corpn* [1985] Ch 232 and in which Ackner LJ concurred. The court risks no confusion if it asks first whether, as a matter of construction, the clause is a penalty and, if it answers that question in the negative, considers whether relief in equity should be granted having regard to the position of the parties after the breach.

228. I therefore conclude that clauses that authorise the withholding of sums otherwise due to the contract-breaker may fall within the scope of the rule against penalties.

229. Different considerations may arise when, on its rescission of a contract of sale, the vendor seeks to retain instalments of the price which the purchaser has made; in English law the equitable remedy against forfeiture may be available to preserve the purchaser's claim for restitution of the instalments: *Stockloser v Johnson* [1954] 1 QB 476; *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130. But we are not concerned with such circumstances in this appeal.

230. *Clauses requiring the transfer of property on breach*: Again I see no reason in principle why the rule against penalties should not extend to clauses that require the contract-breaker to transfer property to the innocent party on breach. There is authority in both English law and Scots law supporting this approach. In *Jobson v Johnson* [1989] 1 WLR 1026 the Court of Appeal considered a clause that required a purchaser of shares to re-transfer shares to the vendor for a fixed consideration if he defaulted on payment of instalments of the price. The clause was treated as a penalty because it fixed the re-transfer price at a modest figure regardless of the number of the much larger instalments which the purchaser had paid before his default. The case was an unusual one and the approach of the court to a remedy was influenced by the absence of a counterclaim for relief from forfeiture. I do not accept the conclusion in that case that the court had power in English law to modify a penalty (see para 283 below). But that does not, in my view, call into question the court's unanimous conclusion that the clause was caught by the rule against penalties. See also *Else (1982) Ltd* (above) Evans LJ at pp 137h and 138e. As I have said in para 227 above I see no confusion resulting from an assessment first, whether a clause is a penalty and, if it is not, considering whether to grant relief from forfeiture.

231. In the Scottish case of *Watson v Noble* (1885) 13 R 347 a ship-owner sold seven shares in a trawler to the appellant and was paid £100 for them. In a subsequent agreement the owner agreed to employ the appellant as captain of the vessel and to hold the shares in trust for him. The ship-owner imposed an obligation on the captain to remain sober and attentive to his duties on pain of dismissal and forfeiture of both his shares and the right to claim repayment of the £100 which he had paid for the shares. In an application by the appellant for repayment of the £100

after his dismissal, the Second Division treated the forfeiture of the shares as a penalty which could not be enforced and, because the ship-owner refused to transfer the shares, required him to repay the £100 which he had received for them.

232. There is also considerable support in Australian authority for the application of the rule against penalties to clauses requiring a party in breach to transfer property to the innocent party. See, for example, *Bysouth v Shire of Blackburn and Mitcham (No 2)* [1928] VLR 562, Irvine CJ at pp 574-575; *Forestry Commission of New South Wales v Stefanetto* (1976) 133 CLR 507, Mason J at p 521; *Wollondilly Shire Council v Picton Power Lines Pty Ltd* (1994) 33 NSWLR 551, Handley JA at p 555F-G; *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 in which the point was conceded (p 665); and *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* [2008] NSWCA 310, Allsop P at paras 101-102. The Court of Appeal in New Zealand has taken a similar view: *Amaltal Corpn Ltd v Maruha (NZ) Corpn Ltd* [2004] 2 NZLR 614, Blanchard J at para 61.

233. I am satisfied therefore that the rule against penalties can be applied to a contractual term that provides for the transfer on breach of contract of property from the contract-breaker to the innocent party.

234. *Clauses requiring the purchaser to pay an extravagant non-refundable deposit*: In English law a non-refundable deposit is a guarantee by a purchaser that the contract will be performed: *Howe v Smith* (1884) 27 Ch D 89, Cotton LJ at p 95; *Soper v Arnold* (1889) 14 App Cas 429, 435 per Lord MacNaghten. It provides the vendor with some assurance of performance while the property is taken off the market during the period from the date of the contract to the completion of performance. If the contract is performed, the deposit forms part of the purchase price. If the purchaser breaks the contract, the vendor keeps the deposit. As Fry LJ stated in *Howe v Smith* (at p 101):

> "It is not merely a part payment, but is then also an earnest to bind the bargain so entered into, and creates by the fear of its forfeiture a motive in the payer to perform the rest of the contract."

Where the deposit was fixed at a reasonable figure, its forfeiture on breach of contract does not bring into play the rule against penalties, its purpose not being related to any loss that the vendor may have suffered and that he may seek to recover in damages: *Wallis v Smith* (1882) 21 Ch D 243, Jessel MR at p 258. But in *Stockloser v Johnson* [1954] 1 QB 476, Denning LJ suggested (at p 491) that a party could not call a stipulation for an initial payment of 50% of the purchase price a deposit and thereby achieve a forfeiture from which equity could give no relief. He

said (at p 492) that the equity of restitution was to be tested not at the time of the contract but by the conditions existing when it was invoked. This suggests that he was considering relief from forfeiture rather than the rule against penalties. More directly relevant is Lord Radcliffe's statement in *Campbell Discount Co Ltd v Bridge* [1962] AC 600, when discussing deposits (at p 624):

> "… I do not see any sufficient reason why in the right setting a sum of money may not be treated as a penalty, even though it arises from an obligation that is essentially a guarantee."

235. The Judicial Committee of the Privy Council has developed the idea that an extravagant deposit should not be forfeited on breach of contract. In *Linggi Plantations Ltd v Jagatheesan* [1972] 1 MLJ 89, Lord Hailsham (at p 94) suggested that where, on investigation, the real nature of an initial payment, which was termed a deposit, was shown to be the imposition of a penalty, it might be recovered by the purchaser, and that it was only a reasonable deposit that was irrecoverable. More recently, in *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573, the Board addressed the question whether a deposit of 25% of the purchase price in the contract for the purchase of land from a bank at auction in Jamaica (where 10% deposits were customary) could be forfeited. Lord Browne-Wilkinson, who gave the Board's advice, spoke (at p 579) of the risk that the special treatment which the law gives to deposits being abused if the contracting parties attach the label "deposit" to a penalty. The Privy Council made the validity of a deposit conditional upon whether it was "reasonable as earnest money". Lord Browne-Wilkinson stated (at p 580):

> "In order to be reasonable a true deposit must be objectively operating as 'earnest money' and not as a penalty. To allow the test of reasonableness to depend upon the practice of one class of vendor, which exercises considerable financial muscle, would be to allow them to evade the law against penalties by adopting practices of their own."

The Board therefore took as a norm the long established practice both in Jamaica and the United Kingdom of a deposit of 10% and required a vendor who sought a larger percentage to show special circumstances to justify that deposit. In effect, the Board applied a test of commercial justification akin to the test which Colman J later applied in *Lordsvale Finance plc*.

236. In *Polyset Ltd v Panhandat Ltd* (2002) 5 HKCFAR 234 the Hong Kong Court of Final Appeal carried out a thorough review of the law relating to deposits. The court considered the cases which I have mentioned and concluded that the court

would intervene to prevent forfeiture where parties abused the concept of deposit. The forfeiture of a deposit would be enforced only if it were "reasonable as earnest money". Where the deposit exceeded the conventional amount, the court would permit forfeiture only if the party seeking to forfeit could show that exceptional circumstances justified the higher amount (Ribeiro PJ at para 90, Bokhary PJ at paras 10-18, Chan PJ at paras 40-42; Lord Millett NPJ at para 165). Because Bokhary PJ and Ribeiro PJ considered that the test of "genuine pre-estimate of loss" applied in the rule against penalties when considering whether a sum was liquidated damages, they did not view the "reasonable as earnest money" test as part of the law of penalties. But if, as I think correct, the true test for penalties is wider than the "genuine pre-estimate of loss" test (see paras 242-255 below), the Hong Kong court's conclusions were wholly consistent with Lord Browne-Wilkinson's approach in *Workers Trust*.

237. Historically, Scots law has followed English law in treating deposits as outside the rule against penalties, citing English authorities in support of the view that a deposit was a guarantee of or security for performance: *Commercial Bank of Scotland Ltd v Beal* (1890) 18 R 80; *Roberts & Cooper v Salvesen & Co* 1918 SC 794; *Zemhunt (Holdings) Ltd v Control Securities plc* 1992 SC 58. There has been no discussion whether that exclusion is confined to reasonable deposits. But in none of those cases was there a question whether the deposit was extravagant. In *Roberts & Cooper*, in which the First Division upheld the forfeiture of a £3,000 deposit on the purchase of a ship for £30,000 when the purchaser repudiated the contract, Lord Skerrington (at p 814) suggested that there was no reason why in a proper case a clause for the forfeiture of a purchaser's deposit should not be construed as a penalty and be unenforceable. I agree. As Scots law has followed English law in relation to the law of deposits, I see no reason why it should not adopt the modern approach of excluding only reasonable deposits from the rule against penalties.

238. I conclude therefore that in both English law and Scots law (a) a deposit which is not reasonable as earnest money may be challenged as a penalty and (b) where the stipulated deposit exceeds the percentage set by long established practice the vendor must show special circumstances to justify that deposit if it is not to be treated as an unenforceable penalty.

239. *Circumstances other than breach of contract:* The rule against penalties applies only in the context of a breach of contract. In English law the House of Lords has so held in *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399, 403 per Lord Roskill. In Scots law the question has not reached the House of Lords or the Supreme Court. But in *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296, Lord Keith, when a Lord Ordinary, held (p 298) that the rule against penalties had no application in a case which was not a case of breach of contract, and more recently, in *EFT Commercial Ltd v Security Change Ltd* 1992 SC 414, the First Division has re-asserted that position.

240. Mr Bloch, counsel for Mr Makdessi, suggested in the course of debate that the court could extend the rule against penalties. He referred to the controversial decision of the High Court of Australia in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, in which the court held that bank charges, which were imposed on customers on the occurrence of events which were not breaches of contract, could be characterised as penalties and thus be unenforceable.

241. As this suggestion is peripheral to the main arguments in this appeal, I deal with it shortly. I am satisfied that the rule against penalties in both English and Scots law has applied only in relation to secondary obligations – penal remedies for breach of contract. In Scotland, the courts administer an equitable as well as a common law jurisdiction without having two branches of jurisdiction. There is no freestanding equitable jurisdiction to render unenforceable as penalties stipulations operative as a result of events which do not entail a breach of contract. Such an innovation would, if desirable, require legislation.

*(b) The true test for a penalty*

242. In para 221 above I suggested (a) that there was a problem in the way in which the courts had read Lord Dunedin's second proposition and (b) that his proposition 4(a) contained the essence of the test: that is, whether the secondary obligation was exorbitant and unconscionable.

243. The rule against penalties is a rule of contract law based on public policy. It is a question of construction of the parties' contract judged by reference to the circumstances at the time of contracting; the public policy is that the courts will not enforce a stipulation for punishment for breach of contract.

244. In the first of the quartet of cases, *Clydebank Engineering*, the House of Lords held that the courts would not enforce a measure that was extravagant and unconscionable: Earl of Halsbury LC at p 10, Lord Davey at p 16 and Lord Robertson at p 20. Different expressions were used to describe the manifestly excessive nature of the measure in comparison with the interest which the challenged clause protected. But at its heart was the idea of exorbitance or gross excessiveness.

245. The phrase in Lord Dunedin's second proposition appears to have come from the opinion of Lord Kyllachy as Lord Ordinary in the *Clydebank Engineering* case ((1903) 5 F 1016 at p 1022) where he contrasted a measure which was "reasonable and moderate" and one which was "exorbitant and unconscionable" and said of the latter that:

> "the amount stipulated might be such as to make it plain that it was merely stipulated *in terrorem*, and could not possibly have formed … a genuine pre-estimate of the creditor's probable or possible interest in the due performance of the principal obligation."

246. While Lord Kyllachy's emphasis on a genuine pre-estimate suggests that he was considering clauses which are intended to fix the level of damages paid on breach of contract, the overriding test of exorbitance fits the wider range of circumstances in which the rule against penalties has been applied, including enhanced interest charges (*Lordsvale Finance*), the agreement to pay an employee sums in excess of common law damages (*Murray*), and deposits (*Workers Trust & Merchant Bank Ltd*). Lord Robertson's focus in the *Clydebank Engineering* case on the innocent party's interest in the due performance of the principal obligation and his posing of the question -

> "had the respondents no interest to protect by that clause, or was that interest palpably incommensurate with the sums agreed on?"

- provide the framework for the application of the exorbitance test to those wider circumstances.

247. Lord Dunedin's propositions were his summary of existing authorities. In his second proposition he drew on Lord Kyllachy's phrase to state the paradigms of a penalty on the one hand and liquidated damages on the other. Exorbitance featured in his proposition 4(a) and also in the speeches of Lord Atkinson (p 97: "unreasonable, unconscionable or extravagant") and Lord Parmoor (p 101: "extravagant or unconscionable"; "extravagant disproportion between the agreed sum and the amount of any damage capable of pre-estimate"). The focus on the disproportion between the specified sum and damage capable of pre-estimation makes sense in the context of a damages clause but is an artificial concept if applied to clauses which have another commercial justification.

248. Similarly, I doubt whether it is helpful to rely on the concept of deterrence. Many contractual provisions are coercive in nature, encouraging a contracting party to perform his or her obligations; the prospect of liability in common law damages itself is a spur to performance. Similarly, a deposit provides a motive for performance (para 234 above). Instead, the broader test of exorbitance or manifest excess compared with the innocent party's commercial interests fits the various applications of the rule against penalties and is consistent with the repeated warnings by the courts against imposing too stringent a standard. Thus in *Robophone*

*Facilities Ltd v Blank* [1966] 1 WLR 1428 (CA) Diplock LJ warned (at p 1447E), "The court should not be astute to descry a 'penalty clause'". In *Philips Hong Kong Ltd v Attorney General of Hong Kong* (1993) 61 BLR 41, Lord Woolf (at p 59) said:

> "[T]he court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld. Any other approach will lead to undesirable uncertainty especially in commercial contracts."

In *Murray* (above) Arden LJ expressed a similar view when she said (at para 43), "The parties are allowed a generous margin".

249. When the court makes a value judgment on whether a provision is exorbitant or unconscionable, it has regard to the legitimate interests, commercial or otherwise, which the innocent party has sought to protect. Where the obligation which has been breached is to pay money on a certain date, the innocent party's interests are normally fully served by the payment of the stipulated sum together with interest and the costs of recovery. More complex questions arise where there is an obligation to perform by a certain date, such as the construction of the torpedo boats in *Clydebank Engineering*, as the assessment of the loss suffered by the innocent party may often be difficult and parties may have an interest in fixing the level of compensation in advance to avoid the necessity of an expensive trial. In Scots law a distinction has also been drawn between the breach of an obligation to perform some act and the wilful breach of a prohibition; in the latter circumstance the court is less inclined to treat a harsh contractual remedy as unconscionable. Thus in *Forrest & Barr v Henderson, Coulbourn & Co* (1869) 8 M 187, Lord Neaves (at p 202) stated:

> "There are great differences in the stipulations themselves that are so made, and, in particular, there is a great difference according as the breach of contract consists in faciendo and in non faciendo. If a man wilfully goes against what he has promised not to do, that is an unfavourable case for restriction."

Lord Deas expressed a similar view at p 196.

250. As the rule against penalties is based on public policy and has developed over time, its current form is of more significance than its historical development. Lord Neuberger and Lord Sumption have discussed the origins and development of the rule in English law in paras 4-11 of their judgment. Professor David Ibbetson in "A Historical Introduction to the Law of Obligations" (1999) (pp 255-256) records how Scots law and South Africa's Roman-Dutch law came to influence the modern

English rule in *Dunlop*. It may therefore be helpful to say something about the development of the rule in Scots law.

251. In early Scots law penalties were associated with usury. While there are examples of the Court of Session enforcing penalties in the early 16th century, in *Home v Hepburn* (1549) Mor 10033 the Court of Session prohibited the imposition of punishments for breach of contract. In the abbreviated report of that case the court held:

> "de practica regni, poenae conventionales non possunt exigi, nisi quatenus interest actores, quia sapiunt quendam usuram et inhonestum questum …"

Balfour's *Practicks* (1579) gives a vernacular account of the case in these terms (Stair Society vol I, p 151):

> "Be the law of this realme, poena conventionales, sic as ane soume of money adjectit, with consent of parties, in ony contract or obligatioun, in name of pane, may not be askit be ony persoun bot in sa far as he is interestit, hurt or skaithit; because all sic painis are in ane maner usuraris, and dishonest, made for lucre or gane."

It is of note that the judgment referred to the innocent party's interest in performance ("interesse" – to have an interest) as well his injury or damage ("skaith"), foreshadowing Lord Robertson's formulation in *Clydebank Engineering*. Viscount Stair in his "Institutions of the Law of Scotland" regarded the power to modify exorbitant bonds and contracts as part of the *nobile officium* of the Court of Session, recognising that "necessitous debtors" yield to "exorbitant penalties" (Stair, IV.3.2). A penalty clause was seen as a secondary obligation, an additional means of enforcement; tendering the penalty did not release the contract-breaker from his primary obligation: *University of Glasgow v Faculty of Physicians and Surgeons* (1840) 1 Rob 397, 415.

252. The Court of Session, "as the supreme court of law and equity," exercised an equitable power of mitigation (Bell, *Commentaries on the Law of Scotland*, 7th ed (1870) vol I, 700). Many of the cases concerned the imposition of additional rent on an agricultural tenant who departed from the agreed cropping cycle of the land (as in *Stration v Graham* (1789) 3 Pat 119). In relation to penalty clauses in bonds, the courts enforced the penalty only to the extent of recovering the principal sum due,

interest and expenses. The power to modify a penalty was placed on a statutory basis and the extant provision is section 5 of the Debts Securities (Scotland) Act 1856:

> "[A]nd in all cases where penalties for non-payment, over and above performance, are contained in bonds or other obligations for sums of money, and are made the subject of adjudication, or of demand in any other shape, it shall be in the power of the court to modify and restrict such penalties, so as not to exceed the real and necessary expenses incurred in making the debt effectual."

More recently, in *Wirral Borough Council v Currys Group plc* 1998 SLT 463, Lord Hamilton (at p 467) confirmed that the statutory power to modify extends to money obligations other than bonds. Although the Scottish Parliament has enacted legislation to abolish the remedy of adjudication as a means of debt recovery (the Bankruptcy and Diligence etc (Scotland) Act 2007), the court retains a power to modify such penalties for failure to fulfil monetary obligations.

253. By the mid-19th century, case law on penalty clauses had moved to contracts for the supply of goods and services and construction contracts. Three cases, in which Lord Inglis participated, provided the backdrop for the *Clydebank Engineering* decision, the first of the quartet of cases which set out the modern law. In *Johnston v Robertson* (1861) 23 D 646, the Second Division held that a charge of £5 per week for the late completion of a poor house was liquidated damages and not a penalty; Lord Justice Clerk Inglis (at p 655) posed the question whether the stipulation was a reasonable and appropriate mode of enforcing the obligation to complete the work by the specified date and whether the sum was proportionate to the loss suffered by the innocent party. In *Craig v McBeath* (1863) 1 M 1020, 1022, Lord Justice Clerk Inglis cited *Home v Hepburn* in support of the proposition that "Parties cannot lawfully enter into an agreement that the one party shall be punished at the suit of the other". Lord Young enunciated a similar principle in *Robertson v Driver's Trs* (1881) 8 R 555, 562, stating that the law will not let people punish each other. In *Forrest & Barr* (above), which concerned the purchase and erection of a crane in a shipyard by a specified date and a penalty of £20 per day for delay, Lord President Inglis stated (at p 193) that equity would interfere to prevent a claim being maintained to an exorbitant and unconscionable amount. Lord Deas, Lord Ardmillan and Lord Neaves used the same expressions (at pp 198, 199 and 203 respectively); Lord Kinloch (at p 201) spoke of a claim being "so utterly extravagant and unreasonable" that the court could infer that it was a penalty or punishment.

254. This approach to penalty clauses is consistent with the judgments of the House of Lords in *Dunlop* in which an extravagant disproportion between an agreed

sum and the innocent party's interest in the due performance of the contract would amount to what Lord Parmoor described (p 100) as:

> "a penal sum inserted as a punishment on the defaulter irrespective of the amount of any loss which could at the time have been in contemplation of the parties ..."

255. I therefore conclude that the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract. Where the test is to be applied to a clause fixing the level of damages to be paid on breach, an extravagant disproportion between the stipulated sum and the highest level of damages that could possibly arise from the breach would amount to a penalty and thus be unenforceable. In other circumstances the contractual provision that applies on breach is measured against the interest of the innocent party which is protected by the contract and the court asks whether the remedy is exorbitant or unconscionable.

*(ii) Whether the rule against penalties should be abrogated or altered?*

256. I am not persuaded that there is any proper basis for abrogating the rule against penalties or restricting its application to commercial transactions where the parties are unequal in their bargaining power and there is a risk of oppression.

257. The rule against penalties is an exception to the general approach of the common law that parties are free to contract as they please and that the courts will enforce their agreements – *pacta sunt servanda*. The rule against penalties may have been motivated in part by a desire to prevent oppression of the weaker party by the more powerful party to a contractual negotiation. As I have said, Viscount Stair spoke of this danger when he spoke of necessitous debtors having to yield to exorbitant penalties (IV.3.2). Diplock LJ in *Robophone* (p 1447A) recognised the reality that many contracting parties could not contract à la carte but had to accept the table d'hôte of the standard term contract. In *AMEV–UDC Finance Ltd v Austin* (1986) 162 CLR 170, Mason and Wilson JJ (at pp 193-194) suggested that the rule was aimed at preventing oppression and that the nature of the relationship between the contracting parties was a factor relevant to unconscionableness. In *Philips v Hong Kong* (pp 58-59) Lord Woolf suggested that in some cases the fact that one of the contracting parties was able to dominate the other as to the choice of the contract terms was relevant to the application of the rule. But the application of the rule does not depend on any disparity of power of the contracting parties: *Imperial Tobacco Co (of Great Britain and Ireland) Ltd v Parslay* [1936] 2 All ER 515 (CA), Lord Wright MR at p 523. Because the rule is not so limited, Ms Joanna Smith QC argued

that the rule interferes with freedom of contract in circumstances in which it is not needed.

258. The rule may also be criticised because it can be circumvented by careful drafting. Indeed one of Cavendish's arguments was that clause 5.1 could have been removed from the scope of the rule if it had been worded so as to make the payment of the instalments conditional upon performance of the clause 11 obligations. This is a consequence of the rule applying only in the context of breach of contract. But where it is clear that the parties have so circumvented the rule and that the substance of the contractual arrangement is the imposition of punishment for breach of contract, the concept of a disguised penalty may enable a court to intervene: see *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] QB 433, Bingham LJ at pp 445-446 and, more directly, the American Law Institute's "Restatement of the Law, Second, Contracts" section 356 on liquidated damages and penalties, in which the commentary suggests that the court's focus on the substance of the contractual term would enable it in an appropriate case to identify disguised penalties.

259. It may also be said against the rule that it promotes uncertainty in commercial dealings as the contracting parties may not be able to foresee the judges' value judgment on whether a particular provision is exorbitant or unconscionable. There is beyond doubt real benefit in parties being able to agree the consequences of a breach of contract, particularly where there would be difficulty in ascertaining the sum in damages which was appropriate to compensate the innocent party for loss caused by the breach. Parties save on transaction costs where they can avoid expensive litigation on the consequences of breach of contract. It has also been said that judges should be modest in their assumptions that they know about business: *Wallis v Smith* (1882) 21 Ch D 243, Jessel MR at p 266.

260. Legislative measures have been introduced to control unfair terms in contracts. In recent years, the Unfair Terms in Consumer Contracts Regulations 1999 and the Consumer Protection from Unfair Trading Regulations 2008 have given effect to European Directives and more recently the Consumer Rights Act 2015 has been brought into force. But while this legislation may have reduced the need for the rule against penalties in consumer contracts, it has no bearing on commercial contracts.

261. There are therefore arguments that can be made against the rule against penalties, or at least against its scope. But I am persuaded that the rule against penalties should remain part of our law, principally for three reasons.

262. First, there remain significant imbalances in negotiating power in the commercial world. Small businesses often contract with large commercial entities and have little say as to the terms of their contracts. Examples such as the relationship between a main contractor and a sub-contractor in the construction industry and that between a large retail chain and a small supplier spring to mind.

263. Secondly, abolition of the rule against penalties would go against the flow of legal developments both nationally and internationally. Both the Law Commission of England and Wales and the Scottish Law Commission have looked at the rule against penalties and neither has recommended its abolition. The Law Commission's Working Paper No 61 on "*Penalty Clauses and Forfeiture of Monies Paid*" in 1975 proposed the extension of judicial control to embrace penalty clauses that come into operation without any breach of contract. More recently, the Scottish Law Commission's "Report on Penalty Clauses" in 1999 recommended the retention of judicial control over penalties whether they took the form of a payment of money, a forfeiture of money, a transfer of property or a forfeiture of property. It recommended a criterion of "manifestly excessive" and the abolition of any requirement that the clause be founded in a pre-estimate of damages. It also recommended that judicial control should not be confined to cases where the promisor is in breach of contract.

264. As counsel's very helpful researches showed, other common law countries such as Australia, Canada, New Zealand, Singapore and Hong Kong have rules against penalties, as has the commercially important law of New York, the Uniform Commercial Code and, as I have mentioned, the American Law Institute's "Restatement of the Law, Second, Contracts".

265. In the civil law tradition, which has had a profound influence on Scots law and which under Lord Mansfield influenced the development of English commercial law, the modern civil codes of Belgium (article 1231), France (article 1152), Germany (section 343), and Italy (article 1384) and the Swiss Code of Obligations (article 163) all provide for the modification of contractual penalties using tests such as "manifestly excessive", "disproportionately high", or "excessive". Further, in what Mr Bloch described as "soft law", recent international instruments prepared by expert lawyers, such as the Council of Europe's Resolution (78) 3 on Penal Clauses in Civil Law (1978) (article 7), the Principles of European Contract Law (1995) (article 9.509), the Unidroit Principles of International Commercial Contracts (1994) (article 7.4.13) and Uncitral texts on liquidated damages and penalty clauses (1983) (article 8) also provide for the restriction of "grossly excessive" or "manifestly excessive" or "substantially disproportionate" penalty clauses. The Draft Common Frame of Reference (III – 3:712) also provides for the reduction of stipulated payments for non-performance if they are "grossly excessive".

266. Thirdly, I am not persuaded that the rule against penalties prevents parties from reaching sensible arrangements to fix the consequences of a breach of contract and thus avoid expensive disputes. The criterion of exorbitance or unconscionableness should prevent the enforcement of only egregious contractual provisions.

267. Ms Smith's alternative proposal, that the rule should not extend to commercial transactions in which the parties are of equal bargaining power and each acts on skilled legal advice, does not appeal to me. Creating such a gateway to the application of the rule would risk adding to the expense of commercial disputes by requiring the court to rule on issues of fact about the bargaining power of the parties and the calibre of their respective legal advisers.

268. I therefore turn to the application of the rule against penalties in the two appeals.

*The application of the rule against penalties:*

*(a) in the Cavendish appeal*

269. Clause 5.1, which removes a seller's valuable rights to receive the interim payment and final payment if he is in breach of clause 11.2, was likely to deprive the defaulting shareholder of a substantial sum of money. The parties have agreed that the enforcement of the clause would deprive Mr El Makdessi of up to $44,181,600. Breach of clause 11.2 therefore comes at a high price.

270. There is clearly a strong argument, which Lord Neuberger and Lord Sumption favour, that in substance clause 5.1 is a primary obligation which made payment of the interim and final payments conditional upon the seller's performance of his clause 11.2 obligations. But even if it were correct to analyse clause 5.1 as a secondary provision operating on breach of the seller's primary obligation, I am satisfied that it is not an unenforceable penalty clause for the following six reasons.

271. First, it is important to consider the nature of the obligations of the sellers which could trigger the withholding of the instalments under clause 5.1. Clause 11.2 imposed restrictive covenants on the sellers, prohibiting them from competing with the company. Having sold substantial blocks of shares in the company for a price which attributed a high value to its goodwill, the sellers were prohibited from derogating from what they had sold.

272. Secondly, the factual matrix in the uncontested evidence of Mr Andrew Scott, WPP's director of corporate development, and Mr Ghossoub and recorded in the agreed statement of facts and issues showed the importance of personal relationships in the marketing sector and particularly in the Middle East. The statement of facts and issues recorded (at para 5) that the success of the Group's business depended on the personal relationships which Mr Ghossoub and Mr El Makdessi had built up with their key clients and in para 33, which Lord Neuberger and Lord Sumption quote at para 66 of their judgment, it explained that the agreement was structured to protect the goodwill of the Group. The continued loyalty of the sellers was critically important to preserving the value of the Group's goodwill.

273. Thirdly, that evidence and the agreement itself showed that a large proportion of the agreed purchase price was attributable to that goodwill. Extrapolating from the maximum consideration which the sellers could have received for the shares which they sold, the company had a maximum value of $300m which compares with its certified NAV (without goodwill) of $69.7m.

274. Cavendish therefore needed to be assured of the sellers' loyalty. It had a very substantial and legitimate interest in protecting the value of the company's goodwill. It did so by giving the sellers a strong financial incentive to remain loyal to the company by complying with the restrictions set out in clause 11.2. The sellers, who, like Cavendish, had access to expert legal advice and negotiated the contract over several months, agreed to peril their entitlement to the deferred consideration on their continued loyalty.

275. Fourthly, I am not persuaded by Mr Bloch's argument that clause 5.1 was exorbitant because it could be triggered by a minor breach of clause 11.2, such as an unsuccessful solicitation of a senior employee. That appears to me to be unrealistic. Clause 5.1 was not addressing the loss which Cavendish might suffer from breach of the restrictive covenant, whether an isolated and minor breach or repeated and fundamental breaches. It was addressing the disloyalty of a seller who was prepared in any way to attack the company's goodwill. No question therefore arises of a presumption of a penalty where the same sum is payable on the occurrence of several events which may cause serious or trifling damages as in Lord Dunedin's proposition 4(c) in *Dunlop*. In any event, that presumption would not apply because the losses arising from any breach of clause 11.2 were generically the same – see Lord Parker of Waddington in *Dunlop* at p 98. As Lord Neuberger and Lord Sumption have said (para 75), loyalty is indivisible.

276. Fifthly, Mr Bloch submitted that clause 5.1 might operate perversely as far as Mr El Makdessi was concerned because a minor breach of clause 11.2, which did not harm the company's goodwill, would result in his losing more by the loss of the interim and final payments than a major breach which diminished the profits of the

company and thus the deferred consideration. Similarly, he submitted that a breach that was detected before the interim payment or the final payment would have more serious consequences for the seller than one detected later. But again clause 5.1 is not addressing the loss which Cavendish may incur from a particular breach. The relevant questions are broader, namely (i) whether Cavendish had a legitimate interest in the circumstances to protect its investment in the company and (ii) whether the making of its later instalments of price depend upon each seller's performance of his clause 11.2 obligations was a manifestly excessive means of protecting that interest.

277. Finally, I am not persuaded that the company's entitlement to seek a disgorgement of Mr El Makdessi's profits arising from his breach of fiduciary duty and the possibility that Cavendish itself might have a claim in damages if Mr El Makdessi breached clause 11.2 after he ceased to be a director make the operation of clause 5.1 exorbitant or unconscionable. The former is *res inter alios acta* as each of Cavendish and the company have separate legal personality. Any award of damages to Cavendish would be designed to place it in the same position financially as if the contract had been performed. If an award of damages together with the price reduction which clause 5.1 effects involved double counting, I would expect the price reduction to be credited against the claim for damages.

278. In summary, I am persuaded that in the circumstances of this share purchase, Cavendish had a very substantial legitimate interest to protect by making the deferred consideration depend upon the continued loyalty of the sellers through their compliance with the prohibitions in clause 11.2. I do not construe clause 5.1 as a stipulation for punishment for breach; it is neither exorbitant nor unconscionable but is commensurate with Cavendish's legitimate interests. It may therefore be enforced.

279. Clause 5.6, which provides for the compulsory transfer of the defaulting shareholder's retained shareholding, is more difficult. But I have come to the view that it also may be enforced. Mr El Makdessi does not contest the obligation placed on the defaulting shareholder to transfer his shares on breach of contract. But he challenges the price at which the compulsory transfer is to be effected, as the formula for the calculation of the price excludes the value of goodwill.

280. There is again a strong argument, which Lord Neuberger and Lord Sumption favour, that clause 5.6 is a primary obligation to which the rule against penalties does not apply. But if all such clauses were treated as primary obligations, there would be considerable scope for abuse. I construe the clause as a secondary obligation, which is designed to deter (a) the sellers from breaching their clause 11.2 obligations and (b) a seller who is an employee from misconduct which damages the interests of the Group and leads to summary dismissal (viz the Schedule 12 definition of "defaulting shareholder").

281. Clause 5.6, like clause 5.1, is not a provision which fixes the damages payable for a breach of contract. It seeks to regulate the terms on which a defaulting shareholder severs his connection with the company. It falls to be construed in the context of the agreement as a whole, in which Cavendish agreed to pay a price for the shares which it purchased on the basis that the sellers remained involved in the company for transitional periods and complied with their clause 11.2 duties for at least two years after they had exercised their put options under clause 15 or had otherwise ceased to hold shares in the company. I think that Mr El Makdessi was correct in accepting that, if a seller acted in breach of clause 11.2 by competing with the company in any of the ways listed in that clause, Cavendish would act reasonably in seeking to remove him from any involvement in the company, including by the compulsory transfer of his shareholding. On the departure of the defaulting shareholder, the company would lose both his work on its behalf and also his valuable personal connections. It was readily foreseeable at the time of contracting that the departure on default of either of the sellers would cause significant damage to the company's goodwill and thus materially reduce its value.

282. Against that background, the question for the court is whether the defaulting shareholder option price, which was the net asset value of the company excluding any goodwill value, was an exorbitant or unconscionable undervaluation when measured against Cavendish's legitimate interest in protecting its investment from the risk of either of the sellers acting against the company's interests. In my view, the terms were harsh; but they were not exorbitant. They were not a punishment but, in the particular context of the purchase of a marketing business in the Middle East, were a legitimate means of encouraging the sellers to comply with their clause 11.2 obligations which were critical to Cavendish's investment. Nor were the terms unconscionable for any broader reason. The contract was negotiated in detail by parties of relatively equal bargaining power and with skilled legal advice; a seller could readily comply with the obligations in clause 11.2, which were, in Lord Neaves's words in *Forrest & Barr* (para 249 above), obligations in *non faciendo*, or prohibitions.

283. For completeness, I comment on Mr Bloch's suggestion that the court has a power to modify the terms on which clause 5.6 would operate. In English law a penalty clause cannot be enforced. For the reasons given by Lord Neuberger and Lord Sumption in their judgment (at paras 84-87) I think that the decision of the Court of Appeal in *Jobson v Johnston* was incorrect in so far as it modified a penalty clause and should be overruled. In Scots law the statutory power of the court to modify a penalty (para 252 above) does not extend to a penalty in support of a primary obligation other than for payment of a sum of money. If there is in Scots law a residual common law power of modification of penalties in support of primary obligations such as to supply goods or services as in *Craig v McBeath* (above), I do not see how the power of abatement can extend to modifying the price of a compulsorily transferred asset.

*(b) in Mr Beavis's appeal*

284. I agree (a) that the relationship between ParkingEye and Mr Beavis was a contractual relationship in the form of a licence and (b) that the parking charge incurred on breach of the obligation to park for no more than two hours engages the rule against penalties. If my analysis of the rule against penalties is correct, the only relevant questions are (i) did ParkingEye have a legitimate interest to protect by the imposition of the parking charge (ii) whether the level of the charge is exorbitant or unconscionable.

285. This is because, first, the charge was not and did not purport to be a claim for damages for any loss that ParkingEye would suffer as a result of a motorist exceeding the two-hour maximum parking time. ParkingEye suffered no loss. Secondly, the fact that the charge encouraged the motorist to comply with the terms of the licence and deterred him or her from overstaying or parking irresponsibly outside the marked parking bays did not make it a penalty. Deterrence in that sense is not the test for a penalty.

286. ParkingEye had a legitimate interest to protect. It provided a service to its clients, the owners of the retail park which leased units to retailers. It undertook to manage the car park in a way which benefitted the owners and the retailers and also the public seeking to visit units within the retail park by encouraging the public to remain in the car park for no longer than two hours. ParkingEye imposed the parking charge in order to encourage the prompt turnover of car parking spaces and also to fund its own business activities and make a profit.

287. That legitimate interest would not justify the parking charge if it were out of all proportion to that interest, or, in other words, exorbitant. In deciding whether the charge was exorbitant, I think that the court can look at the statutorily authorised practice of local authorities in England and Wales and also the recommendations of the accredited trade association, the BPA. Neither is conclusive and the question is ultimately a value judgment by the court. But local authority practice, the BPA guidance, and also the evidence that it is common practice in the United Kingdom to allow motorists to stay for two hours in such private car parks and then to impose a charge of £85, support the view that such a charge was not manifestly excessive. There was no other evidence that suggested otherwise. In so far as the criterion of unconscionableness allows the court to address considerations other than the size of the penalty in relation to the protected interest, the fact that motorists entering the car park were given ample warning of both the time limit of their licence and the amount of the charge also supports the view that the parking charge was not unconscionable.

288. I therefore conclude that the rule against penalties is no bar against the enforcement of the parking charge imposed on Mr Beavis.

*Mr Beavis's other ground of appeal: the Unfair Terms in Consumer Contracts Regulations 1999*

289. I was initially in some doubt about the correct answer to this challenge. But on further consideration I am persuaded for the reasons given by Lord Neuberger and Lord Sumption and also by Lord Mance that the £85 charge did not infringe the 1999 Regulations.

*Conclusion*

290. I would therefore allow the appeal in *Cavendish v El Makdessi* and dismiss the appeal in *ParkingEye v Beavis* and make the declarations that Lord Neuberger and Lord Sumption propose in para 115 of their joint judgment.

**LORD CLARKE:**

291. I agree that the appeal in *Cavendish* should be allowed, that that in *Beavis* should be dismissed and that we should make the declarations proposed by Lord Neuberger and Lord Sumption. In reaching those conclusions I agree with the reasoning of Lord Neuberger and Lord Sumption, Lord Mance and Lord Hodge. As to the relationship between penalties and forfeiture, my present inclination is to agree with Lord Hodge (in para 227) and with Lord Mance (in paras 160 and 161) that in an appropriate case the court should ask first whether, as a matter of construction, the clause is a penalty and, if it answers that question in the negative, it should ask (where relevant) whether relief against forfeiture should be granted in equity having regard to the position of each of the parties after the breach.

**LORD TOULSON: (dissenting in part on ParkingEye Limited)**

292. I agree with paras 116 to 187 of the judgment of Lord Mance and paras 216 to 283 of the judgment of Lord Hodge. In short, I agree with them on all points of general principle about the doctrine of penalties, its interrelationship with forfeiture and the application of the principles in the Cavendish case.

293. On the essential nature of a penalty clause, I would highlight and endorse Lord Hodge's succinct statement at para 255 that "the correct test for a penalty is

whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract". Parties and courts should focus on that test, bearing in mind a) that it is impossible to lay down abstract rules about what may or may not be "extravagant or unconscionable", because it depends on the particular facts and circumstances established in the individual case (as Lord Halsbury said in the *Clydebank* case, [1905] AC 6, 10, and Lord Parmoor said in the *Dunlop* case, [1915] AC 79, 101), and b) that "exorbitant or unconscionable" are strong words. I agree with Lord Mance (para 152) that the word "unconscionable" in this context means much the same as "extravagant".

294. On the inter-relationship between the law relating to penalties and forfeiture clauses, I agree specifically with paras 160-161 of Lord Mance's judgment and paras 227-230 of Lord Hodge's judgment. Ms Smith argued in her written case and orally that if relief were to be granted at all to Mr El Makedessi it should be pursuant to the relief against forfeiture, because clauses such as 5.1 were properly to be regarded as forfeiture clauses and the penalty doctrine was therefore not capable of being applied. I would reject that argument for the reasons given by Lord Mance and Lord Hodge. I agree with them that the proper approach is to consider first whether the clause was an exorbitant provision to have included in the contract at the time when it was made; and, if not, to consider next whether any relief should properly be granted under the equitable doctrine of relief against forfeiture in the circumstances at and after the time of the breach. As Lord Mance and Lord Hodge have noted, this approach was followed by the Court of Appeal (Ackner, Kerr and Dillon LJJ) in *BICC plc v Bundy Corpn* [1985] Ch 232. It is logical and just.

295. I disagree with the other members of the court in the parking case. Since I am a lone voice of dissent and the judgments are already exceedingly long, I will state my reasons briefly. Everyone agrees that there was a contract between Mr Beavis and ParkingEye, but I begin by looking at what was the consideration for, and essential content of, the contract. The parties were content to argue the case, as they had in the Court of Appeal, on the basis that by using the car park Mr Beavis entered into a contract by which he agreed to leave it within two hours; and that his failure to do so was a breach of contract for which he agreed to pay £85 (subject to a discount for prompt payment). Moore-Bick LJ expressed doubt whether this was the correct analysis, and since this is a test case it is right to consider the matter.

296. Where parties intend to enter into legal relations, it does not require much to constitute consideration. Some benefit must be conferred both ways; but the benefit provided by the promisor does not have to be for the promisee personally; it may be for some third party whom the promisee wishes to benefit. (This has nothing to do with the doctrine of privity.) Any act or promise in exchange for an act or promise can constitute consideration.

297. In this case we are concerned with a car park forming an integral part of a retail park occupied by a number of well-known chains. The use of the car park was not merely a benefit to the user. It was of obvious benefit to the freeholder (and the lessees of the retail outlets) that members of the public should be attracted to the retail park by its availability, and that was no doubt why it was provided. As Mr Christopher Butcher QC correctly submitted, the use of the car park by Mr Beavis was sufficient consideration for a contract governing the terms of its usage. The form of notice stated that "Parking is at the absolute discretion of the site", but once a motorist had parked he would obviously have to be given reasonable notice of a requirement to leave.

298. The most important term of the contract was that the user was permitted to stay for a maximum of two hours. That requirement was displayed in bigger and bolder letters than anything else. There were subsidiary requirements; that the user should not return within one hour after leaving; that parking should be within the bays marked; and that certain bays were restricted to use by blue badge holders (ie persons with mobility problems). The contract further stated, although this was not legally necessary, that "By parking within the car park, motorists agree to comply with the car park regulations", meaning the provisions stated in the notice (since there were no other regulations). Overstaying would therefore be a breach of contract (as, for example, would be parking except within the lines of an appropriate marked bay). In the case of a breach of any description, the user agree to pay the sum of £85. This was therefore, as the parties rightly accepted, an agreement to pay a specified figure for a breach of contract. It was not an agreement allowing a motorist to overstay in consideration of a payment of £85. On overstaying (or for that matter on returning within one hour after leaving the car park) the user would be a trespasser. We are not concerned in this case whether the agreement to pay £85 would leave the landowner free to sue the user for damages for trespass, although he would no doubt in theory be entitled to seek injunctive relief.

299. It is convenient to consider the effect of the Unfair Terms in Consumer Contracts Regulations 1999 ("the Regulations") before considering the effect of the common law on penalty clauses. Regulation 8(1) provides that an unfair term in a contract concluded with a consumer by a seller or supplier shall not be binding on the consumer. An unfair term is defined in regulation 5(1):

> "A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer."

300. Regulation 6(1) requires the question of unfairness to be assessed, taking into account the nature of the goods or services, and by referring to all the circumstances at the time of the conclusion of the contract and to all the other terms of the contract.

301. Regulation 6(2) excludes from the assessment of fairness terms (provided that they are in plain intelligible language) relating to the definition of the main subject matter of the contract or to the adequacy of the price or remuneration, as against the goods or services supplied in exchange. The term which levies £85 on a user of the car park who overstays, or returns within an hour or parks badly, does not provide remuneration for the services of ParkingEye, nor does it relate to the definition of the subject matter of the contract. It is simply a penalty for doing one of the things prohibited. Its enforceability depends on whether it satisfies the requirement of fairness within the meaning of the Regulations.

302. Schedule 2 to the Regulations provides an indicative list of terms which may be considered unfair, including a term requiring a consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation.

303. The Regulations give effect to the European Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts ("the Directive"). Article 3(1) of the Directive is the counterpart to regulation 5(1) and is identically worded.

304. In *Director General of Fair Trading v First National Bank plc* [2001] UKHL 52, [2002] 1 AC 481, para 17, Lord Bingham described this provision as laying down a composite test, covering both the making and the substance of the contract, which must be applied bearing in mind the object which the Regulations are designed to promote. He said that fair dealing requires that the supplier should not, deliberately or unconsciously, take advantage of the consumer's necessity, indigence, lack of experience, unfamiliarity with the subject matter of the contract, weak bargaining position or any factor listed in or analogous to those listed in the Schedule.

305. In the same case Lord Millett, at para 54, suggested as a matter for consideration whether, as between parties negotiating freely a contract on level terms, the party adversely affected by the term "or his lawyer" might reasonably be expected to object to it.

306. More recently in *Aziz v Caixa d'Estalvis de Catalunya, Tarragona i Manresa* (Case C-415/11) [2013] 3 CMLR 89, the Court of Justice of the European Union has addressed the interpretation of article 3(1) of the Directive. It observed (at para

44) that the system of protection introduced by the Directive is based on the idea that the consumer is in a weak position vis-à-vis the seller or supplier.

307. In agreement with the opinion of Advocate General Kokott, the court held that the reference in article 3(1) to a "significant imbalance" in the parties' rights and obligations under the contract must be interpreted as requiring the court to evaluate to what extent the term places the consumer in a worse position than would have been the situation under the relevant national law in the absence of that term. Applying that test, it follows that the £85 penalty clause created a significant imbalance within the meaning of the regulation, because it far exceeded any amount which was otherwise likely to be recoverable as damages for breach of contract or trespass.

308. As to whether the imbalance was contrary to the requirement of good faith, the court, at para 76 in agreement with the Advocate General held that

> "in order to assess whether the imbalance arises 'contrary to the requirement of good faith', it must be determined whether the seller or supplier, dealing fairly and equitably with the consumer, could reasonably assume that the consumer would have agreed to the term concerned in individual contract negotiations."

309. That test is significantly more favourable to the consumer than would be applied by a court in this country under the penalty doctrine. Whereas the starting point at common law is that parties should be kept to their bargains, and it is for those objecting that a clause is penal to establish its exorbitant nature, the starting point of the Directive is that the consumer needs special protection, and it is for the supplier to show that a non-core term which is significantly disadvantageous to the consumer, as compared with the ordinary operation of the law without that term, is one which the supplier can fairly assume that the consumer would have agreed in individual negotiations on level terms. The burden is on the supplier to adduce the evidence necessary to justify that conclusion.

310. I do not consider that such an assumption could fairly be made in the present case. The Consumers' Association through Mr Butcher advanced a number of telling points. By most people's standards £85 is a substantial sum of money. Mr Butcher reminded the court by way of comparison that the basic state pension is £115 per week. There may be many reasons why the user of a car park in a retail park may unintentionally overstay by a short period. There may be congestion in the shops or the user may be held up for any number of reasons. There may be congestion trying to get out of the car park. In short there may be numerous unforeseen circumstances.

No allowance is made for disabilities (other than the provision of bays for blue badge holders). Similarly there may be good reasons for a person to return to the car park within two hours, for example because the shopper has left something behind (and the car park may incidentally be half empty). There may be reasons why a user parks with his wheels outside the marked bay (for example because of the way the adjacent vehicle is parked or because he is a wheelchair user and none of the blue bays are available). Examples could be multiplied. The point is that the penalty clause makes no allowance for circumstances, allows no period of grace and provides no room for adjustment.

311. The court was referred to a code of practice published by the British Parking Association which addresses some of these matters, but the significant fact is that it is not a contractual document. A competent lawyer representing a user in individual negotiation might be expected, among other things, to argue that the supplier should at least commit to following the code of practice.

312. More broadly the penalty clause places the whole cost of running the car park on the shoulders of those who overstay by possibly a very short time, although their contribution to the cost will have been very small. The trial judge and the Court of Appeal were impressed by a comparison with the charges at local authority car parks. The comparison is seductive but superficial. Apart from the fact that local authorities operate under a different statutory scheme, a large amount of the cost is raised from all users by hourly charges, as distinct from placing the entire burden on the minority of overstayers; and there is not the same feature in the case of a municipal car park as there is in a supermarket car park, where the car park is ancillary to the use of the retail units some of whose customers are then required to underwrite the entire cost as a result of overstaying.

313. There is of course an artificiality in postulating a hypothetical negotiation between the supplier and an individual customer with the same access to legal advice, but because it is a consumer contract, and because the supplier is inserting a term which alters the legal effect under the core terms in the supplier's favour, the supplier requires as it were to put itself in the customer's shoes and consider whether it "can reasonably assume that the customer would have agreed" to it.

314. I am not persuaded that it would be reasonable to make that assumption in this case and I would therefore have allowed the appeal. It has been suggested that managing the effective use of parking space in the interests of the retailer and the users of those outlets who wished to find spaces to park could only work by deterring people from occupying space for a long time. But that is a guess. It may be so; it may not. ParkingEye called no evidence on the point. But it is common knowledge that many supermarket car parks make no such charge. I return to the point that it was for ParkingEye to show the factual grounds on which it could reasonably

assume that a customer using that car park would have agreed, in individual negotiations, to pay £85 if he overstayed for a minute, or parked with his wheels not entirely within a marked bay, or for whatever reason returned to the car park in less than one hour (perhaps because he had left something behind). On the bare information which was placed before the court, I am not persuaded that ParkingEye has shown grounds for assuming that a party who was in a position to bargain individually, and who was advised by a competent lawyer, would have agreed to the penalty clause as it stood.

315. Lord Neuberger and Lord Sumption in para 107 have substituted their judgment of reasonableness of the clause for the question whether the supplier could reasonably have assumed that the customer would have agreed with the term, and on that approach there is not much, if any, difference in substance from the test whether it offended the penalty doctrine at common law. That approach is consistent with their statement in para 104 that the considerations which show that it is not a penalty demonstrate also that it does not offend the Regulations. I consider that the approach waters down the test adopted by the CJEU and at the very least that the point is not acte clair.

316. Mr Beavis's argument that the clause was a penalty at common law is more questionable, but in the circumstances nothing would be gained by discussing that matter further.