

# Law on penalties: reconsidered

For the first time in a century, the Supreme Court has recently considered the law of penalties, when handing down its judgments on two cases relating to contractual penalty clauses [1]. In principle, these decisions will be applicable to liquidated damages clauses in construction contracts.

## The previous position

Prior to these decisions, the amount of liquidated damages had to represent a genuine pre-estimate of the employer's loss. A liquidated damages clause would be unenforceable if the level of damages was extravagant, bore no resemblance to the employer's loss, or was intended to deter a breach of contract.

## The Supreme Court's decision

The court decided that the doctrine of penalties should be upheld, but it rejected the 'genuine pre-estimate' test, which was established just over a hundred years ago [2].

Instead, it decided that the test as to whether a clause constituted an unenforceable penalty should be whether or not it imposed a detriment which was 'out of all proportion to any legitimate interest of the innocent party'.

For example, in the ParkingEye case, the car park owner set a high charge (£85) for overstays, as it relied on these amounts to keep the business afloat. Whilst this penalty also punished the wrongdoer, the court held it was enforceable as it could be backed up by a legitimate business interest. This points towards quite a significant relaxation of the test - the amount charged bore no resemblance to ParkingEye's actual loss (which would probably be next to nothing in most circumstances), but the fact that it allowed the business to make a small profit meant that it was enforceable.

Whether an employer could claim that it relies on high levels of liquidated damages in its construction contracts to stay afloat remains to be seen, but seems unlikely. It does mean, however, that when calculating the amount of liquidated damages in a contract, an employer can include considerations such as (a) the knock-on effect of delay on

the rest of the project, (b) loss of reputation, (c) any amounts it might become obliged to pay to its future occupiers as a result of the delay.

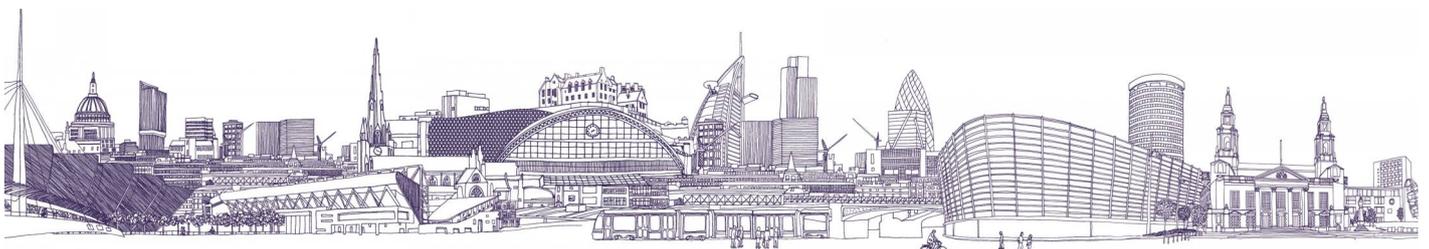
The judgment also represented a tilt back towards freedom of contract and noted that, between 2 properly advised parties of similar bargaining power, the presumption is that the parties themselves are the best judges of what is legitimate.

## Points to note

1. Commercial interests, such as goodwill, reputational damage, third party interests, and other losses which can be easily quantified, will be taken into account in determining the level of liquidated damages which is recoverable.
2. There is a strong initial presumption that a clause is not disproportionate if it has been negotiated in a commercial contract between 2 comparable parties and their respective legal advisors.
3. An employer may be obliged to show documentary evidence of the legitimate commercial interest which the liquidated damages relate to.
4. If a contractor successfully challenges a liquidated damages clause, the employer remains entitled to general damages in the usual way.

## Conclusion

A liquidated damages calculation based upon 'legitimate commercial interests' might sound really quite similar to one based upon 'a genuine pre-estimate of loss', but in practice, it looks likely to be an easier test for employers to meet. We think that the main difference is that clauses which are intended to deter a breach of contract will now be enforceable (this being a legitimate commercial interest of the employer). However, a fine line needs to be drawn between liquidated damages which are intended to deter a breach, which are allowed, and liquidated damages which are intended to punish the contractor, which are not.



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[1] *Cavendish Square Holdings -v- El Makdessi and ParkingEye Limited -v- Beavis* [2015] UKSC 67

[2] *Dunlop Pneumatic Tyre Company, Limited Appellants; -v- New Garage and Motor Company, Limited Respondents* [1915] AC 79

If you would like to discuss any of the issues raised in this update, please contact:



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