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LEGITIMATE INTEREST – CHANGING THE LAW OF PENALTIES?

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Much has previously been written about what may constitute an unenforceable contractual penalty clause. However, a refreshing decision by the Supreme Court now provides greater scope in England and Wales to avoid the pitfalls of penalty clauses, if the clause is commercially justifiable.

In what marks a divergence of the common law of England and Wales and the Isle of Man, the Supreme Court stated in *Cavendish Square Holding BV v El Makdessi and ParkingEye Ltd v Beavis*[1] that the test used to determine whether a contractual provision for payment of a specified sum upon breach of contract is a liquidated damages or a penalty clause must take account the legitimate interest of the innocent party in ensuring the performance of the contract.

Previously the question of whether a provision was liquidated damages or a penalty was determined, as a matter of construction, by whether or not the amount stipulated was a genuine pre-estimate of loss flowing from the breach, as of the time of agreement (**Genuine Pre-estimate Test**), in line with the tests set out by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*[2]. A provision found to be a penalty clause is unenforceable (**Penalty Rule**) against the party who breached the contract.

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1 Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67.

2 Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79 paras 86-87.

In the Isle of Man, the Genuine Pre-estimate Test was confirmed as the correct approach to the validity of such clauses by the Staff of Government Division in *Allen v Shepherd*[3] in 2000.

However, in England and Wales the principles underlying the law remained unclear, creating difficulties in its application to complex cases[4]. When the two cases of *Cavendish and ParkingEye* came before the Supreme Court together in 2015 it took the opportunity to re-examine the origins of the Penalty Rule and its underlying principle. The two cases concerned the provisions of a share purchase and shareholders' agreement, and an £85 carpark overstay charge respectively.

Following a lengthy analysis, the Supreme Court stated that the underlying principle of the Penalty Rule was to regulate the available remedies for a breach of the primary obligations only; it did not regulate the primary obligations themselves. It went on to reason that the true test was therefore "*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*."[5]

The new test adds greater flexibility to the Penalty Rule. Contractual clauses aimed at deterring a breach of contract rather than the recovery of compensation may now be enforceable by way of liquidated damages in England and Wales if the innocent party can show they had a legitimate interest in ensuring contract was performed.

In the Isle of Man however, whilst the judgment of *Cavendish and ParkingEye* may be highly persuasive, it is not binding on the Manx Courts. Under the doctrine of precedent the Manx High Court remains obliged to follow *Allen* and apply the Genuine Pre-estimate Test until such time that it can be challenged on appeal in the Staff of Government Division, affording it the opportunity to review the position in light of the recent developments in UK jurisprudence.

Whilst the *Cavendish and ParkingEye* ruling is likely to be of significance to the construction and energy sector, parties to contracts governed by the laws of the Isle of Man should bear in mind that under Manx law provisions for breach of contract may still require justification as a genuine pre-estimate of loss, evidence of which will be taken as at the time the agreement was made.

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[3] Allen v Shepherd 1999 – 01 MLR 328 (SGD)

[4] Robophone Facilities Ltd v Blank [1966] 1 WLR 1428.

[5] Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67, para 32.

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