



ENGLISH CONTRACT LAW UPDATE: WHAT EXACTLY IS A PENALTY CLAUSE?

English law is increasingly the law of choice in international oil and gas contracts, and in this and a series of further Client Alerts we will be reporting on recent significant contract law cases to come before the higher English Courts.

Ever had to hesitate for thought when explaining to your business clients or a counterpart exactly what constitutes a penalty clause under English contract law? Probably the biggest area of debate has been around whether the typical JOA default forfeiture provision constitutes a contractual penalty. There are many other areas in oil and gas transactions where the subject is relevant however – an option for liquidated damages is included in the model form AIPN JOA for breach of the Transfer provisions, and increasingly this form of remedy is being used in Farmout Agreements, AMIs, and financing arrangements (for example, the common use of higher interest rates in periods of default).

Fortunately the UK Supreme Court has recently had the opportunity to review the rule on penalties in the conjoined cases *Cavendish Square Holding BV v. Talal El Makdessi* and *ParkingEye Limited v. Beavis* [2015] EWSC 67. The Law Lords comment on the fact that over the past century or so the courts have struggled to formulate predictable principles for the doctrine. Their judgments provide a welcome opportunity to assimilate and rationalise the significant body of case law.

WHICH CLAUSES MIGHT INVOKE THE PENALTY RULE?

The rule is invoked in relation to “secondary” contractual obligations which operate following the breach of a primary obligation. Most commonly the secondary obligation requires the breaching party to pay over a fixed sum of money in the event of a breach – ostensibly “liquidated damages.” The common law rule has, as a matter of legal policy, treated as unenforceable clauses of this nature which are considered penal. Any determination of unenforceability would still enable the innocent party to bring a claim for breach of contract in accordance with ordinary damages rules.

WHAT IS THE RELATIONSHIP BETWEEN THE RULE ON PENALTIES AND THE EQUITABLE DOCTRINE OF RELIEF AGAINST FORFEITURE?

Whilst these cases fell squarely within the penalties determination, the Lords have also provided useful guidance on the relationship between the rule on penalties and the equitable doctrine of relief from forfeiture. Whilst both have their historical origin in equity, the penalty rule was developed by the common law courts and its application results in the offending clause being treated as unenforceable. In contrast, the equitable rule on relief from forfeiture applies where a proprietary or possessory interest has been granted (*e.g.*, a lease) which is subject to revocation or determination on breach of a contractual term

(e.g., non-payment of rent). The key distinction is that the forfeiture is in principle enforceable, but relief from its enforcement may be granted, primarily in a situation where the breaching party is subsequently able to pay the sums due.

The Lords consider that the two rules do not operate exclusively. A contractual provision might ultimately be assessed under both rules. If it survives the penalty challenge, it may still be open for the breaching party to pursue relief in equity from enforcement of the forfeiture, if it is at that time in a position to remedy the breach.

WHEN WILL A CLAUSE BE CONSIDERED PENAL?

If a clause by its construction falls within the potential scope of the rule, the core question becomes, is it penal? The Lords reviewed the case law since the mid 19th century, including in particular the oft cited *Dunlop Tyres v. New Garage* (1915). This case set out guiding principles for assessing penalties, including that a clause may be penal if it stipulated for the recovery of an extravagant and unconscionable amount in comparison with the greatest loss that could be suffered resulting from the breach. This had led to a notion that a liquidated damages clause could only avoid the penalty rule if it constituted a genuine pre-estimate of the damages that the innocent party might suffer as a consequence of breach.

The Lords determined that the courts must analyze a clause with a wider perspective taking into account the interests of the innocent party in performance of the contract in the commercial context of the transaction. Determining a penalty is not simply an assessment of whether a clause constitutes an accurate pre-estimate of damages. The true test is whether the secondary obligation imposes a detriment on the contract-breaker out of all proportion to the legitimate interest of the innocent party in enforcement of the primary obligation. Financial compensation for specific breaches is not the only legitimate interest that the innocent party may have in performance of the breaching party's primary obligations.

HOW DID THE LORDS APPLY THESE RESTATED PRINCIPLES TO THE FACTS IN QUESTION?

In *Cavendish*, the defendant had sold shares in his company to the plaintiffs, with consideration payments to be made in instalments. The sale contract provided that Cavendish as buyer could withhold further substantial consideration instalments in the event of breach of certain restrictive covenants by Makdessi – which breaches were admitted. Makdessi challenged these provisions as penalties. The Supreme Court disagreed. Cavendish had a legitimate interest in the observance of the restrictive covenants which went beyond the recovery of financial loss resulting from particular breaches – the goodwill associated with the business purchase was critical to Cavendish and the observance of the restrictive covenants was critical to the maintenance of the goodwill. The price formula, which permitted Cavendish to withhold a substantial portion of the consideration following Makdessi's breach, had nothing to do with punishment, akin to a penalty, but everything to do with Cavendish's core commercial objective in acquiring the shares.

Furthermore the Lords indicated that the terms of a contract between parties of equal bargaining power should generally be respected. As Lords Neuberger and Sumption concluded, these commercial provisions “...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 recognize the proper commercial interests of the other.”

The second case raised an entirely different set of facts, which was whether a charge of GBP85 payable if a motorist overstayed a two-hour free parking limit constituted an unenforceable penalty. The defendant in the case, ParkingEye, conceded that the GBP85 payable was not a pre-estimate of the actual damages that it might suffer as a consequence of any particular overstay by a motorist. Notwithstanding this, in the Supreme Court’s view the charge was not a penalty because ParkingEye had a legitimate interest in charging motorists for overstaying their free parking limit. This deterred parkers from occupying spaces for a long time, thereby preventing use by other shop customers, and provided ParkingEye with an income stream to provide its parking services to the landowners. The Lords also made comparison with parking overstay charges levied by local authorities (set by statute), and in that context the ParkingEye charges, whilst marginally higher, could not be said to be extravagant. This is a further example of the Lords being willing to look at the wider context of a transaction to assess commercial or business norms. For similar considerations, the Supreme Court denied an additional claim by Beavis that the payment obligation was not binding by reason of being unfair under the Unfair Contract Terms in Consumer Contracts Regulations 1999.

DOES THIS JUDGMENT FORESHADOW A WIDER MOVEMENT BY THE COURTS TO POLICE UNFAIR OR “UNCONSCIONABLE/EXTRAVAGANT” CONTRACTUAL OBLIGATIONS?

In short – no. The Lords were clear that the penalty rule applies to secondary obligations which come into play following the breach of a primary obligation – the rule should not be extended (as arguably may have started to occur in some decisions in other common law jurisdictions) to become a general substantive test of the fairness of the parties’ primary contractual obligations.

CONCLUSION – HOW MAY THIS CASE IMPACT COMMON PROVISIONS IN OIL AND GAS TRANSACTION AGREEMENTS?

The specific issue of whether the typical JOA forfeiture on default clause constitutes a penalty has not been determined before the English High Court. On the principles set out by the Lords in this case, the forfeiture provisions would arguably survive the penalty rule – they are a very common commercial arrangement in the upstream environment and provide justifiable protection to non-defaulting JV parties who have no alternative but to cover the ongoing costs of a defaulting party. There would appear however to remain ample scope for a defaulting party to avoid forfeiture if it (or its financiers or perhaps an administrator) can subsequently put itself in a position to pay off the JOA arrears in response to enforcement action.

Whilst the assessment of liquidated damages and other remedies will depend on the facts and circumstances of each transaction, undoubtedly in *Cavendish* the Lords have signaled the way for commercial parties to have greater freedom to determine financial remedies following a breach. They have removed the notion that only an accurate pre-estimate of contract damages will survive the penalty rule. The courts should not strike down a provision under the rule on penalties if its purpose is to protect a legitimate business interest and, in the relevant commercial context, it is not extravagant, unconscionable or out of proportion to that interest to be protected. It is clear that, in a contract between well advised parties of comparable commercial bargaining power, the courts' initial presumption will be that the parties themselves are the best judges of what is a legitimate remedy in their business environment.

If you have additional questions, please do not hesitate to contact the Thompson & Knight attorney with whom you regularly work or the attorneys listed below.

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