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Share Purchase Agreements and Penalties:

Cavendish Square Holdings BV v Makdessi [2013] 1 All E.R. (Comm) 787

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Introduction

"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 a contract or to compensate the innocent party for breach." (Colman J. in *Lordsvale Finance Plc v Bank of Zambia* [1996] 3 All E.R. 156 at 165–166). In *Cavendish*, Burton J. considered "penalty" challenges to provisions in a share purchase agreement which prevented a seller who breached the agreement from receiving agreed payments and which forced him to sell his remaining shares at a lesser value than had been agreed for an option exercised when the seller was not in breach.

Background

The claimant C was in the WPP group of advertising and marketing communications multinational. The defendant M had established the largest advertising and marketing group in the Middle East (the company). In 2008 C purchased a majority of M's shares in the company, with an option to purchase the remaining shares at a future date on a valuation basis which included goodwill. The payment schedule was complex but involved substantial sums on completion of the share purchase and further delayed sums dependent on future operating profits. M remained as a non-executive director. In order to protect the goodwill of the company, the agreement between C and M contained restrictive covenants against M being "engaged, concerned or interested in competition" with the company. The agreement also contained clauses which provided that, in the event of breach of the restrictive covenants when M would become a "defaulting shareholder", M was not entitled to the further sums (cl.A) and would grant C an option to purchase its remaining shares on a valuation basis which excluded goodwill (cl.B).

After completion and payment of the completion sums M breached his fiduciary duty to the company by being concerned in a competitor. C and the company raised proceedings for damages for breach of covenant and breach of fiduciary duty respectively: M admitted breach of fiduciary duty but, in relation to the allegations of breach of covenant, argued, inter alia, that the defaulting shareholder clauses A and B were unenforceable as penalties.

The rule against penalties

The rule has lost some of its bite. In *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] B.L.R. 271 at 280 Jackson J. said:

"Because the rule about penalties is an anomaly within the law of contract, the courts are predisposed, where possible, to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power."

The onus of establishing that a provision is an unenforceable penalty is on the asserting party and the courts are reluctant to find that a clause is unenforceable.

The starting point is *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] A.C. 79, where the issue was whether a clause that provided for payment of a specific sum for each item sold in breach of a supply contract was a penalty rather than liquidated damages. Lord Dunedin at 86 said that the "essence of a penalty is a payment of money stipulated as in terrorem of the offending party"; Colman J.'s definition in *Lordsvale* above uses more accessible language. One test is whether the sum is "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach" (Lord Dunedin at 87). There is a rebuttable presumption of a penalty where a single lump sum is payable for one or more events which lead to different degrees of damage. In addition, *Dunlop Pneumatic* also established that the impossibility of precisely pre-estimating damage was not a bar to a clause being enforceable.

Although the "ordinary candidate" in the rule against penalties is the liquidated damages clause, recent case law has widened the scope of the rule to cover clauses which operate on breach and to focus on commercial justification rather than solely on the issue of genuine pre-estimate, provided that the dominant purpose was not to deter the other party from breach. The rule has been applied, albeit unsuccessfully, to "take or pay" clauses in supply contracts (*M&J Polymers Ltd v Imerys Minerals Ltd* [2008] 1 All E.R. (Comm) 893, *Patersons of Greenoakhill Ltd v Biffa Waste Services Ltd* [2003] CSOH 18). In *M&J Polymers* Burton J. said at [44] that "as a matter of principle, the rule against penalties may apply. However, it is certainly not the ordinary candidate for such rule". He concluded at [46] that the take or pay clause was commercially justifiable, did not amount to oppression, was negotiated and freely entered into between parties of comparable bargaining power, and did not have the predominant purpose of deterring a breach of contract nor amount to a provision "in terrorem". He added that the he would uphold and enforce a clause which might be described in similar terms to those used by Millett L.J. in *Jervis v Harris* [1996] Ch. 195 at 207

"where the Court [was] asked for the first time to strike down [as a penalty] a standard claim which has been familiar to … lawyers for generations".

The rule has also been extended to a provision which entitles an innocent party to withhold moneys which it would otherwise be required to pay (*Jobson v Johnson* [1989] 1 All E.R. 621).

Decision

Burton J. accepted that the damage likely to accrue from breach of the restrictive covenants would be the same in kind since it derived from any advantage a competitor would gain as a result of M's breach of covenant. In relation to cl.B, the parties agreed that it was manifestly sensible to decouple a defaulting shareholder in the event of a breach: however, M argued that the price was an extravagant undervaluation, that there was no commercial justification and that its purpose was to deter breach since the valuation basis excluded goodwill. C, by contrast, argued that cl.B was not a penalty because it had been fully negotiated between experienced commercial parties using experienced commercial solicitors; it also argued that the cl.B valuation basis, Net Asset Value, was not necessarily an undervaluation since the alternative basis took into account future profits which might have been affected by M's breach.

The judge held at [51] that M had not satisfied the onus of establishing that cl.B was a penalty. He found that it served a commercial purpose (decoupling the parties on a speedy and conventional basis); it was not oppressive and its purpose was not to deter a breach; the valuation basis was not disproportionate when compared to "the greatest loss that could conceivably be proved to have followed from the breach" as a result of damage to goodwill; and it was in any event the subject matter of thorough negotiation.

M's challenge to cl.A was more complex; since any loss would be derivative loss suffered by C through damage to its shareholding in the company and, thus, only recoverable by the company itself (per the *Prudential Assurance Co* case [1982] Ch. 204), cl.A could not be a genuine pre-estimate of loss. However, at [53], the judge rejected this argument as being out of step with the modern approach which was based on whether there was a commercial justification, was it extravagant or oppressive, was its purpose to deter and had it been negotiated on a level playing field. At [59]–[60] he held that its purpose was to adjust the consideration to reflect a breach of covenants which were intended to protect goodwill and as such it was not oppressive. Taking both cll.A and B together he held that they both intended to adjust the consideration; cl.A in respect of the shares actually paid for and cl.B for shares to be purchased by option. However, he held that the ability of the company to recover damages for its loss meant that cl.B, when taken together with cl.A, involved double-counting and as such was a penalty. C had to give credit in the price it paid for the shares under cl.B for any sums recovered by the company in an action for damages for breach of fiduciary duty [63].

Conclusion

Cavendish usefully summarises the modern law on penalties and emphasises the court's reluctance to interfere with contractual provisions which have been properly negotiated. It is interesting that, notwithstanding the involvement of two commercial firms, the "double-counting" issue had not been anticipated by a term in the agreement preventing the company from pursuing M from damages if C relied on cll.A and B.