

## UK Supreme Court substantially re-formulates contractual “penalty” principles, holding they had become an “haphazardly constructed edifice”

In a landmark decision in *Cavendish Square Holding BV vs Talal El Makdessi*, the UK Supreme Court recently overturned a Court of Appeal decision ([discussed here](#)), and substantially re-formulated the English law principles relating to contractual penalty clauses. Upholding the validity of provisions in a purchase agreement that forfeited deferred consideration upon breach of non-competition covenants by the seller, the Supreme Court held that the true test as to whether a clause was penal (and therefore unenforceable) was whether it imposed a secondary obligation on the contract breaker “*out of all proportion to any legitimate interest of the innocent party*” in enforcing the obligation breached.

### *Background and facts*

The facts were that a member of the WPP group, the global advertising group, bought shares in a company from Makdessi. Makdessi retained a shareholding in the target company. Both parties were represented by highly experienced lawyers and the purchase agreement was the subject of extensive negotiations between the parties.

It appears to have been accepted that the purchase price included a substantial element of goodwill associated with the target company. In fact, Makdessi expressly acknowledged and agreed this in the purchase agreement.

The purchase agreement provided that the consideration payable to Makdessi included an upfront payment and two deferred elements. The deferred elements of the consideration were dependent on the operating profit of the target company in certain periods after completion of the transaction.

The purchase agreement also contained various restrictive covenants. These covenants included covenants by Makdessi not to solicit employees or clients from, or compete with, the target company. The purchase agreement went on to provide (the “**Defaulting Shareholder Covenant**”) that if Makdessi breached these restrictive covenants: (i) he would not receive any of the deferred consideration; and (ii) the buyer had the option to acquire his remaining shares in the target at net asset value (a value which was apparently materially below the then market value of his remaining shares).

The Court of Appeal held that the Defaulting Shareholder Covenant was a penalty and was accordingly, unenforceable. However, recently the Supreme Court overturned the Court of Appeal decision to hold that the Defaulting Shareholder Covenant was valid and enforceable.

***Key points***

At the outset, the Supreme Court noted that, “[t]he penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well” adding that, “the law relating to penalties has become a prisoner of artificial categorisation”. However, the Court declined to abolish the doctrine of penalties altogether holding that such doctrine, in its core, exists to restrain exorbitant or unconscionable consequences following from breach.

The key points that emerged from the Supreme Court decision are:

- In the case of simple damages clause in standard contracts, previous tests using the concepts of ‘deterrence’ and ‘genuine-pre estimate of loss’ may be sufficient to determine the validity of the clause. However, for more complex cases, 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 Defaulting Shareholder Covenant was plainly not a liquidated damages clause, it was not concerned with regulating the measure of compensation for breach of the restrictive covenants, and it was not a contractual alternative to damages at law. While this clause had no relationship, even approximate, with the measure of loss attributable to the breach, the purchaser 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 the purchaser, and the loyalty of the sellers was critical to the goodwill.
- Clauses which constitute primary obligations are generally not capable of being a penalty in contrast to secondary clauses that regulate those primary obligations upon breach. The Defaulting Shareholder Covenant was in reality a price adjustment clause and therefore a primary obligation and, even though the occasion for its operation was a breach of contract, this did not change the substantive conclusion that the clause was primary rather than secondary. It is not a proper function of the penalty rule to empower the courts to review the fairness of the parties’ primary obligations.
- 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 this case, parties were, on both sides, sophisticated, successful and experienced commercial people bargaining on equal terms over a long period with expert legal advice.

*Implications*

The principles which previously applied to the determination of whether a clause was penal in English law were rigid, artificial and difficult to apply and were capable of giving rise to anomalous results which did not reflect commercial realities.

It is quite common in complex commercial transactions for sophisticated and well advised parties to agree that the primary terms of their transaction (such as, for instance, in the context of an M&A transaction, the price paid) should be adjusted in certain circumstances including in circumstances where covenants which apply to the seller post-closing are breached. It is difficult to rationalise why the courts should interfere in the freedom of well advised and sophisticated parties to contract as they wish in relation to the primary terms of their transaction. In recognising this, this is a welcome decision by the UK Supreme Court.

In applying the principles in this ruling, there will now be a strong initial presumption that well advised and sophisticated parties bargaining on equal terms will be the best judge as to the reasonableness of their bargain. In cases where a serious question arises as to whether a clause is a penalty, some of the key questions will include whether:

- The relevant provision is, in substance, a primary or secondary obligation (the latter being more in the nature of clauses which function merely as a surety for performance); and
- Whether the detriment arising to the breaching party is out of all proportion to the “legitimate interest” (which appears to be a relatively flexible concept) of the non-breaching party.

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