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UK Supreme Court clarifies the law on penalties *Cavendish Square Holding BC v Talal El Makdessi* [2015] UKSC 67

The UK Supreme Court has recently clarified the English (and Scottish) law on penalties in the (joint) appeals in *Cavendish Square Holding BV v Talal El Makdessi* ("**Cavendish**") and *ParkingEye Ltd v Beavis* [2015] UKSC 67 ("**ParkingEye**"). The Supreme Court resisted calls to abolish the rule against penalties altogether, or at least in relation to commercial transactions, and confirmed that the existing law on penalties remains good law. However, their Lordships clarified that the correct test for determining whether a provision is penal is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract (per Lord Hodge). In clarifying the correct test in those terms, their Lordships emphasised that such test does not reflect, if it ever did, a mutual exclusivity between a penalty and a genuine pre-estimate of loss. The Supreme Court also confirmed that the rule against penalties applies to forfeiture clauses.

The facts

In *Cavendish*, parties entered into a share purchase agreement ("**SPA**") in relation to shares in an advertising and marketing communications company in the Middle East. The sellers were two founding partners of the business, and the buyer was a major international advertising company. The purchase price included a significant element of goodwill, and the payment terms provided for part of the consideration to be deferred and payable in two instalments. The sellers agreed to observe certain restrictive covenants (non-compete, non-solicitation *etc.*) aimed at protecting the goodwill of the company. The SPA further provided that upon breach of the restrictive covenants, the sellers would (i) lose their entitlement to the deferred consideration, and (ii) at the buyer's option, be required to sell the remainder of their stake in the company at a price excluding any element of goodwill. One of the sellers, Mr Makdessi, breached the restrictive covenants, and the buyer, Cavendish, sought to enforce the above provisions, the effect of which on Mr Makdessi was that he would lose over $44 million. Mr Makdessi admitted breaches of the restrictive covenants,

For more information, contact:

Martin Hunt
+44 20 7551 7508
mhunt@kslaw.com

Hywel Jones
+44 20 7551 7569
hjones@kslaw.com

Egishe Dzhazoyan
+44 20 7551 7518
edzhazoyan@kslaw.com

Alex Blomfield
+44 20 7551 2142
ablomfield@kslaw.com

Grigori Lazarev
+44 20 7551 7578
glazarev@kslaw.com

Kelly Nash
+44 20 7551 2148
knash@kslaw.com

King & Spalding
London
125 Old Broad Street
London EC2N 1AR
Tel: +44 20 7551 7500
Fax: +44 20 7551 7575

www.kslaw.com

but claimed that the relevant provisions were unenforceable as penalties because they did not represent a genuine pre-estimate of loss.

ParkingEye concerned an £85 parking charge levied against Mr Beavis by a car park manager, ParkingEye Ltd, for exceeding its two-hour free parking limit. One of Mr Beavis's grounds for resisting the parking charge was that it amounted to an unenforceable penalty.

The correct test

The Supreme Court judgement is of considerable length and detail, with the three main speeches delivered by Lord Neuberger and Lord Sumption (jointly), Lord Mance, and Lord Hodge (also commenting on Scots law). The main point on which all Law Lords agreed is that the law on penalties remains good law, and that it should neither be abolished (partially or altogether), nor extended to provisions that operate other than on a breach of contract.

However, their Lordships clarified that the relevant test is broader than the question of whether the stipulated sum represents a genuine pre-estimate of loss (as per the second proposition of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79, at 86). As Lord Mance explained, the "*dichotomy between the compensatory and the penal is not exclusive. There may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden*" (at [152]). Similarly, Lord Hodge stated that where the test is to be applied to a liquidated damages clause, a disproportion between the stipulated sum and "*the highest level of damages that could possibly arise from the breach*" remains relevant, however, "*in other circumstances, the contractual provision that applies on breach is measured against the interest of the innocent party which is protected by the contract and the court asks whether the remedy is exorbitant or unconscionable.*" (at [255], see also Lord Neuberger and Lord Sumption, at [32]).

In arriving at that conclusion, their Lordships emphasised that Lord Dunedin himself recognised that his propositions might be neither helpful nor conclusive in a particular case and that the essential question was whether the relevant provision was "*unconscionable*" or "*extravagant*" (Lord Hodge at [221], see also Lord Neuberger and Lord Sumption at [22]). Indeed, it was recognised in *Dunlop* itself that the clause in question (which was upheld) did not purport to be a pre-estimate of loss, its "*true object*" being "*to prevent the disorganization of* [Dunlop's] *trading system and the consequent injury to their trade in many directions*" (per Lord Atkinson, at 92). Their Lordships also drew (amongst other things) on the reasoning in a trio of authorities preceding *Dunlop*: the House of Lords decision in *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] A.C. 6, and the two decisions of the Privy Council in *Commissioner of Public Works v Hills* [1906] A.C. 368 and in *Webster v Bosanquet* [1912] A.C. 394.

In addition, their Lordships found support for their conclusion in a number of more recent cases, and in particular in the 'commercial justification' line of authorities (in particular, *Lordsvale Finance Plc v Bank of Zambia* [1996] Q.B. 752, *United International Pictures v Cine Bes Filmcilik ve Yapimcilik AS* [2003] EWCA Civ 1669 and *Murray v Leisureplay Plc* [2005] EWCA Civ 963). The decision of Colman J in *Lordsvale Finance Plc v Bank of Zambia* [1996] Q.B. 752 is of particular note. In that case, the judge upheld a provision in a loan agreement which provided for an increase in the rate of interest following a default in payment. The commercial justification for that provision was that once a debtor defaulted on its payment obligations, it represented a higher credit risk. Lord Neuberger and Lord Sumption stated that the "*emphasis on justification provides a valuable insight into the real basis of the penalty rule*", namely that a "*damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach*" (at [26], see also the discussion per Lord Mance at [146], and per Lord Hodge at [222]).

Whilst each of the three main speeches in *Cavendish* provides its own formulation of the correct test, the essence of the test remains the same. Lord Neuberger and Lord Sumption stated, at [32], that

> "*[t]he 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 innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance.*"

Lord Mance, at [152] said this:

> "*What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable. In judging what is extravagant, exorbitant or unconscionable, I consider (despite contrary expressions of view) that the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor.*"

Similarly, Lord Hodge, referring to "*the overriding test of exorbitance*" (at [246]), stated, at [255] that

> *"the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract."*

Applying the test to the facts in *Cavendish*, their Lordships concluded that the SPA provisions disentitling Mr Makdessi from receiving the deferred consideration and requiring him, at Cavendish's option, to sell his remaining shares at a value excluding any element of goodwill served to protect Cavendish's interest in "*measuring the price of the business to its value*" (per Lord Neuberger and Lord Sumption, at [75] and [82], see also Lord Mance, at [181] and [183]) and "*protecting the value of the company's goodwill*" (per Lord Hodge, at [274]).

It is worth pointing out, however, that Lord Neuberger and Lord Sumption concluded that the withholding clause and the option clause in the SPA were primary obligations, as they in effect were price adjustment clauses which were not concerned with providing a pre-estimate of loss (at [74] and [83]). Lord Mance appears to agree with that conclusion (at [183]). However, Lord Hodge construed those provisions as secondary obligations (at [270] and [280]). Given that each of Lord Clarke and Lord Toulson agreed with the analyses of Lord Hodge on the one hand and the other Law Lords on the other hand, the overall position appears to be that the provisions in *Cavendish* are to be viewed as primary obligations. Whilst this difference of opinion did not in the event result in different decisions as to the enforceability of those clauses, it points to a likely analytical difficulty with which the parties in future cases might expect to have to grapple.

In *ParkingEye*, their Lordships upheld the £85 parking charge on the basis that ParkingEye's legitimate interest in imposing it was (i) to maximise traffic in the car park for the benefit of the car park owner, the retailers and the shoppers, and (ii) to provide funds for the operation of that parking scheme.

Further considerations

In addition to clarifying the correct test for penalties, the decision in *Cavendish* is notable for confirming and clarifying a number of other issues. First, it confirms that the rule against penalties is not restricted in its application

to clauses requiring payment of money (such as liquidated damages clauses and take-or-pay provisions[1]), but also applies to clauses providing for withholding of money or property, and to clauses requiring payment of money or transfer of property (Lord Mance at [170], Lord Hodge at [226]-[238]).

Secondly, insofar as clauses providing for the withholding of money (or property) otherwise due are concerned, such as the withholding clause in *Cavendish* or the 'suspend and withhold' provisions in a building subcontract in *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] A.C. 689, their Lordships confirmed that such clauses, whilst they might be construed as forfeiture clauses, are nevertheless subject to the rule against penalties (albeit that Lord Neuberger and Lord Sumption were not prepared to decide the point in *Cavendish* at [69]-[73]).

The correct approach to forfeiture clauses is to determine first whether it is penal, and if it is not, then, secondly, to consider whether equitable relief against forfeiture should be granted (per Lord Mance, at [160]-[161] and Lord Hodge, at [227]-[228], with whom both Lord Clarke and Lord Toulson specifically agreed). In this regard, Lord Hodge's discussion in relation to non-refundable deposits is especially helpful as it confirms that the rule against penalties might apply to deposits: "*a deposit which is not reasonable as earnest money may be challenged as a penalty*" (see [234]-[238], see also Lord Mance at [170]). In practical terms, this decision opens up the possibility for those resisting a forfeiture clause to have two bites at the cherry, first, challenging it as a penalty, and then seeking relief from forfeiture.

Thirdly, whilst resisting the call formally to abolish the rule against penalties as between sophisticated commercial parties, their Lordships gave considerable weight to the fact that the parties in *Cavendish* were sophisticated business people with the benefit of expert legal advice (Lord Neuberger and Lord Sumption at [75], Lord Mance at [152] and [181], and Lord Hodge at [274] and [282]). This suggests that the parties' relative bargaining power and legal advice that they receive will be an important factor in construing an alleged penalty clause. In practice, this will likely mean that in a commercial context, it will become even more difficult to challenge a provision as penal.

Fourthly, their Lordships expressly recognised that parties might seek to circumvent the rule against penalties by "careful drafting" such that the relevant obligation to pay money (or right to withhold money or property) is expressed as a primary obligation. However, as Lord Hodge explained, in such circumstances the court would be able to rely on the concept of a disguised penalty: "*where it is clear that the parties have so circumvented the rule and that the substance of the contractual arrangement is the imposition of punishment for breach of contract, the concept of a disguised penalty may enable a court to intervene*" (Lord Hodge at [258]). Similarly, Lord Neuberger and Lord Sumption stated "*We do not doubt that price adjustment clauses are open to abuse, and if clause 5.1 were a disguised punishment for the Sellers' breach, it would make no difference that it was expressed as part of the formula for determining the consideration*" (at [77]). These warnings make it clear that the potentially difficult distinction between primary and secondary obligations is one of substance and not form, and that it cannot be resolved, at the negotiations stage, simply by means of careful drafting.

Practical implications

Drafting considerations

There are a number of practical implications of the renewed emphasis on the legitimate interest and its proportionality to the remedy for breach of contract. The question that the parties and their advisors need to ask

[1] Following the decisions in M & J Polymers Ltd v Imerys Minerals Limited [2008] EWCH 344 (Comm) and E-NIK Ltd v Department for Communities and Local Government [2012] EWHC 3027 (Comm), it became clear that take-or-pay clauses could potentially constitute penalties.

themselves is whether the relevant provision (be it a liquidated damages clause, take-or-pay provision, price adjustment clause or other) "*imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party*" (per Lord Neuberger and Lord Sumption, at [32]). It may make sense for transactional lawyers to encourage their clients to include contractual language that identifies explicitly what interest is sought to be protected by such provisions and then include the parties' acknowledgement that it is a legitimate interest. The decisions in *Dunlop, Cavendish, Lordsvale* and other 'commercial justification' cases might prove helpful in identifying and articulating the legitimate (non-compensatory) interest in any specific case. However, this is not a closed category and the relevant interest in each individual case will depend on the circumstances of the transaction.

Whilst such express identification of interest and acknowledgement will not be conclusive, they might help create the necessary presumption and assist the court in construing the relevant obligation and determining whether or not it is a penalty: "*a strong initial presumption must be that the parties themselves are the best judges of what is legitimate*" (per Lord Neuberger and Lord Sumption, at [35], see also [15]).

Further, given the considerable weight that the Supreme Court attributed in *Cavendish* to the relative bargaining power of the parties and the legal advice they received, it might also be helpful to record (either in the provision itself or in the recitals) that the parties negotiated at an arm's length and with comparable bargaining power (if that is the case), and that each party received appropriate legal advice. Again, this will not be conclusive, but such language might further assist the court in construing the provision in question as being non-penal.

As noted above, the Supreme Court recognised that parties might seek to draft around the rule against penalties by expressing the relevant right to withhold money or property or obligation to pay money or transfer property as a primary obligation. Whilst it is important to bear in mind the Supreme Court's warning about disguised penalties, it might nevertheless be possible (and indeed advisable) in some instances to express such provisions as primary obligations arising, for example, upon the occurrence of an objectively ascertainable trigger event rather than as a secondary obligation arising upon breach of a primary obligation. It might also be helpful to try to integrate (such as through cross-referencing) the relevant right or obligation with other primary obligations, such as price determination formulae. However, as noted above, such drafting might be of little assistance if, in substance, it seeks to disguise a penalty: "*the purpose of the penalty rule depends on the substance of the term and not on its form or on the label which the parties have chosen to attach to it*" (per Lord Neuberger and Lord Sumption, at [15]).

What about existing contracts?

The reasoning of the Supreme Court in *Cavendish* makes it clear that clauses drafted to reflect a genuine pre-estimate of loss (such as typical liquidated damages clauses) will continue to be enforceable and Lord Dunedin's test in *Dunlop* will remain applicable. Lord Neuberger and Lord Sumption explained at [32] that "*In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach, and we therefore expect that Lord Dunedin's four tests would usually be perfectly adequate to determine its validity.*" Lord Hodge made the same point at [255], and Lord Mance at [152]. In essence, Lord Dunedin's test must be understood as a specific expression of the broader test as formulated in *Cavendish.* Therefore, insofar as straightforward liquidated damages clauses are concerned, the advice and drafting should proceed on the basis that Lord Dunedin's test continues to apply. In more complex or unusual cases, it is possible that a party might have a further or alternative non-compensatory interest. In those cases, Lord Dunedin's test might not apply. However, in all cases the overall test of exorbitance as formulated in *Cavendish* will apply.

Dispute Resolution

Cavendish will have a number of practical implications for dispute resolution. The broader test of exorbitance will likely mean that those provisions that might traditionally have been considered penal on the basis that they do not represent a genuine pre-estimate of loss could nevertheless be held enforceable because they reasonably protect a legitimate interest. Given that the legitimate interest is not a closed category and will depend on the facts of the specific case, litigants might in the future be more hesitant to raise a penalty defence, whilst those relying on such clauses are likely to feel more confident that they will be upheld.

In terms of pleading a penalty, particularly in complex cases, the *Cavendish* test will now frame the relevant issues of fact and law. Insofar as existing authorities are concerned, the cases on which the Supreme Court relied in reaching its decision will likely be of considerable assistance: in particular *Clydebank, Hills*, *Dunlop* (especially Lord Atkinson's speech) and the more recent line of authorities on 'commercial justification', including *Lordsvale*, *Cine Bes* and *Leisureplay.* As explained above, Lord Dunedin's propositions will remain applicable to straightforward liquidated damages clauses, although, it is possible that the parties might want to approach even such clauses using the broader language of the *Cavendish* test.

The distinction between primary and secondary obligations, and the related question of disguised penalties, will likely prove to be a fertile ground for argument, given that the Supreme Court itself was split on whether the relevant provisions in *Cavendish* were primary or secondary in nature. This potentially difficult distinction might be further blurred by 'careful drafting', with the practical result that even ostensibly primary obligations (such as conditions precedent or subsequent) might become vulnerable to attack as disguised penalties.

The *Cavendish* test will likely result in a broader scope and nature of evidence gathering and disclosure, as the relevant enquiry is not restricted to the question of whether the stipulated sum is a genuine pre-estimate of loss. Similarly, the broader test in *Cavendish* might mean that a wider range of questions than before might require expert evidence, such as market practice on setting a particular level of liquidated damages or operation of retention provisions in construction contracts.

Conclusion

The penalties test formulated in *Cavendish* and its application to the facts in the *Cavendish* and *ParkingEye* appeals (in both cases the alleged penal provisions were upheld) suggest that in the future it will be more difficult to challenge provisions as penalties. This will likely be especially the case in the context of complex commercial transactions, where the parties are often highly sophisticated and rely on expert legal advice. Nevertheless, as the rule against penalties remains part of English law, parties should continue to be careful with drafting provisions that might fall foul of the rule.

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