Wilberforce
CHAMBERS

Cavendish v Makdessi

[2015] UKSC 67

A SEA CHANGE?

Introduction

The leading authority on the law of penalties has for over 100 years been *Dunlop Pneumatic Tyre Company Ltd v New Garage & Motor Company Limited* [1915] AC 79.

The basic proposition from that case is that a clause providing for a payment of a sum of money on breach of contract is an unenforceable penalty if that sum does not represent a genuine pre-estimate of the loss likely to flow from that breach. Such clauses are very common in construction contracts of all types – often see them in very simple form of LD clauses, but they also come in more complex forms: claw back provisions for example.

That basic proposition – if it ever was good law – most certainly is not any more in light of the recent decision of the SC in Cavendish v Makdessi, particularly in complex commercial cases and cases which are concerned with more than simply a damages clause that operates on breach.

Talk will cover 3 topics:

Penalties pre-Nov 2015

Decision in Cavendish

Practical Implications

Penalties Pre-Nov 2015

Dunlop involved a price maintenance clause: purchasers were required to sell tyres, covers and tubes made by Dunlop at list prices – in the event of a breach the defaulting purchaser was to pay Dunlop £5 for each tyre, cover or tube. HL decided that the relevant clause was an enforceable liquidated damages clause

Although there were four judgments, the focus has (until now) been on the famous propositions identified by Lord Dunedin. The most famous is the second proposition:

"The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage."

There are two points of particular significance that have been taken as flowing from this proposition in particular, and which have informed the development of the doctrine ever since. (i) the proposition posits a dichotomy between clauses which are penalties, and clauses which provide for a genuine pre-estimate of loss, and (ii) a penalty is said to be a clause which is *'in terrorem'* of the offending party, which more modern cases have interpreted as meaning *'intended to deter breach'*.

Thus the law on penalties has been dominated by the twin concepts of 'genuine pre-estimate' and 'deterrence'.

But for about 20 years, the lower Courts have been struggling with this, because not all clauses obviously fall within this dichotomy. As Mance LJ said in Cine Bes *There are clauses which may operate on breach but which fall into neither category and they may be commercially perfectly justifiable*".

This led to the development of the commercial justification test which was relied upon heavily by Burton J in finding in favour of Cavendish at first instance. BUT the problem for the lower Courts has been how to reconcile – or at least appear to be reconciling – that approach with the speeches in *Dunlop*. The tendency has been for Courts to treat the commercial justification test as part of the question whether a clause was intended to deter a breach; if the clause had a commercial justification, that was evidence that it was not intended to deter.

BUT that raises squarely a couple of fundamental questions. First, how does one go about distinguishing between legitimate commercial justifications and deterrent intent? And more fundamentally, what is wrong with deterrent intent at all?

Cavendish v Makdessi

The Facts

Cavendish is a holding company within the WPP group of companies; the world's leading marketing communications services group. Prior to February 2008, Mr Makdessi was the founder and owner (later joined by Mr Joseph Ghossoub) of various advertising, marketing, public relations and media buying businesses in the Middle East. Mr Makdessi was instrumental in developing and building up this Middle Eastern business, which, by 2008, had become extremely successful. CA called Mr Makdessi one of the most successful business men in the Lebanon; Burton J described him as "the big bad wolf".

In 2008 Mr Makdessi and Mr Ghossoub entered into an agreement for the sale of part of their shares to Cavendish. Following the Agreement, Cavendish owned 60% of the issued share capital of the Company with the Sellers

continuing to hold, in aggregate, 40%. Mr Makdessi continued as director and non-executive chairman of the company.

There were four features of the Agreement which the argument on penalties turned on.

First, the parties to the Agreement were sophisticated commercial parties, negotiating with the assistance of the best legal advice, and acting on a level-playing field. There was no element of control, oppression or imbalance in the transaction.

Second, the purchase price consisted of certain fixed initial payments of some $30million each to the sellers, and then two instalments of deferred consideration to be paid a number of years after the acquisition. Those two payments, which were called *"the Interim Payment"* and *"the Final Payment"*, were to be calculated according to contractual formulae relating to the profitability of the business after acquisition. The total purchase price was subject to a cap of US$147.5m.

Third, much of the value of the company, and hence the purchase price, was attributable to goodwill, rather than physical assets (as one might expect from a successful marketing business). The company's relationships with key clients were of central importance to its value.

Fourth, a considerable amount of the goodwill of the company resided in the vendors (and particularly Mr Makdessi). As the founder and owner of the business, it was he who had developed the relationships with key clients and key employees. In order to protect and retain that goodwill after the sale, the Agreement contained restrictive covenants in clause 11.2 prohibiting him from competing with the business, soliciting key employees and so forth for a period after acquisition. If he did so, he became a 'Defaulting Shareholder.'

The Disputed Clauses

Shortly before the trial at first instance, Mr Makdessi conceded that he was a Defaulting Shareholder. The issue that then arose was whether two provisions of Clause 5 of the Agreement - which spelt out the consequences of a seller becoming a "Defaulting Shareholder" – were unenforceable penalties.

In particular, clause 5.1 provided that:

> "*If a seller becomes a Defaulting Shareholder he shall not be entitled to receive the Interim Payment and/or the Final Payment which would other than for his having become a Defaulting Shareholder have been paid to him and the Purchaser's obligations to make such payment shall cease"*.

Note that this clause is not a clause providing for the payment of a sum of money on breach: rather, it allows the innocent party to withhold a sum of money that would otherwise be due; it is a 'withholding' clause.

Clause 5.6 of the Agreement provided as follows:

> "*Each Seller hereby grants an option to the Purchaser pursuant to which, in the event that such Seller becomes a Defaulting Shareholder, the Purchaser may require such Seller to sell to the Purchaser (or its nominee) all (and not some only) of the Shares held by that Seller (the Defaulting Shareholder Shares).*

The shares were to be sold at the Defaulting Shareholder Option Price – effectively a net asset valuation which took no account of goodwill.

Again, this is not a clause requiring payment of a sum of money on breach. It is – at its highest – a clause requiring the transfer of property on breach.

The negotiations prior to the Agreement included discussions as to clause 5.6, with Mr Makdessi's solicitors, Lewis Silkin, ultimately backing down as to the basis on which the valuation under clause 5.6 would be carried out. (WPP was represented by Allen & Overy).

The Decisions below

Burton J held that the clauses were not penal, had not been designed to deter, were the subject of detailed negotiations between the parties on a level playing field which negatived oppression and that each clause had a legitimate commercial purpose: clause 5.1 was designed to adjust the commercial consideration for the deal. Clause 5.6 was designed to decouple the parties in the event of a breach.

CA disagreed. Despite recognising that to find a clause penal is an interference with freedom of contract, Christopher Clarke LJ expressed the view that each clause was extravagant and unconscionable. Cavendish obtained permission to appeal to the SC.

ParkingEye Ltd v Beavis

Shortly before the hearing, another case was joined to Cavendish for consideration by the SC.

This was a consumer case concerning Mr Beavis of the Happy Haddock Fish Shop in Billericay. It concerned the question of whether an £85 charge for overstaying in a car park was a penalty. The court at first instance and the CA

had both decided it was not, largely by reference to the fact that (although the £85 was plainly designed to have a deterrent effect) it was in the legitimate interests of ParkingEye to make such a charge in order to allow a high turnover of parking within the car park.

While the factual context of that case was very different from the Cavendish appeal, it had one interesting feature in common – as with Cavendish, the purpose of the clause in question had nothing to do with compensating for breach.

What were the issues in the Supreme Court, and what did it decide?

We had three grounds of appeal:

First that as a matter of principle and policy the doctrine of penalties should not apply in the modern commercial world where parties to a commercial agreement with equal bargaining power and experienced legal advisers have arrived at a deal which reflects a negotiated position with a real commercial purpose and justification.

In the SC, we also argued that the doctrine was so uncertain, ambiguous, outdated and unnecessary that it should be abolished.

Second that neither withholding clauses nor forced transfer clauses (and hence neither clause 5.1 nor clause 5.6) were capable of engaging the doctrine;

Third that neither clause was penal in any event by reference to the proper test for a penalty (which we said had been too narrowly applied in previous cases and in the CA): each clause had a commercial purpose and neither clause was oppressive or unconscionable

The short answer is: we won!

The 7 man SC were not in complete agreement on all issues, but they did all agree that the true test for a penalty had been too narrowly applied in the past, and that on a proper understanding of the law, neither 5.1 nor 5.6 was penal.

The judgments are split between a judgment of Lords Neuberger and Sumption, with whom Lord Carnwath agreed; and separate judgments from Lords Mance, Hodge, Clarke and Toulson. Careful with Clarke – he changed his mind.

<u>Ground 1: Abolition of the doctrine</u>

Lords Sumption and Neuberger described the penalty rule in England as "*an ancient haphazardly constructed edifice which has not weathered well…*". They noted that the application of the rule is "*often adventitious*" and that the test for distinguishing penal from other principles "*is unclear*". They went on to say that they doubted that the courts would have invented the rule today if it had not already existed and they expressly acknowledged that there is a case to be made for its abolition But none of their Lordships was prepared to take the ultimate step of abolishing the doctrine.

<u>What about abolition in commercial cases?</u>

The SC also did not accept Cavendish's contention that the penalty doctrine should no longer apply to commercial contracts (i.e. to contracts made between sophisticated parties negotiating on a level playing field).

But despite this refusal to draw a bright line, the SC did plainly acknowledge that the court must in future be very careful before it interfered in such contracts – thereby clarifying the position as it applies to commercial contracts.

Lords Neuberger and Sumption held that "*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" (para [35]).

And indeed, when looking specifically at the nature of the clauses themselves, all of their Lordships had regard to these facts, with the majority pointing out that the parties to a negotiated contract were the best judges of the degree to which they should each recognise the commercial interests of the other.

Ground 2: The scope of the doctrine

Despite the view expressed by various Judges over the years that the penalty area is limited to a narrow field, the Court of Appeal has previously decided that its remit goes beyond provisions that are solely concerned with the payment of a sum of money in the event of a breach. In particular it has decided that it extends to

- withholding clauses: See *The Padre Island [1989] 1 Lloyds Rep 239*.
- forced transfer clauses: See the odd case of *Jobson v Johnson [1989] 2 WLR 1026.*

The issue of whether the CA was right to take this view has never previously been considered by the HL or SC.

The question of whether the doctrine should apply in such circumstances was a key issue in the appeal to the SC.

The SC was prepared to accept that forced transfer clauses were capable of falling within the penalty doctrine and the majority thought that this also applied to withholding clauses (although Neuberger/Sumption and Carnwath were attracted by our argument that a withholding clause is more properly to be

characterised as a forfeiture clause – thereby leaving a lack of clarity as to withholding clauses).

Ground 3: The proper test for a penalty

This is the most significant part of the judgment as matters have transpired. We argued that neither clause 5.1 nor clause 5.6 was a penalty, because they were not about compensating for breach at all; the former was a price adjustment clause, and the latter was simply a way of bringing about the de-coupling of the parties' relationship on pre-agreed terms. The commercial reason for the clauses was that if the sellers breached the restrictive covenants, that changed the basis on which WPP had purchased the company, and the consequent threat to the business' goodwill made it a less valuable acquisition.

In looking at *Dunlop Pneumatic Tyre Company Ltd v New Garage and Motor Company* [1915] AC 79 and the Dunedin propositions, Lords Sumption and Neuberger concluded that "*the law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions: between a penalty and genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent*" (para [31]).

The source of these errors, they thought, was an over-literal reading of the four propositions in Dunlop. Indeed, all 7 took the view that Lord Dunedin's judgment in *Dunlop* (and in particular his "propositions") has been given far too much emphasis in the later authorities and that the judgments of the other Law Lords were of equal significance.

In particular, and most significantly, they noted with approval the approach of Lord Atkinson. Lord Atkinson was not concerned primarily with questions of pre-estimate of loss, but rather emphasised and focused on the nature of the commercial interest of *Dunlop* in being able to uphold its price maintenance regime generally, an interest which went beyond compensation for loss – a

point we made strongly at the hearing. Lords Sumption and Neuberger considered that this was the true basis for the decision: in fact the clause in *Dunlop* failed all but the last of Lord Dunedin's tests and was justifiable only by reference to the wider interests identified by Lord Atkinson (para [24]), a point with which Lord Mance agreed.

This led Lords Sumption and Neuberger to the view that it was "*unfortunate*" that Lord Dunedin's speech had achieved the status of "*a quasi-statutory code*" in the subsequent case law. While they considered that it was likely to remain a *"useful tool"* in dealing with simple damages clauses (and in fact Lord Hodge expressly stated that the genuine pre-estimate of loss test would continue to apply to the paradigm penalty case – which of course would include liquidated damages provisions), the orthodox reading of that speech as the definitive statement of the law of penalties is now very firmly gone.

That re-reading of the decision in *Dunlop*, and in particular the significance of the nature and extent of the commercial interest underlying the clause in question, left the SC free to re-consider the approach of the lower Courts to the question of commercial justification. Lords Sumption and Neuberger approved of the emphasis on commercial justification, regarding that as in essence the same as the reasoning of Lord Atkinson in *Dunlop*. In short they agreed that the fact that a clause is not a genuine pre-estimate of loss does not necessarily mean that it is penal.

But unsurprisingly given their approach to *Dunlop*, they were less keen on the rationalisation of the commercial justification test as part of the question whether a clause's purpose was to deter and they noted that clauses may not deter a party at all – they may be easily able to pay the penalty – but that does not affect their ability to claim the protection of the law of penalties.

This led the SC to a sea change in the law as previously understood: the concept of deterrence, the SC held, *"does not add anything"* (para [31]).

The new Test

Lords Sumption and Neuberger identified the 'real question' in a disarmingly simple fashion: *"The real question when a contractual provision is challenged as a penalty is whether it is penal…"* (para [31]).

This led them to set out what can now be regarded as the definitive statement of the test for a penalty in English law: the true test is *"whether the clause is a secondary obligation which imposes a detriment on the contract breaker which is out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation*" (para [32]).

One obvious question is to ask what it is that makes an interest legitimate. There is some guidance in their judgment:

- There is no legitimate interest in simply punishing the contract breaker: an interest can only be in performance or an appropriate alternative. BUT

- A legitimate interest may extend beyond an interest in receiving compensation for breach (something the majority traced back to the earliest equitable roots of the doctrine, and saw reflected in the decision in *Dunlop* and the commercial justification cases).

It follows that the exercise that lawyers will have to undertake now is to (i) identify the innocent party's legitimate interest in enforcing the contract and (ii) compare that to the detriment imposed on the contract breaker with a view to ensuring that it is proportionate.

<u>The Application of the new test to clause 5.1 and 5.6</u>

All 7 Justices agreed that the clauses were not penal.

Lords Sumption and Neuberger considered that clause 5.1 was a primary obligation: it was a price adjustment clause, and had nothing to do with regulating the measure of compensation for breach (para [74]). But while the finding that it was a primary obligation ought to have disposed of the question – the law on penalties only applying to secondary obligations – they went on to consider whether it imposed a detriment out of all proportion to the legitimate interest of *Cavendish*. Quite why they did so is not immediately apparent, although it may have been to 'check' that it was not a disguised punishment for breach masquerading as a price adjustment clause.

Whatever the reason for doing so, happily they found no reason for such a conclusion. They considered that given the critical importance of goodwill to Cavendish in valuing the business, it plainly had a legitimate interest in Mr Makdessi observing the restrictive covenants which went beyond recovery of the loss, and the business was clearly worth less to Cavendish with the risk that he would not observe them than without. They also considered that there was no juridical standard for valuing how much less the business was worth in such circumstances –this was quintessentially a matter for negotiation between the parties: para [75]. They thus concluded that Clause 5.1 was not a penalty. The other law lords agreed.

They reached the same result with Clause 5.6, but reasoned the other way around. They considered that the same interest as justified Clause 5.1 also justified 5.6; an interest in ensuring that the price which Cavendish paid for the retained shares matched the value which the sellers were contributing to the business. That was a legitimate function which the parties were best placed to value: see para [82].

But further, Lords Sumption and Neuberger considered that a contractual provision conferring an option to acquire shares for commercial reasons other than compensating for breach was a primary obligation, not a secondary obligation, even if it operated on breach, and hence was outside the scope of the law of penalties: para [83].

Lord Hodge however, for his part, despite recognising that there was a strong argument for both clauses being primary obligations, expressed no concluded view on this as to 5.1 and positively disagreed on 5.6 – saying that he regarded it as a secondary obligation – a conclusion with which Lord Clarke agreed; an indication, perhaps, of the problems ahead for the courts in interpreting this decision.

Where does that leave us now?

Scope for litigation

There remains ample scope for litigation and you are likely to start to see the following disputes arising:

(i) whether a provision is a primary or secondary obligation – a potentially illusory distinction and one on which their Lordships did not agree;

(ii) whether – even if it is a primary obligation – it can nevertheless be viewed as a disguised penalty – in the sense that it is really a provision designed to punish for breach. A concept left open by the SC and something that is always difficult to identify;

(iii) what the legitimate commercial interests of the innocent party may be – a question which may very well be tied up with the question of whether the clause is a primary obligation;

(iv) how the Courts are going to apply the test of whether or not a clause is *"out of all proportion"* to that legitimate interest, and in particular the extent to which they will second-guess the parties' own judgment on that issue, especially in a commercial case;

You will also begin to see provisions that operate on breach being drafted with an eye to this new test – you will see contracts which seek to identify commercial interests and expressly include an acknowledgement that each party was of comparable bargaining power and each party had been fully advised by solicitors. Innocent parties will rely on such provisions to argue that the clause in question is not penal.

BUT the answer to such arguments will not always be straightforward and in my view we will not have to wait another 100 years to see this issue return to the SC in one form or another.

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