Deferred Consideration and Penalties

The recent judgment in *El Makdessi v Cavendish Square Holdings BV and another [2013] EWCA Civ 1539* is likely to have a significant impact on the drafting of share purchase agreements, as well as all commercial contracts which contain liquidated damages for specific breaches, and provides useful guidance as to what may or may not be considered a penalty.

Historically, the overriding principle in determining whether a particular amount was a penalty or not, was considering whether it was a genuine pre-estimate of the other party’s loss. The courts appear to have moved on and even when the genuine pre-estimate test is not satisfied, a clause may be enforceable if it is commercially justifiable.

Background

Mr Makdessi founded an advertising business in the Middle East (Target). He eventually sold a part of his shareholding in the Target to a company, which subsequently novated that agreement to Cavendish Square Holdings BV, a company ultimately owned by WPP, the global advertising giant. Both parties were advised by top UK law firms and, therefore, had the benefit of high quality legal advice.

It is very common in acquisitions for the buyer to try to restrict the sellers from competing against them following completion in order to ensure that the goodwill of the business being bought is retained. The enforceability of such restrictive covenants depends on whether they are reasonable and that depends on the facts of each case. However, where there was deferred consideration (in the form of an “earn out” or otherwise) or good/bad leaver provisions, the SPA may provide for forfeiture of that deferred consideration, or a significant adjustment downwards, or where the seller retains some shareholding that such shares be sold to the buyer at a low value. There were similar provisions in a share purchase agreement in this case, which provided that in the event of a breach of a restrictive covenant:

- Mr Makdessi would lose his entitlement to a couple of the instalments due to him for the share purchase;
- Cavendish would have the option to acquire Mr Makdessi’s remaining shareholding in the Target at a substantial discount.

At the time of signing, the potential effect of these provisions on what Mr Makdessi made out of the deal could have been anything between zero and $44 million.
The covenants were subsequently breached and Cavendish exercised its option. This went to the High Court where several arguments were put forth by both Mr Makdessi and Cavendish.

Mr Makdessi argued that the consequences of breach were unenforceable as penalties. Firstly, he argued that the loss suffered by Cavendish was irrecoverable under the reflective loss principle i.e. a loss in value of Cavendish’s shareholding in the Target that was reflective of a loss that the Target had suffered and could recover would not be recoverable by Cavendish, even where the loss was due to a breach of a duty owed to Cavendish by Mr Makdessi. Based on the same, a figure greater than zero could not be a genuine pre-estimate of loss. Secondly, while there were four separate restrictive covenants, the breach of each of them had the same consequence regardless of whether a particular breach was minor or serious.

Cavendish argued that the remedies must be judged by considering whether there was a commercial purpose/justification and whether the predominant intention behind them was not to deter. The commercial purpose of the relevant clauses was to adjust the consideration payable to Mr Makdessi due to the substantial loss of goodwill following a breach of the restrictive covenants by him. By giving Cavendish an option to buy the shares at net asset value from Mr Makdessi, it had the commercial purpose of swiftly decoupling Makdessi from the Target in circumstances where he had shown that his continued involvement with the Target was damaging to it.

**Outcome**

The High Court agreed with Cavendish for the reasons advanced by Cavendish and Mr Makdessi appealed to the Court of Appeal.

The Court of Appeal reversed the Hight Court’s decision. It provided the following guidance in relation to penalty clauses:

- it stated that recent authority indicated that the court was no longer deciding a clause to be penal simply on the basis of whether it contained a genuine pre-estimate of the loss or not. The courts were using a broader test of whether the clause was “extravagant and unconscionable” and primarily concerned with deterrence and whether there was a commercial justification for the clause;

- for a particular remedy to be penal, it needed to be extravagant. In this case the remedies were not genuine pre-estimates as Cavendish’s loss was likely to be zero because its losses would be reflective of the loss of the Target and there was no correlation between the severity of the breach and the effect of the proposed remedies. A provision whereby Mr Makdessi could lose his entitlement to the entire outstanding purchase price for a minor breach was extravagant.
however, even where a particular remedy is extravagant and not a genuine pre-estimate, it is not necessarily penal if it is commercially justifiable. The court concluded that in this case, effectively, Mr Makdessi would not only lose his entitlement to the outstanding purchase price, but also remain liable to the Target for its losses. The argument that the breach of restrictive covenants would lead to a loss of goodwill that was being compensated by the proposed remedies was incorrect. The loss flowing from a breach of any of the four restrictive covenants could not be anywhere close to the amount that Mr Makdessi stood to lose and, therefore, the clause was not commercially justifiable and was instead a deterrent.

the court suggested that if the outstanding payment had been made conditional upon compliance with certain terms, rather than providing that a part of the purchase price would not be payable in case of a breach, the law of penalties would not have applied.

Comment

While the case relates specifically to earn-out provisions in share purchase agreements, it is of relevance to all commercial contracts containing liquidated damages and other similar provisions requiring payment of a particular sum in case of a breach. Some things to bear in mind when negotiating similar clauses are as follows:

- when it relates to the law of penalties, the courts are willing to interfere in an agreement which has been negotiated between parties of equal bargaining position who have had the benefit of legal advice;

- even when one of the parties to the litigation itself has been in breach of the contract and does not approach the court with clean hands, as was the case with Mr Makdessi, the court will not unconditionally satisfy the innocent party;

- the ‘genuine pre-estimate’ test is not the only test for determining whether a particular clause was penal. Even if a particular provision fails that test, it could be enforceable if it passes the ‘commercial justification’ test;

- a possible solution, as highlighted in the judgment, is to draft such provisions in such a way that that outstanding payment is made conditional upon the seller’s compliance with certain terms, rather than providing that the buyer would not be required to pay in the event the seller breaches the relevant terms.

It is still quite possible that this may not be the end of this matter. If this case is appealed to the Supreme Court, we will be sure to update you as to its result.

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For further information please contact:

Michael Archer
Partner
T: +44 (0) 20 7469 0410
E: m.archer@beale-law.com