

PENALTY CLAUSES - DECISION BY THE UK SUPREME COURT IN THE CASE OF CAVENDISH SQUARE HOLDING BV V TALAL EL MAKDESSI

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Facts:

By an agreement, Mr Makdessi agreed to sell to Cavendish a controlling stake in the holding company of the largest advertising and marketing communications group in the Middle East. The contract provided that if he was in breach of certain restrictive covenants against competing activities, Mr Makdessi would not be entitled to receive the final two instalments of the price paid by Cavendish (clause 5.1) and could be required to sell his remaining shares to Cavendish, at a price excluding the value of the goodwill of the business (clause 5.6). Mr Makdessi subsequently breached these covenants. Mr Makdessi argued that clauses 5.1 and 5.6 were unenforceable penalty clauses. The Court of Appeal, overturning Burton J at first instance, held that the clauses were unenforceable penalties under the penalty rule as traditionally understood.

The judgment of the UK Supreme Court:

The Supreme Court allowed the appeal in *Cavendish v El Makdessi*, upholding the validity of the disputed clauses.

Legal Principles Discussed:

In the joint leading judgment by Lords Neuberger and Sumption (with which Lord Clarke and Lord Carnwath agreed), both judges held that the true test of whether a clause is penal, and therefore unenforceable, is whether the offending clause is a secondary obligation which imposes a detriment on the party in breach, out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.

They went on to explain that the validity of a clause providing for the consequences of a breach of contract depends on whether the innocent party can be said to have a legitimate interest in the enforcement of the clause. There is a legitimate interest in the recovery of a sum constituting a reasonable pre-estimate of damages, but the innocent party may have a legitimate interest in performance which extends beyond the recovery of pecuniary compensation. The law will not generally uphold a contractual remedy where the adverse impact of that remedy significantly exceeds the innocent party's legitimate interest.

Lords Neuberger and Sumption also described the penalty rule as “an ancient, haphazardly constructed edifice which has not weathered well” but maintained that the penalty rule should not be abolished in light of its endorsement by and application across all major systems of law in the western world.

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Reasons for the Judgment:

The court went on to conclude that neither clause 5.1 nor clause 5.6 were unenforceable penalty clauses for the following reasons.

The court construed clause 5.1 as a price adjustment clause. It went on to explain that the relevant clause was not a secondary provision but a primary obligation. The sellers earn consideration for their shares by (amongst other things) observing the restrictive covenants. Whilst clause 5.1 has no relationship with the measure of loss attributable to the breach, Cavendish also had a legitimate interest in the observance of the restrictive covenants, in order to protect the goodwill of the Group generally. The goodwill of the business was critical to Cavendish and the loyalty of Mr Makdessi was critical to the goodwill. The court cannot assess the precise value of that obligation or determine how much less Cavendish would have paid for the business without the benefit of the restrictive covenants. The parties were the best judges of how it should be reflected in their agreement. To that end, in finding that neither of the disputed provisions was avoided by the penalty rule, the court also considered that the agreement had been extensively negotiated between informed and legally advised parties dealing on equal terms, and a large proportion of the price for the shares represented goodwill.

A very similar analysis was applied to clause 5.6. The clause was also justified by the same legitimate interest as the first provision, being an interest in matching the price of the retained shares to the value that the seller was contributing to the target's business. In this instance, the court considered that the price formula in the disputed clause had a legitimate function, i.e. it reflected the reduced consideration which Cavendish would have been prepared to pay for the acquisition of the business on the hypothesis that they could not count on the loyalty of Mr Makdessi.

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