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Milbank Client Alert:
Penalties in English Law Contracts: The Risks and Their Avoidance

In a judgment issued on 4 November 2015 in relation to the conjoined appeals in the cases of Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67, the Supreme Court of the United Kingdom updated the long established English law rules on contractual penalties. Set out below are the key points that decision makers should keep in mind when negotiating clauses that provide for specific remedies for breaches of contract.

WHAT IF A CLAUSE IS A PENALTY?

The English law rule on contractual penalties is strict. If a court concludes that a contractually agreed remedy for a breach of contract is a penalty, the clause will be void and therefore unenforceable. The result? Left with no pre-agreed remedy (and assuming the clause becoming ineffective does not render the entire contract void), the innocent party's recompense will be limited to the damages that (i) are suffered as a result of the breach and (ii) are unable to be avoided by taking reasonable steps to mitigate losses.

WHAT KINDS OF CLAUSES MIGHT BE PENALTIES?

Any clause that operates to the detriment of a party to a contract as a result of his breach of contract could be a penalty (whether or not the detriment can be said to be designed to deter him from breaching the contract). Classic examples of potential penalty clauses include those providing for: (i) the loss of deposits and the withholding of payments, (ii) the deferral or reduction of consideration, (iii) break fees, (iv) liquidated damages, (v) default interest, (vi) the transfer of assets for nil consideration or at an undervalue, (vii) take-or-pay payments and (viii) compulsory buy-outs and other consequences of shareholder default.

WHAT MAKES A CLAUSE A PENALTY?

Whilst at least three of the judges thought that penalty clauses should be differentiated by reference to primary obligations (to which the rule did not apply) and secondary obligations, it is not clear that this was the view of the majority. Furthermore, seeking to

make this distinction would not be helpful in all cases as a potential penalty clause in a contract may be both a conditional primary obligation in one circumstance and a secondary contractual obligation in another. The essence of a penalty clause is that the detriment imposed on the party in breach of contract is out of all proportion to the innocent party's legitimate interest in the enforcement of the obligation that has been breached. In other words, to be a penalty, a clause must trigger a disadvantage to a party because of his breach of contract which is exorbitant or unconscionable in the overall context of the particular contract. Thus:

- In *Cavendish*, even though triggered by the vendor's breach of restrictive covenants under an SPA, neither the termination of his right to receive very substantial future sums by way of deferred consideration nor the fact that the buy-out price payable to him under the "defaulting shareholder" provisions was much lower than the price he would have received under other provisions of the agreement were seen by the court as consequences that were exorbitant or unconscionable given the importance to the purchaser of ensuring that the restrictive covenants were honoured, with the result that neither provision offended the rule against penalties.

- Even before *Cavendish*, provisions in loan agreements increasing interest rates following a default would not fail as penalties where the increases were commercially justified (i.e., to reflect the increased cost of lending to a borrower with greater credit risk) and the primary purpose of imposing them was not to deter the borrower from breach. The decision in *Cavendish* moves away from the deterrence element of the test (as this was considered unhelpful) and makes it clear that such provisions will be enforceable so long as the increases they impose are not unconscionable or extravagant (and so are commercially justified).

- Provisions depriving a management shareholder of options or requiring a buy back of stock at nominal value where the employee is a "bad leaver" will normally be effective on the basis that the employee will not have contributed to the value of the business in the manner originally envisaged.

- Provisions imposing break fees where a contract is terminated for default will be effective so long as the fees are not unconscionable or extravagant in the circumstances (i.e., greater than the highest levels of damages that could possibly arise from the breach). So, for example, a prepayment fee payable under a fixed term debt instrument following a default will be enforceable where the fee is quantified by reference to the discounted value of the interest that the creditor would have received had the debt remained outstanding.

- Provisions in an investment fund limited partnership (or equivalent) agreement under which an investor who fails to meet a capital call is obliged to sell back his

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investment at a discount to cost or fair market value (the level of discount usually being in the order of 80-90%) are likely to be effective on the grounds that this mechanism provides a legitimate means by which the interests of the fund (and of compliant investors) are protected.

- Provisions in agreements under which a deposit placed by the buyer with the seller (or into escrow) will be forfeited if the buyer defaults will not be a penalty so long as the deposit is not excessive. Where the size of the deposit is in line with the market norm for comparable transactions, the forfeiture provision can be expected to satisfy the test and so be effective. However, the fact that the deposit is larger than the norm does not mean that the forfeiture provision will fail as a penalty: if the vendor is able to show special circumstances to justify a larger deposit, the forfeiture provision should still be effective because the special circumstances mean that loss of the larger deposit cannot be said to be unconscionable or exorbitant in the particular circumstances.

WHAT IS THE LIKELIHOOD OF A CLAUSE BEING A PENALTY?

The rule against penalties operates where a contract provides for a remedy for breach which is grossly excessive. Whether a particular clause fails this test will depend on the circumstances existing at the time when the relevant contract was concluded. The fairness of the underlying bargain struck will not be the subject of court review, and a court will start with a strong presumption that the best judges of the appropriate remedy for a breach of a contractual obligation are the contracting parties themselves, particularly where the contract has been freely negotiated between commercial parties with similar bargaining power and with the benefit of appropriate expert legal advice.

WHAT STEPS SHOULD YOU TAKE IN LIGHT OF THE SUPREME COURT DECISION?

The Supreme Court decision has made it less likely now that a clause will be construed as a penalty. In light of this, it should not be necessary to revisit existing provisions that are capable of being construed as penalties. Going forward:

- Avoid including references in contracts to provisions that might be penalties as constituting a "genuine pre-estimate of loss". Instead, record that the parties have received appropriate legal advice. It may also be helpful to reflect the commercial rationale of the clause in a recital or in the clause itself.

- Bear in mind that if both parties to a contract have been properly advised and are of a comparable bargaining position there is a strong presumption that a clause will not be construed as a penalty. It is thus beneficial for your counterparty to be properly represented despite the fact that it may make negotiations more difficult.

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