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## English Court Finds Shareholder Default Provisions Unenforceable as a Penalty

*Decision serves as a reminder that careful consideration should be given to provisions dealing with the consequences of breaches of restrictive covenants and other terms of commercial agreements.*

On 26 November, in *Cavendish Square Holdings BV v Makdessi*,<sup>1</sup> the Court of Appeal of England and Wales held that certain transfer and other forfeiture provisions triggered by the default of one of the parties to a share purchase agreement were unenforceable as penalties. The provisions were held not to reflect a genuine pre-estimate of the buyer's loss and to lack commercial justification.

### Background

Following extensive negotiations, and with the help of experienced legal advisers, the parties to *Cavendish* entered into a share purchase agreement pursuant to which the claimant, Cavendish Square Holdings BV, became the majority shareholder of a holding company for an advertising and marketing group in the Middle East. The defendant, Mr Makdessi, was one of the two selling shareholders (both of whom retained minority stakes in the holding company) and remained a nonexecutive director of the company. The agreement contained an earn-out mechanism pursuant to which the sellers were entitled to additional payments in respect of the sold shares (potentially up to US\$82 million in total), determined on the basis of a formula based on a multiple of the profits of the group over a period of years. In addition, the agreement contained put options in respect of the sellers' remaining shares, entitling the shareholders to sell these shares to Cavendish on the basis of a formula that was also based on a multiple of the profits of the group over a period of years (capped at US\$75 million for each seller).

The agreement contained a number of restrictive covenants to protect the goodwill of the group after completion of the transaction, and it required the defendant to dispose of his interest in a competing business. The agreement also contained provisions stating—in the event that either of the sellers became a defaulting shareholder, including by breaching the restrictive covenants—that seller would forfeit his right to the earn-out payments and his put option in respect of the remaining shares. Instead, the seller would be required to sell to Cavendish any shares he held at the time of the breach at net asset value on the date of default (a valuation method not taking into account any goodwill and likely to lead to a far lower valuation of such shares than the amount due under the put option).

In December 2010, Cavendish discovered that Mr Makdessi was involved and interested in a competitor company. Cavendish claimed that Mr Makdessi was in breach of the restrictive covenants in the agreement, and the company contended that he was also in breach of his fiduciary duties as a director. The defendant admitted breach of fiduciary duties and reached a settlement with the company. However, Mr Makdessi submitted that the forfeiture provisions in the agreement amounted to unenforceable penalty clauses.

The judge, at first instance, held that the defaulting provisions were not penal as their purpose was not to deter breach but to decouple the parties quickly and on a conventional basis and to adjust the consideration between

1. [2013] EWCA 1539 (Civ), available at <http://www.bailii.org/ew/cases/EWCA/Civ/2013/1539.html>.

them by reducing the price, which was substantially based on goodwill. He held that they had a commercial purpose and a commercial justification. The defendant appealed.

## Court of Appeal's Decision

The Court of Appeal found that the relevant provisions in the share purchase agreement were unenforceable penalties and unanimously allowed the defendant's appeal. On review of the authorities, the court commented that recent cases indicate that the courts now adopt a broader test than the traditional one of whether a provision is a genuine pre-estimate of loss. Analysis based on the traditional test is still necessary but is not conclusive. There may be a good commercial justification for a provision even if it is not a genuine pre-estimate of loss. It is not penal unless the sum payable on breach is extravagant and unconscionable and the provision's predominant function is deterrence of breach.

Applying the modern test to the facts of the case, the court found that, in the context of the share purchase agreement as a whole, the sums to be forfeited by the defendant under the defaulting provisions were likely to be extravagant and unreasonable when compared with the greatest loss recoverable by the claimant (which was equal to zero as a matter of law). In addition, there was no proportionate relationship between the types of breach that could trigger the operation of the defaulting provisions and the amounts forfeited. Under the provisions, all of the potential earn-out payments were forfeited as soon as a seller became a defaulting shareholder, even if the breach was trivial or short-lived.

The court further held that the terms of the default provisions in question did not serve to fulfil some justifiable commercial or economic function. The range of activities which would amount to breach and their possible consequences was very wide, and many of them could not attract compensation anywhere near the amounts to be forfeited by the defendant. These provisions went beyond compensation and their predominant function was that of deterrence.

## Conclusion

*Cavendish* serves as a reminder that careful consideration needs to be given to provisions dealing with the consequences of breaches of restrictive covenants and other terms of commercial agreements, particularly where the breach would result in a payment or a forfeiture of a sum of money. When applying the relevant test, the court will take into account any commercial justification for allegedly penal clauses. However, if the provision requires extravagant payment without sufficient commercial justification, the court is likely to find it unenforceable, even where the agreement was part of a commercial bargain reached after extensive negotiations.

With regard to drafting deferred consideration clauses, one possible alternative would be to make the buyer's obligation to pay such consideration conditional on the seller's compliance with its obligations under the agreement (e.g., restrictive covenants), rather than providing that the buyer's obligation to pay will cease in the event of the seller's breach. The court in the *Cavendish* case highlighted this as one of the anomalies of the law relating to penalties.

## Contacts

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