Taking a penalty

Taking a penalty is always an issue for footballers, particularly England in international matches. For business people, penalties are also a serious concern.

In contract negotiations, a major commercial issue is often the level of agreed compensation which should apply if during the life of the contract, one party breaches a key term. The first instinct of the affected party may be to maximise the level of compensation sought in the contract. However this needs to be resisted, for as in football, it has got to be placed just right.

The Courts have held -- "In general a contractual provision which requires one party in the event of his breach of contract to pay or forfeit a sum of money to the other party is unlawful as being a penalty, unless such provision can be justified as being a payment of liquidated damages being a genuine pre-estimate of the loss which the innocent party will incur by reason of the breach.

How to be the right side of the line? For almost a century key guidelines have been:-

1. Use of wording “liquidated damages” indicates what parties mean –but is not conclusive;
2. The essence of a penalty clause is to frighten the breaching party and so intended to deter – this is an objective test;
3. A court will determine whether a sum is a penalty or liquidated damages – in respect of the circumstances at the time the contract was made, not at the later time of breach;
4. Four indicators :-
    a. If the sum is “extravagant and unconscionable” compared to the greatest loss arising from the breach –it is a penalty;
    b. If the breach is not to pay a sum and the stipulated sum is greater than the sum which has not been paid –it is a penalty;
    c. Where a lump sum is payable , on the occurrence of one or more different events, some of which are serious but others are less so – it may be a penalty;
    d. But – it can still be a genuine pre-estimate, where it is not possible to make a precise pre-estimate; indeed, the sum agreed is the outcome of negotiations as to the deal between the parties.

A recent case has reviewed and developed the legal position in respect of these four indicators above. Briefly, the case involved a share purchase agreement in which Mr El Makdessi agreed to sell 48% of his advertising business (taking the buyer’s holding up to 60%), with the purchase price being paid partly upfront and part deferred. The business had been built up on personal contacts and so in order to protect the goodwill of the business going forward, Mr El Makdessi agreed to anti-compete provisions.

Following his breach of these provisions, the buyer sought to rely on the contractually agreed sums as liquidated damages. This provided: -

- The buyer was released from paying the deferred purchase price for the 48% shares bought;

- The buyer could exercise a put option to acquire the remaining 40% equity from Mr El Makdessi and his partner at a reduced net asset price.

The initial judge found for the buyers. Both parties were commercially savvy and had been advised by major London law firms and generally, the courts will seek to give certainty in commercial agreements in such circumstances. Goodwill in the business was a critical part of the deal and this clause was not therefore disproportionate.

The Court of Appeal took the opportunity to review the law, observing that recent cases "show the court adopting the broader test of whether the clause was extravagant and unconscionable with a predominant function of deterrence; and robustly declining to do so in circumstances where there was a commercial justification for the clause."

In Mr El Makdessi's case, the clauses applied the same compensation to a variety of different events, some more serious than others and yet this could cost the sellers up to $82m. The price for the original 48% equity could have cost up to $148 m., with only $34m paid upfront whilst the net asset value for 100% of the company was the lesser figure of $70m.As such, this was not a genuine pre-estimate of loss but "extravagant and unreasonable". However this was not necessarily conclusive for if there were commercial justification, it might still not be a penalty.

The Appeal Judge went on to note : - " Nowadays, when a term which provides for excessive payment on breach may be valid if it has a proper commercial justification, the term "unconscionable" would, perhaps more appropriately be used for a clause which provides for extravagant payment without sufficient commercial justification. Such a clause is likely to be regarded as penal and deterrence its predominate function, on the basis that if it requires excessive payment and lacks commercial justification for doing so, there is little room for any conclusion other than its function is to deter breach or, to put it positively, to secure performance."

What does this mean in practice for you when negotiating a contract? Points to note:-

- generally ,courts do not wish to interfere in contracts whose terms were freely agreed at the time by experienced business people – such negotiation of complex interlinking terms made between parties of similar strength may usually suffice as commercial justification; price for the 48% shares bought;
- however, there are limits. Where the sum is excessive, then it may not be "proper" or "sufficient" commercial justification and as such, be invalid as a penalty.
- particularly where dealing with a scenario where the actual loss is unclear at the negotiation, and negotiators are seeking to reach an agreed cap on an uncertain unknown future situation, nonetheless they may need later to justify that such a cap fell in the ballpark of possible loss, appropriate to its specific nature (and not one cap fits all).

For footballers about to take a penalty, the decision is whether to place or to belt the ball. Similarly for business people who wish to protect against a future uncertain loss –if you aim too high when agreeing the contract, then you risk such protection not being liquidated damages which you can enforce but a penalty which the courts will strike out. Now, that is an own goal.

1 Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd [1993]
2 Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited [1915]
3 El Makdessi v Cavendish Square Holdings BV [2013]