

Business Update - Share purchase agreements: penalty and forfeiture clauses

In *El Makdessi v Cavendish Square Holdings BV* and another, the Court of Appeal considered whether clauses in a share purchase agreement were unenforceable penalties. The clauses in question provided that, on the seller's breach of a restrictive covenant the buyer would be :

1. Released from its obligation to pay certain deferred consideration.
2. Entitled to force the seller to transfer the remainder of his shares in the target company to the buyer at a price based on net asset value (which was less advantageous than the price that would apply on a sale of the shares where there had been no breach).

The court found that, taken in the context of the agreement as a whole, the relevant clauses were not a genuine pre-estimate of the buyer's loss. On the contrary, they were extravagant and unreasonable. While this was not, of itself, conclusive in determining whether the clauses were penal, the court also found that, in the circumstances, the provisions lacked commercial justification. Their predominant function was to act as a deterrent to breach. The sum the seller stood to lose under these clauses was out of all proportion to the loss attributable to the breach. This took these clauses way beyond compensation and into the territory of deterrence.

Accordingly, the court held that the relevant clauses were penal and the buyer could not enforce them.

In limited cases, the courts will relieve against forfeiture for breach of covenant or condition where the primary object of the bargain is to secure a stated result, and where the forfeiture provision is added by way of security for the production of that result, taking into account the conduct of the applicant for relief, the gravity of the breaches, and the disparity between the value of the property of which forfeiture is claimed compared with the damage caused by the breach (*Shiloh Spinners Ltd v Harding* [1973] AC 691, 723).

There may be some overlap between the application of the rule against penalties and relief against forfeiture. In *Jobson v Johnson*, the court applied the penalty rule to a clause entitling the innocent party to the re-transfer property which had previously been transferred to the contract breaker, a clause which was also a forfeiture clause.

However, the courts have developed different approaches to the enforcement of penalty clauses and the enforcement of forfeiture clauses. As stated by Nicholls LJ in *Jobson v Johnson*:

"In the case of a penalty clause in a contract, equity relieves by cutting down the extent to which the contractual obligation is enforceable.... In the case of forfeiture clauses equitable relief takes the form of relieving wholly against the contractual forfeiture provision, subject to compliance with conditions imposed by the court. Be that as it may, I see no reason why the court's ability to grant discretionary relief against forfeiture should deprive a defendant of the relief automatically granted in respect of a penalty clause if, exceptionally, a contractual provision has characteristics which enable a defendant to pray in aid both heads of relief."

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