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Are earn out provisions in a business sale contract unenforceable penalties?

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Litigation: Does an earn out clause in a substantial business sale contract, negotiated over 6 months where both sides were represented by leading London law firms, represent an unenforceable penalty because it is not a genuine pre-estimate of loss? David Bowden, freelance independent consultant, comments on the submissions made to the Supreme Court of the United Kingdom on 21 to 23 July 2015 in this appeal.

Original news

Cavendish Square Holdings BV v. Talal el Makdessi
UKSC 2013/0280
Mr Makdessi sold his advertising business that operated in 15 Middle Eastern countries to Cavendish. There were a number of contracts put in place to affect this. Broadly Mr Makdessi agreed that he wouldn't carry out certain activities in a number of countries. In breach of this, Mr Makdessi was involved in the running of another business (Carat) which did compete with Cavendish and solicited Cavendish's business, clients and employees.

There were complex clauses in the sale agreement setting out how Cavendish would pay for Mr Makdessi's business. One of these included an earn out clause whereby interim and final payments would be calculated on audited consolidated operating profit for 2007-11 respectively. There were also claw back clauses in the sale agreement. Mr Makdessi contended that two clauses (clauses 5.1 and 5.6) were unenforceable because they were not a genuine pre-estimate of Cavendish's loss but were penalty clauses.

Following a 5 day trial in December 2012, Burton J gave judgment ***[2012] EWHC 3582 (Comm)*** *for specific performance in favour of the claimant Cavendish in its claims against Makdessi. This decision was overturned on appeal to the Court of Appeal on 26 November 2013, [****2013] EWCA Civ 1540*** *by Lords Justices Patten, Tomlinson and Christopher Clarke. It accepted Mr Makdessi's submissions that these 2 clauses in the sale agreement were penal because they infringed the law on penalty clauses. Christopher Clark LJ found that clauses 5.1/5.6 were "extravagant and unreasonable". He also rejected Cavendish's submissions that these clauses had a commercial justification.*

On 22 May 2014 the Supreme Court of the United Kingdom granted Cavendish permission for a final appeal. This appeal was listed for 3 days and heard on 21 to 23 July 2015 before an enlarged panel of 7 Supreme Court Justices. Judgement has been reserved.

What are the facts?

Cavendish and Team Y&R Holdings Hong Kong Ltd (Team Y&R) are companies in the WPP group of companies, one of the world's largest advertising groups. Mr Makdessi was the founder and owner (with Mr Joe Ghossoub) of what became the largest advertising group in the Middle East. It operated in more than 15 countries via a network of 20 companies. By a sale agreement dated 28 February 2008 Cavendish agreed to buy from Makdessi 47.4% of the shares in Team Y&R taking its shareholding to 60%. Provision was also made for it to buy the remaining 40% by virtue of put and call options.

By the terms of the sale agreement and a director's service agreement dated 11 June 2008 Mr Ghossoub agreed to remain as an employee and director of Team Y&R. Mr Makdessi when negotiating the sale agreement stipulated that he did not wish to remain an employee. Instead he was appointed a non-executive director and chairman of Team Y&R for an initial term of 18 months renewable.

Cavendish's consideration for buying the shareholding was substantial. Cavendish agreed to pay Messrs Makdessi and Ghossoub 4 payments:

- $34 million on completion,
- $31.5 million later on terms set out in the sale agreement,
- An interim and final payment calculated on audited consolidated operating profit for 2007-9 and 2007-11 respectively ("the earn outs").

By clause 7.5 ("the Carat Clause") the Messrs Makdessi and Ghossoub agreed that within four months of completion they would dispose of any shares held by them in Carat Middle East S.a.r.l ("Carat"). They also agreed to procure that a joint venture agreement dated 19 December 2003 to which Group Carat (Nederland) BV, Aegis International BV and Mr Makdessi would be terminated. Carat was a joint venture company established of which Mr Makdessi had 49% of its shares. Carat is defined on its website as "the world's leading independent media planning and buying specialist…Owned by global media group Aegis Group Plc… [with] more than five thousand people in seventy countries worldwide". Carat is admittedly a competitor of Cavendish.

Cavendish sued for breach of the sale agreement. Cavendish contended that in breach of his fiduciary duties and the restrictive covenants Mr Makdessi had throughout 2008-9 in Lebanon and Saudi Arabia (both within a prohibited area in the sale agreement):

- set up rival advertising agencies in Lebanon and Saudi Arabia with "Adrenalin" in their name,
- continued to provide his services to Carat,
- assisted Carat to generate business,
- diverted business to Carat,
- solicited clients and diverted their business to Carat, and
- Adrenalin had poached or tried to poach a number of the Cavendish's customers and employees.

In proceedings Makdessi admitted certain breaches of fiduciary duty by the Defendant. If the relevant covenants in the sale agreement were valid and enforceable this would also constitute breaches of those covenants. Both parties had the benefit of independent legal advice (Cavendish by Allen & Overy, and Makdessi by Lewis Silkin) in what was a substantial commercial transaction negotiated over 6 months.

What ruling did Mr Justice Burton give?

Following a 5 day trial in December 2012, Burton J gave judgment **[2012] EWHC 3582 (Comm)** for specific performance in favour of the claimant Cavendish in its claims against Makdessi.

One issue in the trial was whether the clauses in the various agreements constituted an unenforceable penalty by Cavendish. The trial judge applied the test set out by the House of Lords in *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* **[1915] AC 79** ("Dunlop") and ruled against Mr Makdessi on this and all other points. Cavendish also applied to commit Mr Makdessi to prison based on what it claimed were breaches of the Statements of Truth in his Defence and Counterclaim filed in the proceedings.

What happened in the Court of Appeal?

This decision was overturned on appeal to the Court of Appeal on 26 November 2013, [**2013] EWCA Civ 1540** by Lords Justices Patten, Tomlinson and Christopher Clarke. It accepted Mr Makdessi's submissions that 2 clauses in the sale agreement (clauses 5.1 and 5.6) were penal because the infringed the law on penalty clauses. The Court of Appeal reviewed all the existing authorities on penalties including one from the High Court of Australia. The Court of Appeal had to determine whether the earn out provisions (and claw back provisions if the audited consolidated operating profit produced a negative figure) were a genuine pre-estimate of loss or were an unenforceable penalty clause. Christopher Clark LJ found that clauses 5.1 and 5.6 were "extravagant and unreasonable".

He also rejected Cavendish's submissions that these clauses had a commercial justification because he ruled that the payment terms of clauses 5.1 and 5.6 do not serve to fulfil some justifiable commercial or economic function such as is exemplified in the prior cases, such as:

- modest extra interest in respect of a defaulting loan,
- provision for the payment of the costs of earlier litigation,
- generous measure of damages for wrongful dismissal,
- allocation of credit risk, or

- provision of capital which would be needed if a promised guarantee of a loan was not forthcoming.

Christopher Clark LJ ruled their effect is that Mr Makdessi stands likely to forfeit sums in the tens of millions in circumstances where, because of the unacceptability of double recovery the law, for reasons of public policy, precludes any recovery by Cavendish at all. The sale agreement prescribes a form of double jeopardy because Cavendish has the remedies provided for by the clauses and Mr Makdessi remains liable to Cavendish.

What has happened so far in the Supreme Court?

On 22 May 2014 the Supreme Court of the United Kingdom granted Cavendish permission for a final appeal in a bid to overturn the Court of Appeal's ruling and restore the judgment of Burton J. This permission decision was made by the President (Lord Neuberger) and Lords Reed and Toulson JSCs.

Cavendish continued to be represented by Joanna Smith QC and Richard Leiper (who both appeared below) but James McCreath and Edwin Peel were added to the team. Mr Makdessi continued to be represented by Michael Bloch QC and Camilla Bingham QC (who both appeared below). Neither side were represented by the law firms that dealt with the drafting of the disputed contracts – *Cavendish* instructed Squire Patton Boggs (UK) LLP and *Makdessi*, Clifford Chance LLP. The appeal was listed for 3 days and heard on 21 to 23 July 2015. It was listed before an enlarged panel of 7 Supreme Court Justices. In addition to 2 of those 3 justices that granted permission in May 2014, also on the panel were Lords Mance, Clarke, Sumption, Carnwath and Hodge. At the conclusion of the hearing the court invited further written submissions from all parties on one point that was troubling the court. It granted permission for replies to be made to these submissions by any other party.

Judgement was reserved and it is unclear how long the Supreme Court will take to reach its judgment on this. The court has a 2 month summer vacation in August and September. It may be that the judgment in this case does not appear until early 2016 but we may see it appear in late 2015.

What is the significance of this case?

The case is significant for this reason.

The Supreme Court has had an opportunity to re-examine the common law relating to penalty clauses and genuine pre-estimates of loss. Whilst it remains to be seen whether it will actually do so, one possibility is that the Supreme Court will over-rule the 100 year old rule set out in *Dunlop*. At the very least this will give the Supreme Court a chance to re-explain *Dunlop* in a 21st century context. In doing so, it will re-set the rules on penalties in contracts which will have wide implications for all those drafting contracts.

What were the issues the Supreme Court of the United Kingdom was asked to address?

The Supreme Court has to choose whether the approach of the Court of Appeal or Burton J in the Commercial Court was the correct one. In doing so, it will have to decide what "extravagant or unconscionable" means in the 21st century when applied to business contracts negotiated with the benefit of legal advice on both sides and where each party to the contract had equivalent resources available to it.

What does Cavendish say?

Cavendish's submissions lasted 5 hours in total. Broadly Cavendish says that Burton J got this right, the Court of Appeal were wrong to overturn his judgment and the Supreme Court should restore the trial judge's ruling. This was a commercial contract between substantial business entities negotiated over a period of 6 months with both sides represented by experienced City solicitors. The earn out clauses in the contract are not penalties and are a genuine pre-estimate of Cavendish's loss.

One fall back submission is that the rule on penalties set out in *Dunlop* has had its day and should now be over-ruled. Cavendish submits that scaling back clauses 5.1 and 5.6 is not possible and that this is an all or nothing situation.

In relation to clause 5.6, Cavendish makes two submissions:

- nobody seriously disputes that in the circumstances it was reasonable to provide for a severance, or decoupling, and
- how you achieve that then involves an agreement as to a method of valuation, and a net asset valuation is an admissible method of valuation. A court cannot say it is manifestly extravagant or excessive if that is what the parties agree.

Often parties in contracts provide for additional rights. Cavendish has reserved rights and remedies in a way whereby it has an overlapping remedy. It is trying to secure a practical remedy with clauses 5.1 and 5.6. For example, an injunction in the Middle East is not going to be something which is easy to obtain in order to prevent competition. From a practical business point of view, one really has to look to see how realistic it is to think that the alternative remedies that were provided for by the parties are actually going to be of any value to Cavendish in circumstances where Makdessi decides to compete and decides to compete in a way which Cavendish might not discover for some considerable time. The acceptance of the default was in 2008 and Cavendish didn't identify it until 2010.

Complex commercial contracts are very different from a simple consumer contracts in terms of identifying primary and secondary obligations, or identifying collateral obligations. There is a danger because the courts are not commercially acute in terms of looking at the effect and consequences of individual clauses that it court cannot identify what the party was thinking when it entered into the clause. One has to be careful about that identification and it is difficult in this particular case to distinguish between primary and secondary obligations

What does Makdessi say?
Makdessi's submissions lasted 4½ hours in total. Broadly it says that the Court of Appeal got this right and that the 2 clauses it identified as problematic were penal ones, did not represent a genuine pre-estimate of Cavendish's loss and are therefore void. Penalty should be defined as "forfeiture of sum of money or transfer of property" which is what has happened here. It is a penalty if it is a clause which, in the case of breach, imposes a financial sanction manifestly disproportionate to the interests legitimately protected by the contract.

There is a distinction to be made between those cases where it is easy to put and to estimate in advance the financial consequences of the breach, for example in hire purchase law or leasehold cases. There is a clutch of cases dealing clearly with a financial loss or the risk of a financial loss in the event of a breach. But it is difficult to estimate in advance or possibly even establish after the event what it is. Those cases would include many of the cases such as *Dunlop* itself where you cannot say that any particular consequence would be followed from any particular breach. In cases such as that, the court will have far less basis on which to question the genuineness of the estimate. Therefore there is all the greater the allowance.

The third group of cases will be cases where what is being protected doesn't really have value in monetary terms. For example the case relating to the ploughing up of common pastureland where you might have an interest in it not being ploughed up if in fact it would be more valuable as arable land. In that quite different issues arise and the approach that the court takes in relation to them will also be quite different.

A fourth category will be cases where the interest is of a commercial nature, such as the interest rate cases, but not simply one to be expressed in terms of damages. In interest rate cases one can readily see how a price is put on the fact that the credit worthiness of the borrower has changed. There will be other cases in which the legitimate interest will be even more far removed from that kind of financial calculation, including in those cases a non-profit earning organisations the protection of the objects of the organisations themselves.

Makdessi does not submit that the reservation of a right of damages for the company and for Cavendish and the injunctive relief and the set-offs are themselves manifestly excessive. It is the question of how one judges clauses 5.1 and 5.6 in that context.

In the case of the trivial breach, after perhaps several years of not only complying with the covenants but also working diligently as he was being encouraged by the structure of the agreement in other respects to further the business of the company, then his loss will be all the greater. So, one knows about the calculation. First of all, it could lead to a massive consequence. Secondly, it could clearly lead to a massive consequence out of any conceivable proportion to the damage resulting from the breach, and thirdly, insofar as there is any proportionality, it is inverse or perverse because the scale slides in the wrong direction. A clause is a penal, if in evident breach, a party imposes a financial sanction manifestly disproportionate to the interests protected by the contract.

In this case, the **two** striking things Makdessi comes back to are (apart from good will and deterrence):

- no interest has been identified, and

- Consequences are potentially manifestly excessive but the justification in relation to 5.6 of decoupling, whilst arguable as a matter of concept, is plainly not what this is all about, having regard to the fact that there has been no attempt by Cavendish to find a scaling down solution if the court considers it a way to proceed.

What interventions did the justices make? What points seem to be troubling them?
It was noticeable that over the first 2 days the majority of the interventions came from Lord Mance and Lord Toulson. Their interventions took different approaches. It was clear that Lord Toulson's interventions were influenced to a great degree to the time when he was at the Law Commission which produced its report on unfair contract terms (Cm 6464, February 2015). Beavis's printed case made reference to a decision in another consumer case handed down in November 2014 (*Plevin v Paragon Personal Finance*) in the Supreme Court where Lord Sumption had written the sole pro-consumer judgment. In relation to *Beavis*, there were many interventions from Lord Sumption. Lord Neuberger also pressed the parties as to the characterization of the charge in *Beavis* and in the end invited written submissions from all parties on this. The other justices also intervened to make points but not to the same extent. Several justices queried what "unconscionable" and "extravagant" meant and castigated this language as being Edwardian.

Lord Neuberger said that one of the reasons these cases were here is for the Supreme Court to rule on what the law should be and not what it has previously been understood to be.

What further written submissions did the President ask for?
At the beginning of the 3rd day, Lord Neuberger started with a series of questions directed at Mr Beavis's counsel. He dealt with those as best he could. However towards the close of arguments on the final day, Lord Neuberger was still troubled by this and invited all 4 parties and the intervener to submit some further written submissions. These have to be filed at court and served on the other side by 5pm on Thursday 30 July 2015.

Lord Neuberger wants these submissions to deal with the **characterization** of the arrangement. He said he didn't want to be too specific but that it seemed to him that the characterization of the arrangement is important in order for the Supreme Court to decide whether the £85 charge is capable of being characterized as:

- a penalty rather than a payment,
- a contractual payment, or
- a licence after 2 hours.

Lord Neuberger said he didn't want to limit the parties to various ways which the arrangements have been characterized in oral argument. He said he didn't want to encourage any replies but that it would be unfair to shut them out because there may be something unexpected. He said any such replies should be filed and served by Monday 3 August 2015.

What should lawyers do next?
At the end of the hearing Lord Neuberger gave no indication as to when judgment will appear. It may appear towards the end of 2015 but is more likely to appear in early 2016. It seems likely that the court will accede to submissions and rule that consumer contracts are to be treated differently. For commercial contracts, there is the possibility that the rule in *Dunlop* will be over-ruled after 100 years. Alternatively, the Supreme Court may decide that the rule is so well-known and entrenched that it is better left alone. A third way could be for the Supreme Court to re-explain penalty clauses in a modern commercial context using language or terminology that is more accessible, contemporary or easily understood.

The lengthy joint report on unfair contract terms from the Law Commissions of England & Wales and Scotland has only recently been delivered to Parliament. It remains to be seen what it will do about further amending the law on unfair contract terms. It is apparent from that report and submissions in this case, that small businesses may not be getting sufficient protection.

Interviewed by David Bowden of David Bowden Law (www.DavidBowdenLaw.com).

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