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Penalty clauses: How to avoid falling foul of them

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In November 2015, the UK Supreme Court in *Cavendish Square Holding BV v El Makdessi* ("*Cavendish Square*") and *ParkingEye Ltd v Beavis* ("*ParkingEye*") [2015] UKSC 67 reviewed and clarified the rule on penalty clauses which used to be focused on a narrow assessment of whether the impugned provision was a genuine pre-estimate of loss. *Cavendish Square* was recently considered by the Singapore High Court in *iTronic Holdings Pte Ltd v Tan Swee Leon* [2016] SGHC 77 ("*iTronic*"). *iTronic* provides a good example of the application of the restated rule on penalty clauses.

Cavendish Square – a recap

After a comprehensive review of the contractual penalty rule, the UK Supreme Court reformulated the approach to penalty clauses as follows:

- The penalty rule applies only to secondary obligations, i.e. obligations triggered by a breach of contract. The rule does not apply to primary obligations.
- If the penalty rule applies, we have to then consider whether the consequence of a breach is out of all proportion or "unconscionable" or "extravagant" having regard to the legitimate interests of the innocent party.

In Cavendish Square, M sold a controlling stake in his advertising and marketing company to Cavendish. The SPA contained a restrictive covenant against competing activities. Breach of the covenant entitled Cavendish to:

- withhold the final two instalments of the purchase price; and
- acquire M's remaining stake in the target company at a reduced price that did not take account of goodwill.

At first blush, the above provisions would appear to be secondary obligations triggered by a breach of contract (i.e. the restrictive covenant). However, the UK Supreme Court took the view that the above provisions were, in effect, price adjustment clauses. They reflected the reduced consideration which Cavendish would have been prepared to pay for the business without the loyalty of M. As they were primary obligations, the penalty rule did not apply.

Although there was no need to do so, the court considered that even if the provisions were secondary obligations, Cavendish had a legitimate interest in the observance of the restrictive covenant (i.e. protection and preservation of the goodwill of the target business) where the impact of a breach would not be easy to measure. The provisions were neither extravagant nor unconscionable and they were negotiated by parties who were legally represented.

ParkingEye – a recap

ParkingEye involved the use of a car park for a retail park where users had to pay £85 if they exceeded their allotted time of two hours. In this case, the court held that the obligation to pay £85 was a secondary obligation triggered by breach of a primary obligation (i.e. not to use the car park space beyond two hours). Therefore the penalty rule applied. However the court decided that the £85 charge was enforceable because it was not extravagant or unconscionable. The car park operator had a legitimate interest in obtaining an income stream to meet its costs and in ensuring the efficient use of parking spaces to facilitate a good turnover of customers in the retail outlets.

iTronic

In *iTronic*, various "compensation sums" were payable depending on whether the company proceeded to list, cancelled its plans for a listing or did not list. The Singapore High Court referred to *Cavendish Square* (to our knowledge the first Singapore decision to consider *Cavendish Square*) and decided as follows:

- On the terms of the agreement, securing a listing was not a primary obligation.
- Therefore, payment of the compensation sums was not a secondary obligation triggered by the breach of a primary obligation. In effect, payment of the compensation sums was a conditional primary obligation.
- On the basis of its decision above, the penalty rule did not bite.
- As in *Cavendish Square*, although there was no need to do so, the court considered that even if the provisions were secondary obligations triggered by a breach, they were neither extravagant nor unconscionable. The court took into account the fact that the provisions were negotiated by parties who were legally represented.

Key takeaways post-*Cavendish Square* and *iTronic*

- It is critical to distinguish between conditional primary obligations and secondary obligations which are triggered by a breach. Proper structuring and drafting of a contractual provision to be a primary obligation will help to avoid the penalty rule.
- Break fees in the context of M&A transactions are likely to be construed as primary obligations.
- An option to acquire shares at a price above or below market value, even if triggered by a default or breach, is likely to be considered as a primary obligation. Such provisions are common in joint venture and shareholders agreements.
- Even if an impugned provision is a secondary obligation, the courts have moved away from just considering whether the clause gives a genuine pre-estimate of the loss suffered by the innocent party. In the context of M&A and JV transactions, where investments are typically long term, such an assessment is often difficult to make. With the new approach, parties are allowed a generous margin in estimating loss.
- The focus has shifted to considering whether the innocent party has a legitimate interest in the observance of the primary obligations and whether the consequences of a breach are “extravagant” or “unconscionable”. This means that the background and commercial justification for the deal are important factors. Parties should consider including relevant background information in the agreement (for example, in the recitals).
- If the counterparty on whom a secondary obligation is to be imposed is not represented by lawyers, consider asking it to obtain legal representation.
- Keep notes of negotiations so that in any dispute over a “penalty clause”; relevant documents may be adduced as evidence to justify the clause.

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