

UK Court of Appeal Invalidates Provision in Acquisition Agreement Which Forfeited Deferred Consideration if Seller Breached Non-Competition Covenants

The UK courts have adopted a relatively permissive approach to penalty clauses in recent years and have generally not sought to interfere with commercially reasonable clauses agreed to by sophisticated parties who have had the benefit of legal advice. A very recent decision of the UK Court of Appeal in *Makdessi v Cavendish Square Holdings*, which has come as a surprise to the UK market, seems to represent a departure from this more permissive approach.

Background and facts

The facts were that a member of the WPP group, the global advertising group, bought shares in a company from Makdessi. Makdessi retained a shareholding in the target company. Both parties were represented by highly experienced lawyers and the purchase agreement was the subject of extensive negotiations between the parties over a six month period.

It appears to have been accepted that the purchase price included a substantial element of goodwill associated with the target company. In fact, Makdessi expressly acknowledged and agreed this in the purchase agreement.

The purchase agreement provided that the consideration payable to Makdessi included an upfront payment and two deferred elements. The deferred elements of the consideration were dependent on the operating profit of the target company in certain periods after completion of the transaction.

The purchase agreement also contained various restrictive covenants. These covenants, which were enforceable both by the buyer and the target company, included covenants by Makdessi not to solicit employees or clients from, or compete with, the target company. The purchase agreement went on to provide (the “**Defaulting Shareholder Covenant**”) that if Makdessi breached these restrictive covenants: (i) he would not receive any of the deferred consideration; and (ii) the buyer had the option to acquire his remaining shares in the target at net asset value (a value which was apparently materially below the then market value of his remaining shares).

The Court of Appeal held that the Defaulting Shareholder Covenant was a penalty and unenforceable.

Was the Defaulting Shareholder Covenant a genuine pre-estimate of loss?

The court began the analysis by concluding that the Defaulting Shareholder Covenant was not a genuine pre-estimate of loss. It came to this conclusion principally for the following reasons:

1. The Defaulting Shareholder Covenant did not distinguish between: (i) material and immaterial breaches and (ii) isolated and continued breaches. In the case of an isolated and immaterial breach, Makdessi faced the loss of the entirety of his deferred consideration and having his remaining shares compulsorily acquired from him at below market value.
2. The amount of the deferred consideration was not ascertainable at the time the purchase agreement was signed (i.e it was dependent on future profitability). This suggested that the amount to be withheld from Makdessi could not have been a genuine pre-estimate of loss at the time the purchase agreement was signed.
3. The purchase agreement as a whole subjected Makdessi to a duplication of prejudicial provisions. In the event that the restrictive covenants were breached, Makdessi potentially faced: (i) losing his deferred consideration and having his remaining shares bought out at an undervalue; and (ii) then also being sued by the target company (which was also entitled to enforce the restrictive covenants in the event of breach).

Notwithstanding that the Defaulting Shareholder Covenant was not a genuine pre-estimate of loss, was it commercially justifiable?

Having concluded the Defaulting Shareholder Covenant was not a genuine pre-estimate of loss (which was not of itself fatal), the court then considered whether the Defaulting Shareholder Covenant could be commercially justified.

The buyer argued that the Defaulting Shareholder Covenant was wholly justifiable. The buyer argued in particular that:

- with respect to the forfeiture of the deferred consideration, the buyer had agreed to pay a price substantially based on goodwill and if Makdessi did not comply with the restrictive covenants, which were designed to protect the goodwill of the business, there was nothing objectionable in having the consideration reduced in that event; and
- with respect to the right to acquire Makdessi's remaining shareholding, this provision enabled a repaid decoupling of Makdessi from the target company in circumstances where Makdessi had breached the restrictive covenants.

The court did not accept the buyer's arguments on commercial justification. It is not entirely clear why it did not accept those arguments. The reasoning seems to suggest that the court was particularly troubled by the fact that the terms on which the deferred consideration was adjusted, and Makdessi's remaining shares were acquired from him, were in its view disproportionate (this position was seemingly based in part on points 1 to 3 above). The court determined that those terms "went way beyond compensation and into the territory of deterrence". As one example, the court specifically noted that the proposed acquisition of Makdessi's remaining shareholding did not have to be on terms that were materially below market value.

Implications

This decision has surprised the UK market and suggests that the UK courts may adopt a more formalist and less permissive approach to penalty clauses than has been adopted in other recent cases. It may be however that the Court of Appeal was specifically swayed in this case by the fact that the Defaulting Shareholder Covenant did not distinguish between material and immaterial matters and the fact that, in the event of breach (potentially even an immaterial breach), Makdessi not only lost his deferred consideration but could also be forced to sell his remaining shares at below market value (which, in aggregate, could cause Makdessi to lose sums in the tens of millions of dollars according to the court). However, given that the purchase agreement was heavily negotiated between parties advised by highly experienced lawyers and that the goodwill associated with the target business quite clearly represented a substantial proportion of the purchase price, it seems surprising that the court did not display more reluctance to intervene.