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Commercial

Business Law Briefing

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Business **Protection – Seller Covenants**

Cavendish Square Holding BV v Makdessi

[2015] UKSC 67
[2015] 3 WLR 1373 [2016] BLR 1

The Supreme Court's Judgment Revisited

Scope of the penalty rule

No agreement on the identification of primary obligations

Through a sale and purchase agreement dated 28 February 2008, Cavendish acquired a majority shareholding in a group of companies established by Mr Makdessi, one of the most influential Lebanese business leaders, who maintained very strong relationships with the group's clients and senior employees.

The consideration due to Mr Makdessi under the SPA was to be paid in instalments, including: an initial consideration on completion, an Interim Payment (based on profits in 2007-2009) and a Final Payment (based on profits in 2007-2011). Those payments were expressed to be *"In consideration of the sale of the Sale Shares and the obligations of the Sellers herein …"*

The SPA included restrictions designed to protect the goodwill of the business and each seller expressly recognized the importance of the goodwill of the group to the purchaser. If Mr Makdessi acted in breach of those restrictions he became a Defaulting Shareholder. In that event, there were two possible consequences: first, he was not entitled to receive any further consideration for those shares he had sold (clause 5.1); secondly, Cavendish could require him to sell his remaining shares at Net Asset Value (a price which excluded any value for goodwill) (clause 5.6, a call option).

Cavendish exercised the call option in December 2010, alleging that Mr Makdessi had become a Defaulting Shareholder in the course of 2008, a matter of months after the SPA had been agreed; it also declined to pay the Interim or Final Payments. In due course Mr Makdessi admitted that he was a Defaulting Shareholder (though the precise date of default remains to be determined). However, he alleged that both clause 5.1 and 5.6 were unenforceable because they fell foul of the penalty rule. Whilst the Court of Appeal agreed with these arguments, the seven Supreme Court Justices upheld the decision of the original trial judge, Burton J, that each clause was enforceable.

The joint judgment of Lords Neuberger and Sumption was agreed to by Lord Carnwath and (in almost all respects) by Lord Clarke and so represents the majority judgment for the purposes of identifying the test to be applied. At paragraph 32, they said this:

"The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate business of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance."

They also commented that there is a strong initial presumption of legitimacy in a contract negotiated between properly advised parties of comparable bargaining power (paragraph 35).

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Cavendish Square Holding BV v Makdessi continued...

Applied to a liquidated damages clause, this test offers clarity: generally, the only appropriate alternative to performance is obtaining damages and so the question is whether the clause requires a sum to be paid by way of damages which is out of all proportion to the damages which the innocent party might obtain from the court.

In relation to more sophisticated clauses, 'the true test' explicitly accepts that a clause which operates on breach might seek an alternative to performance other than the payment of damages, an alternative which is appropriate and legitimate.

But 'the true test' asks an anterior question: whether the clause in issue imposed a primary or secondary obligation. If it is a primary obligation, then there is in any event no scope for the penalty rule to operate; only if it is a second obligation can the penalty rule apply. As Lords Neuberger and Sumption explained in paragraph 13:

"There is a fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach. … The penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves."

Is it useful to explain this difference by reference to the facts in *Cavendish*.

In relation to clause 5.1, Lords Neuberger and Sumption found that this was part of the parties' primary obligations. It concerned the consideration payable for the shares and was in reality a price adjustment clause (paragraphs 73-74). In essence, the company was prepared to pay a certain price if the seller did nothing to the detriment of the business's goodwill, but if he did act to its detriment, then the company was prepared to pay only a lower price. Lord Carnwath agreed with this analysis. Lord Hodge (with whom Lords Toulson and Clarke agreed) considered that there was a "strong argument" that clause 5.1 was in substance a primary obligation (paragraph 270).

However, the position is wholly unclear in relation to clause 5.6. Lords Neuberger, Sumption and Carnwath considered that it amounted to a primary obligation; Lords Hodge, Toulson and Clarke found it to be a secondary obligation. (Lord Mance did not express a view.) The former considered that *"a contractual provision conferring an option to acquire shares, not by way of compensation for a breach of contract but for distinct commercial reasons, belongs as it seems to us among the parties' primary obligations, even if the occasion for its operation is a breach of contract"* (paragraph 83). Lord Hodge's objection was that if all such clauses were treated as primary obligations, there would be considerable scope for abuse (paragraph 280).

The court agreed that clause 5.6 was enforceable: it pursued a legitimate function which had nothing to do with punishment and everything to do with achieving Cavendish's commercial objective in acquiring the business. Lord Hodge expressed it as being a legitimate means of encouraging the sellers to comply with their duties to protect the goodwill of the business.

Regrettably, however, the lengthy judgments open, and leave open, a new and difficult question of whether any particular clause amounts to a primary or a secondary obligation.

Finally it is worth recalling that even where a clause is penal and so unenforceable, the innocent party is still entitled to claim his remedy for damages for breach under the general law (see paragraph 9).

Richard Leiper appeared on behalf of the successful appellant.

For 11KBW's Business Protection expertise, see here.

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Business **Protection – Dispute Resolution**

Arbitrators and Apparent Bias

Cofely Ltd v Bingham

[2016] EWHC 240 (Comm)

s.24(1) Arbitration Act 1996 and the common law test

W Ltd v M SDN BHD

(2016) EHWC 422 (Comm)

Relevance of International Bar Association Guidelines on Conflicts of Interest 2014

Two recent cases in the Commercial Court have considered challenges to arbitrators on the ground of apparent bias. In one case the challenge succeeded. In the other it failed.

The challenge succeeded before Hamblen J, as he then was, in Cofely Ltd v Bingham [2016] EWHC 240 (Comm). The Court removed Mr Bingham as arbitrator on the ground of apparent bias where 18 per cent of his appointments and 25 per cent of his arbitrator income over the previous three years derived from cases involving the defendant. Not only did the evidence establish that the defendant routinely influenced arbitrator appointments in his favour, but also that the arbitrator had failed to disclose his past involvement with the defendant, as required by the Chartered Institute of Arbitrators' Code of Professional and Ethical Conduct for Members.

Section 24(1) (a) of the Arbitration Act 1996 enables a party to arbitral proceedings to apply to the Court to remove an arbitrator on the ground that "circumstances exist that give rise to justifiable doubts as to his impartiality". Section 33 requires the tribunal to "act fairly and impartially as between the parties". Hamblen J, at paragraph 72, summarised the authorities relating to Section 24 as follows:

(1) The common law test for apparent bias is reflected in Section 24;

(2) The common law test under Section 24 is whether "the fair-minded and informed observer, having considered the facts, would conclude that there was a real possibility that the tribunal was biased";

(3) Such a fair minded and informed observer, although not a lawyer, is assumed to be in possession of all the facts which bear on the question and expected to be aware of the way in which the legal profession operates in practice;

(4) A "fair-minded" observer reserves judgment until he/she has seen and fully understood both sides of the argument: his/her approach must not be confused with that of the person who has brought the complaint, the assumptions made by the complainer are not to be attributed to the observer unless they can be justified objectively;

(5) An "informed" observer takes a balanced approach and appreciates that context forms an important part of the material to be considered;

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Cofely Ltd v Bingham and W Ltd M SDN BHD continued…

Hamblen J added, at pararaphs 74/75, and 116, that:-

(1) The fact that an arbitrator is regularly appointed or nominated by the same party/legal representative may be relevant to the issue of apparent bias, particularly if it raises questions of material financial dependence;

(2) The tribunal's explanations as to his/her knowledge or appreciation of the relevant circumstances are also a factor which the fair- minded observer may need to consider when reaching a view as to apparent bias; and

(3) Where there is actual or apparent bias there is also substantial injustice and there is no need for this to be additionally proved.

The challenge failed before Knowles J in W Ltd v M SDN BHD (2016) EWHC 422 (Comm).

Again, the Court applied the fair-minded and informed observer/real possibility of bias test, laid down by the House of Lords in Porter v Magill [2002] AC 357. The Judge continued:

"20. What do the present facts amount to? An arbitrator is a partner in a law firm. The firm earns substantial remuneration from providing legal services to a client company that has the same corporate parent as a company that is a party in the arbitration. The firm does not advise the parent, or the party. There is no suggestion the arbitrator does any of the work for the client company.

21. Further, the arbitrator, although a partner, operates effectively as a sole practitioner using the firm for secretarial and administrative assistance for his work as an arbitrator. The arbitrator makes other disclosures where, after checking, he has knowledge of his firm's involvement with the parties, and would have made a disclosure here if he had been alerted to the situation.

22. On considering the facts the fair-minded and informed observer would not, in my view, conclude that there was a real possibility that the tribunal was biased, or lacked independence or impartiality. I reach that view without hesitation."

The Judge observed, at paragraph 26, that the International Bar Association Guidelines or Conflicts of Interest 2014 do not bind the Court, but can be "of assistance", and that it is "valuable and appropriate" to examine them at least as a check. The Judge stated, however, that in some respects the Guidelines could not be given approval.

James Goudie QC

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Business **Regulation**

DBIS Discussion Paper on Enhancing Transparency of Beneficial Ownership of foreign companies undertaking economic activities in the UK

proposed disclosure of beneficial ownership of foreign companies:
- owning land and property
- involved in public contracting

In March 2016, the Department for Business Innovation and Skills published a Discussion Paper on enhancing the transparency of beneficial ownership information on those foreign companies holding land and property here and involved in public procurement contracts.

The Discussion Paper was published against the background of the Fourth Money Laundering Directive 2015, due to be implemented by 2017, and the coming into force here in April of the significant control disclosure provisions in the Small Business Enterprise and Employment Act 2015 which amends the Companies Act 2006 to require companies incorporated here to keep a register of people who have significant control.

The logic for identifying property ownership by foreign companies as an economic activity requiring transparency is well known. The Paper states that in the 10 years between 2004 and 2014, law enforcement investigated over £180m worth of property in the UK as suspected proceeds of corruption. Over 75% of these properties had offshore corporate ownership.

The Government is also considering the case for requiring any company wishing to bid on a contract with the UK Government to identify their beneficial owner or owners. The logic behind identifying public procurement contracts as economic activity requiring such transparency is less well known.

According to the Paper, obtaining ownership information on foreign companies would have a number of potential benefits including:

- ensuring that the Government receives the best value or money on behalf of tax payers;
- ensuring that legitimate businesses participating in public contracting are treated fairly: and
- preventing corrupt individuals and organised crime laundering the proceeds of their crime through public contracts.

The Government would also, apparently, like to use its purchasing power to raise the global level of transparency around the ownership of internationally active companies. Public procurement of goods and services in the UK amounted to £242bn in 2013/14.

Currently, on large projects, bidders are required to provide self-certification information including about their beneficial owners, in order to ensure they are not liable to disqualification from the process. The Paper envisages a mechanism for the maintenance of up to date information and the exclusion of bidders for withholding information.

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