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Lecture

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I. Introduction

1 I propose to consider three recent decisions in the UK, one of the House of Lords, and two of the Supreme Court which appear, at any rate to me, to amount to a change of course, or a decision as to the direction to be taken on a largely uncharted sea. They are also illustrative of a feature of the common law which struck me first as a student and has never really left me. One is often faced by a set of circumstances which appear to be sufficiently commonplace that somebody must have decided what answer the law gave to the problem which they threw up; only to find either that there was no guidance or very little, or, at least, that it was more flexible than at first appeared. The three cases also reveal certain hallmarks of significant decisions at the highest level to which I shall refer.

II. Late redelivery

2 In *Transfield Shipping Inc v Mercator Shipping Inc*[1] ("*The Achilleas*"), the House of Lords was concerned with a bulk carrier called "The Achilleas". Under her charter she was due to be redelivered on *2 May 2004*. She had originally been fixed in January 2003 for five to seven months at a daily hire rate of $13,500; in September 2003 she was fixed for another four to six months at $16,750 per day. By April 2004 market rates were double what they had been the previous September.

3 On *20 April 2004* the charterers gave notice of redelivery between 30 April and 2 May 2004. On *21 April 2004* the owners fixed the vessel to another charterer for a new four to six months' hire following on from the charter which was due to come to an end on 2 May 2004 at a daily rate of $39,500. The latest date for delivery under the new charter was 8 May 2004.

1 [2009] 1 AC 61; [2008] UKHL 48.

4 With less than a fortnight to run, the charterers fixed the vessel under a subcharter to carry coal from Qingdao in China to two Japanese ports. The vessel was delayed at the second port and was not redelivered until 11 May. Meanwhile between 21 April and 5 May the market fell by about 20% – an unusually short time period for such a fall. In return for an extension of the cancelling date from 8 May until 11 May the owners agreed to reduce the rate of hire for the new fixture by $8,000 – from $39,500 to $31,500. The owners then claimed to recover from the charterers hire at the rate of $8,000 a day over the period of the new fixture. That came to about *$1.3m*. The charterers said that all that the owners were entitled to recover was the difference between the market rate and the charter rate for the nine days between the date by which she should have been delivered and the date when she was redelivered (2 May to 11 May). That amounted to about *$158,000*.

5 Who won? The matter was referred to three experienced shipping arbitrators. Two of them held that the owners won. One arbitrator said that the charterers did. The Commercial Court judge agreed with the majority. So did Lord Justice Rix, in the Court of Appeal, with whom Lord Justices Tuckey and Ward agreed. Rix and Tuckey LJJ were themselves previously judges of the Commercial Court. In the end the five members of the House of Lords decided that the charterers' contention was the right one.

6 The majority arbitrators had held that the loss on the new fixture fell within the first rule in *Hadley v Baxendale*,[2] namely, that it arose "naturally, *ie* according to the usual course of things, from such breach of contract itself" because it was loss of a kind which the charterer when he made the contact ought to have realised to be not unlikely to result from a breach of contract consisting of a delay in redelivery: see Lord Reid in *The Heron II*.[3]

7 The dissenting arbitrator did not dispute that the owners would very likely enter into a following fixture during the course of the charter and that late redelivery might cause them to lose it. But he said that a reasonable man in the position of the charterers would not have understood that he was assuming liability for a risk of the type in question, the general understanding in the shipping market being that liability was restricted to the difference between market and contract rate for the overrun period, *ie*, the period between the last due date for delivery and the actual delivery date. I will call this "*the overrun difference*". To impose liability on the basis claimed would involve charterers bearing responsibility for losses in respect of a fixture of

2 (1854) 9 Exch 341.

3 *Koufos v C Czarnikow Ltd (Heron II)* [1969] 1 AC 350 at 382–383.

which at the time of the contract they would have had no knowledge, nor control, as to its duration or terms; it would involve an assumption of risk in relation to which it was difficult to see where a line was to be drawn and give rise to a real risk of serious commercial uncertainty, since the charterers would have no means of assessing the extent of any possible liability in respect of the following fixture.

8 The majority arbitrators appear to have accepted that, if the charterers had asked *their lawyers or their Club* what damages they would be liable for, the answer would be for the overrun difference. That, however, was said to be irrelevant because *a broker* would have said that the not unlikely result of late delivery was that the date for a subsequent fixture would have been missed and damages for loss of this type were, therefore, recoverable.

9 Lord Hoffman gave the leading judgment. He held that the rule that a party may recover losses which were foreseeable ("not unlikely") was not an external rule of law imposed upon the parties in default of provision to the contrary but a *prima facie* assumption about what the parties may be taken to have intended, no doubt applicable in the majority of cases but capable of rebuttal in cases in which "the context, surrounding circumstances or general understanding in the relevant market shows that a party would not reasonably have been regarded as assuming responsibility for such losses".[4]

10 In coming to that conclusion he took into account a number of matters. First, there appeared to be no reported case in which the question in issue had been raised and several in which the *dicta* suggested that the measure of damages was the overrun difference. Second, he referred to various legal articles (none of which had been referred to in the course of the hearing) which suggested that the extent of a party's liability for damages was founded upon the interpretation of the particular contract as a whole construed in its commercial setting. He held[5] that departure from the ordinary foreseeability rule based on individual circumstances would be unusual but limitations on the extent of liability in particular types of contract arising out of general expectations in certain markets such as banking and shipping were likely to be more common. It was necessary in every case to decide whether the loss for which compensation was sought was "of a 'kind' or

4 *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 AC 61; [2008] UKHL 48 at [9].

5 *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 AC 61; [2008] UKHL 48 at [11].

'type' for which the contract-breaker ought fairly to be taken to have accepted responsibility".[6]

11 As Lord Hoffman held, the parties, contracting against the background of market expectations found by the arbitrators, when considering the extent of the liability that they were undertaking would have considered that losses arising from the loss of the following fixture were not a type of loss for which they were assuming responsibility. The judgments of Lord Hope and Lord Walker were to similar effect.

12 The case involved what I will call Hallmarks 1, 2 and 3 of leading cases. *Hallmark 1* is that the end result is not necessarily what you would have expected either before the hearing or at the end of it. The owners' loss was an entirely foreseeable consequence of the charterers' breach which they had brought about by seeking to extract the maximum benefit from a charter on what turned out to be favourable terms. Two arbitrators and four judges had held that the owners should succeed. It is not self-evident that the charterers could not reasonably be regarded as assuming responsibility for the loss suffered on a falling market by owners because they could not fulfil the new charter when that inability was a very likely consequence of the charterers' failure to redeliver by the stipulated date.

13 It seems that at the end of the hearing some members, perhaps a majority, of the court were in favour of dismissing the appeal. Lord Hope said in terms that his impression at the end of the excellent argument from counsel on both sides was that on the facts found the appeal must fail. Baroness Hale said that the issue could be an examination question to which there was no obviously just answer, adding that the examiners would surely have given first class marks to all the judges who had examined the question so far. She had been at first inclined to agree with the judgments below.

14 *Hallmark 2* is that the decision qualifies or explains general statements of principle of long standing, such as that the innocent party may recover damages in respect of loss of the same type or kind of loss as the defendant ought to have realised was not unlikely to result from the breach, even if the loss was unexpectedly large. In essence the decision treated assumption of responsibility[7] rather than foresight of the factual consequences of breach as the critical question in relation to claims in contract, at least in some cases. Lady Hale expressed herself to

6 *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 AC 61; [2008] UKHL 48 at [15].

7 *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 AC 61; [2008] UKHL 48 at [78].

be not attracted by the introduction into the law of contract of the concept of the scope of the duty and said that, if the appeal was to be allowed, "as to which I continue to have doubts",[8] she would prefer it to be on the narrower ground identified by Lord Rodgers to the effect that the parties would not at the time of contracting have had this particular type of loss arising from extremely volatile market conditions in contemplation.[9]

15 *Hallmark 3* is that the decision leaves, as Lady Hale put it, "much room for argument in other contractual contexts"[10] and has attracted some degree of containment. A number of later cases suggest that its practical application is likely to be exceptional.[11] The chief difficulty is in determining what is to be the limit, if any of the losses for which, looking at the matter objectively, the contract breaker is reasonably to be regarded as having assumed responsibility and on what principles or by reference to what factors that is to be determined.

III. Penalties

16 We next come to the penalty shootout – or, to put it more accurately, contractual penalty causes. It all began with defeasible penal bonds, which were promises to pay a specified sum of money subject to a proviso that the bond would cease to have effect if some other obligation was performed; in the 16th century equity took to granting relief against an action in debt on the bond if the obligor paid damages, interest and costs. Around the beginning of the last century some seminal judgments were given, chief among which was the decision of the House of Lords in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*[12] ("*Dunlop*").

17 Almost exactly 100 years later in *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 ("*Makdessi*") our Supreme Court revisited the law which was described by Lords Neuberger and Sumption as "an ancient, haphazardly constructed edifice which has not weathered well and in the opinion of some should simply be

8 *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 AC 61; [2008] UKHL 48 at [93].

9 *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 AC 61; [2008] UKHL 48 at [60].

10 *Transfield Shipping Inc v Mercator Shipping Inc* [2009] 1 AC 61; [2008] UKHL 48 at [93].

11 *Sylvia Shipping Co Ltd v Progress Bulk Carriers Ltd* [2010] EWHC 542 (Comm); *Classic Maritime Inc v Lion Diversified Holdings Berhad Limbungan Makmur Sdn Bhd* [2009] EWHC 11 42 (Comm); *Supershield Ltd v Siemens Building Technologies FE Ltd* [2010] EWCA Civ 7.

12 [1915] AC 79.

demolished".[13] The law has often been described as a naked interference with freedom of contract and the principles behind it have baffled some of our greatest judges.

18 Reduced to bare essentials the facts of the case were these. Mr Makdessi was a Lebanese businessman who founded a group of companies which became the largest advertising and marketing communications group in the Middle East. He and his business partner owned 87% of the group holding company. On 28 February 2008 they agreed to sell 47.4% of the shares to the minority shareholder such that it became the owner of 60%. Much of the total possible price comprised goodwill. By a novation agreement Cavendish (part of the WPP group of companies) became the purchaser ("Agreement"). The Agreement, which had been negotiated by the parties on equal terms with highly competent legal assistance, provided for a series of four payments in respect of the price. The last two were payable at dates after completion and calculated by reference to the profits of the company over four years after the Agreement.

A. Clause 5.1

19 The Agreement contained two important clauses. One of them (cl 5.1) provided that if the Seller became a Defaulting Seller (which included being in breach of a particular clause) he would not be entitled to receive the last two of the payments. In Mr Makdessi's case that would mean that he received up to $44m less.

B. Clause 11.2

20 The clause in question (cl 11.2) provided that the Sellers would not for two years from the Relevant Date, which would be at least some eight years after the Agreement:

> (a) *carry on, or be engaged or interested in "Restricted Activities*" (*ie* the provision of goods or services which competed with the Group companies) in "Prohibited Areas" (*ie* in countries in which any of the Group companies carried on business);
>
> (b) *solicit or knowingly accept any orders, enquiries or business in respect of Restricted Activities in the Prohibited Areas from any Client*, which was defined as any client or potential client who had placed an order with the Group during the past 12 months or been in discussion during that period;

13 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [3].

> (c) *divert away from any Group Company any orders, enquiries or business in respect of the Restricted Activities from any Client;*
>
> or
>
> (d) *employ or solicit or entice away from any Group Company any senior employee or consultant or endeavour to do so.*

C. Clause 5.6

21 By the second clause (cl 5.6) the Sellers granted Cavendish an option to require a defaulting shareholder to sell all of his retained shareholding for, in effect, the proportion of the net asset value of the group which his shares represented, *ie*, excluding anything for goodwill. This would deprive Mr Makdessi of any goodwill value which those shares had at the date of default and also of the right to exercise a put option in respect of those shares at a price which reflected goodwill.

22 Mr Makdessi admitted that after the date of the Agreement he had had an ongoing unpaid involvement in the affairs of a large media company called Carat Middle East Sarl pending the appointment of a replacement CEO; and that his involvement with that company rendered him a Defaulting Shareholder within the meaning of the Agreement.[14] So everything turned on whether the clauses were invalid as penalties.

23 The law in relation to clauses providing for payment of a specified sum in the event of a breach developed in such a way as to distinguish between a sum which represented a genuine pre-estimate of damages and a penalty clause which was out of all proportion to any damages likely to be suffered. If it was the latter, the clause was wholly unenforceable.

24 In *Dunlop* in the House of Lords Lord Dunedin had said that the "essence of a penalty was a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage".[15] He formulated four tests "which, if applicable to the case under consideration, may

14 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [62].

15 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 86.

prove helpful, or even conclusive".[16] They were that the provision would be penal if:[17]

> (a) the sum stipulated for is "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach";
>
> (b) the breach consisted only in the non-payment of money and the clause provided for the payment of a larger sum;
>
> (c) there was "a presumption (but no more)" that it would be penal if it was payable on one or more of a number of events some of which might occasion serious and others but trifling damage; and
>
> (d) that it would not be treated as penal by reason only of the impossibility of precisely pre-estimating the true loss.

25 These tests, familiar to generations of students and practitioners, were habitually applied for a century. Ten years ago, however, there began to develop an approach which would uphold a clause if it could be said to have a commercial justification. In *Lordsvale Finance plc v Bank of Zambia*[18] ("*Lordsvale*"), the court was concerned with a provision in a loan agreement that interest should be payable at a higher rate if the loan was in default. Old authorities had held such provisions to be penal. Colman J assumed that the clause was within the reach of the penalty rule but held that, even if it was not a genuine pre-estimate of damage, the clause was valid because the increase was commercially justifiable and its dominant purpose was not to deter breach. That approach was followed in two subsequent decisions of the Court of Appeal.[19]

26 In *Makdessi* the lower courts felt constrained by the need to fit any analysis into the four tests set out by Lord Dunedin in *Dunlop*. At first instance[20] the judge felt able to get around them. The Court of Appeal did not.[21] Only one judgment was given: but the result was unanimous. This was an echo of the sequence in *Dunlop* where the

16 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 87.
17 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 87.
18 [1996] QB 752.
19 *Cine Bes Filmclik Ve Yapimcilik v United International Pictures* [2004] 1 CLC 401; *Murray v Leisureplay plc* [2005] EWCA Civ 963.
20 *Cavendish Square Holdings BV v Talal El Makdessi* [2012] EWHC 3582 (Comm).
21 *Talal El Makdessi v Cavendish Square Holdings BV* [2013] EWCA Civ 1539.

judge thought that the provision was not penal and the Court of Appeal thought that it was.

D. The Supreme Court

27 The decision of the Supreme Court in *Makdessi* is as lengthy as it is impressive. The court, sitting as a court of seven, declined[22] the invitation to abolish three centuries of a doctrine which, as it noted, was common in some form to almost all major systems of law in the western world, including some civil law systems, and in Singapore, Hong Kong, Australia and New Zealand. Roman law had something to that effect. It also declined to restrict the doctrine to non-commercial cases, or commercial cases between parties of unequal bargaining power, or cases involving the payment of money.

28 It also declined an invitation to extend the doctrine, as had occurred in Australia, where in 2012 the High Court concluded (wrongly, as the UK Supreme Court felt) that there was an equitable jurisdiction to relieve against any sufficiently onerous provision, which was conditional upon a failure to observe some other provision *whether or not* that failure was a breach of contract.[23] In that case the Australian High Court had held the doctrine to be applicable to fees which were not charged upon breach or the happening of an event which the customer had any obligation or responsibility to avoid.

29 In the first judgment Lords Neuberger and Sumption, with whom Lord Carnwath agreed (hereafter "the trio"), said that the fact that Lord Dunedin's approach had achieved the status of a quasi-statutory code was unfortunate. They described the law relating to penalties as having become the prisoner of artificial categorisation as a result of unsatisfactory distinctions between a penalty and a genuine pre-estimate of loss and between a genuine pre-estimate of loss and a deterrent.[24] Here is *Hallmark 4*. The test you thought so useful from an authority at the highest level may turn out not to have been.

30 They went on to say that the essential question was whether the clause was penal; but it was not helpful to ask whether it was intended as a deterrent (*in terrorem*). The true test was whether the impugned provision was a secondary obligation which imposed a detriment on the

22 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [36]–[39], [162]–[170] and [218].

23 *Andrews v Australia and New Zealand Banking Group* [2012] HCA 30; (2012) 247 CLR 205.

24 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [31].

contract breaker out of all proportion to any legitimate interest of the innocent parry in the enforcement of the primary obligation.[25]

31 One needs to discern what – for the UK – the decision has and has not resolved.

32 *First*, the penalty doctrine is not dead, but it is very unwell – probably moribund save in relation to egregious clauses providing for payments on breach.

33 *Second*, it *does* depend on breach so that the rule can be avoided by careful drafting.[26] If the contract does not oblige a party to perform an act but provides that, if he does not do so, he must pay a specified sum, that is a conditional primary obligation to which the doctrine does not apply.[27]

34 *Third*, it extends beyond clauses which require the payment of money. It can apply:

(a) to a requirement to transfer property upon breach for no or inadequate consideration;[28]

(b) to a clause withholding payments of money otherwise due[29] (although, so far as the trio was concerned that was simply an assumption they were prepared to make[30]); and

(c) to the retention of a deposit which was not just reasonable earnest money;[31] although Lord Mance referred to "uncertainties" on the topic.[32]

The trio thought that the doctrine did not apply to clauses providing for the retention of property, including instalments already paid, on breach; although there may be a discretion to relieve against forfeiture and order restitution of instalments paid.[33] The other justices left the question

25 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [32].
26 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [12]–[14] and [257].
27 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [14] and [241].
28 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [16], [157], [170], [183] and [230].
29 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [154]–[156], [170], [226] and [228].
30 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [73].
31 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [16], [156] and [234]–[238].
32 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [170].
33 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [16] and [159].

open.[34] If the clause is penal it is invalid and wholly unenforceable; although a claim for damages arising from breach will remain. Its operation cannot be watered down in some way. A previous Court of Appeal decision which cut down the enforceability of a penalty clause was overruled.[35]

35 *Fourth*, a provision may be justified by some other consideration than the desire to recover compensation such as a legitimate interest in particular performance.[36] As a result, a clause is not necessarily penal because it is not a genuine pre-estimate of loss. The distinction and mutual exclusivity – expressed in *dicta* in decisions at the highest level[37] – between penalty and genuine pre-estimate of loss or between genuine pre-estimate and a deterrent was unsatisfactory.[38] A clause may be upheld even if it is not a genuine pre-estimate of loss and is aimed to deter breach but not if its object is to punish[39] as will be the case if it is extravagant, exorbitant or unconscionable or wholly disproportionate to any legitimate interest of the innocent party in enforcement of the primary obligation.[40]

36 This represented something of a sea change. Earlier cases, in particular *Lordsvale*, had considered clauses to be invalid if their predominant intention was to deter – as was the view of the Court of Appeal in *Makdessi*.[41]

E. The new idea

37 In relation to withholding benefits the trio recognised a critical category of case. A clause may provide for the consideration to be paid to vary according to a number of contingencies one of which may be the absence of a breach of contract. To such a clause the doctrine of penalties did not apply because it was not the function of the doctrine to allow judicial review of the fairness of a party's primary obligations. It

34 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [229].
35 *Jobson v Johnson* [1989] 1 WLR 1026.
36 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [28], [145] and [152].
37 *Clydebank Engineering and Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6; *Commissioner of Public Works v Hills* [1906] AC 368; *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79.
38 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [31] and [248].
39 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [82].
40 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [32], [152] and [255].
41 *Talal El Makdessi v Cavendish Square Holdings BV* [2013] EWCA Civ 1539 at [121].

was open to the parties to provide that the remuneration of one of them should be reduced if there was non-performance of an obligation.[42]

F. Clause 5.1

38 On that basis the trio decided that cl 5.1 was in reality a price adjustment clause.[43] It was in no sense a secondary provision. The sellers were to earn their consideration not only by transferring the shares to Cavendish but by observing the restrictive covenants.[44] It did not matter that the reduction in price bore no relationship whatever to the breach or that some breaches would cause very little recoverable loss. Cavendish had a legitimate interest in the observance of the covenants which extended beyond the recovery of that loss because it had an interest in measuring the price of the business to its value; and the loyalty of Mr Makdessi and his partner was critical to the goodwill which formed the major part of its value. Such loyalty was to be treated as indivisible; and its absence could not be measured by reference to the known and provable consequence of particular breaches.

39 The notion of a conditional primary obligation whereby the consideration could be reduced on account of the non-fulfilment of an obligation on the part of the seller, *ie*, *a breach*, without thereby engaging the doctrine of penalties at all is something of a new development. I call this "the new idea".

40 It does not appear to have had the support of the majority. It did not, I think, have the support of *Lord Mance* because, while some of what he said tallied with the observations of the trio,[45] he regarded the analysis of cl 5.1 as a price formula as not assisting[46] and applied the test of validity without any indication that this was superfluous.[47] "Not without initial hesitation" he decided that cl 5.1 was not extravagant.

41 *Lord Hodge* thought the positon of the trio in relation to cl 5.1 was strongly arguable[48] but felt it unnecessary to decide the point given his conclusion that if the doctrine applied the clause was valid anyway.[49] *Lord Clarke* agreed with Lord Hodge. *Lord Toulson* agreed with Lord Mance and Lord Hodge.

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42 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [73].
43 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [74].
44 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [74].
45 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [183].
46 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [179].
47 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [181].
48 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [270].
49 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [278].

42 But – this is *Hallmark No 5* – nothing is ever quite as clear-cut as you might hope. The trio recognised, as did Lord Hodge,[50] that price adjustment clauses were open to abuse and if the clause was a disguised punishment for the seller's breach it would make no difference that it was expressed as part of the formula for determining the consideration. Classification of terms was a matter of substance and not form.[51]

G. Clause 5.6

43 *The trio* decided that cl 5.6 did not engage the doctrine either. Cavendish had a legitimate commercial interest in not being required to pay the value of the goodwill where the defaulting shareholder's efforts were no longer available to the company and were being deployed for the benefit of the company's competitors and where future goodwill would be dependent on others. A provision conferring an option to acquire shares, not by way of compensation for breach of contract but for distinct commercial reasons, belonged among the parties' primary obligations even if the occasion for its operation was a breach of contract.[52] The clause had nothing to do with punishment.

44 *Lord Mance* held[53] that it had inevitably to be accepted that complete severance of relationships was a natural provision to include as a consequence of a breach of basic restrictive covenants and that an agreement that this should take place on a basis ignoring any goodwill should not be regarded as either exorbitant or unconscionable. *Lord Hodge* held[54] that cl 5.6 was indeed a secondary obligation so that the doctrine *was* engaged; but held the clause to be valid and enforceable.[55] *Lord Toulson* agreed with both Lord Mance and Lord Hodge on all matters of principle. *Lord Clarke* agreed with Lord Hodge on cl 5.6.

H. Harshness

45 Lord Hodge pointed out the harshness of the terms in question but said that they were not exorbitant.[56] Harshness was a consideration which had weighed heavily with the Court of Appeal. The range of breaches which might make Mr Makdessi a defaulting shareholder was

50 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [258].
51 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [15].
52 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [83].
53 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [185].
54 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [280].
55 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [280] and [282].
56 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [282].

extremely wide. The effect of the clauses was that, upon the first breach, which might be pretty modest – say an unsuccessful attempt to solicit an employee – he would lose what would probably be tens of millions both in relation to the shares sold and those retained. That he should suffer thus might be considered a not very well disguised punishment.

46 A majority of the court decided, *obiter*, that the rule against penalties and the entitlement of equity to grant relief against forfeiture can be applied sequentially so that if the clause is not so extravagant that it amounts to a penalty and is, therefore, void, the court may nevertheless grant relief against forfeiture on terms.[57]

I. Uncertainties

47 A number of matters remain uncertain. The *first* is how the difference between substance and form may play out. It may mean no more than that the parties cannot avoid the doctrine by describing a charge as a fee or a minimum payment.

48 *Second*, if the new idea is right (itself debatable) there may be difficulty in distinguishing primary obligations that are conditional on absence of breach from secondary obligations arising on breach.

49 *Third*, the scope of legitimate interest appears to be as broad as it is debatable and the boundary between proportionate deterrence and exorbitance or punishment is not well marked. The number of clauses which can be regarded as intended to punish or to promote no legitimate interest seems likely to be small. Whether or not the parties are of equal bargaining power or competently advised is likely to be of high relevance.

50 *Fourth*, there remains doubt as to whether the doctrine applies to clauses forfeiting payments already made or accrued rights to indemnity removed by retrospective cesser clauses in insurance contracts (probably no to the former; yes, to the latter).[58]

IV. Lies

51 I end with lies. Lots of people tell fibs to their insurers. It is well established in English law that if your claim is worth $900,000 at most

57 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [160], [227], [291] and [292].

58 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 at [73], [154]–[155] and [226].

and you dishonestly claim $1m, knowing that it cannot be worth that, you forfeit the whole. This is known as the "fraudulent claims rule". It does not require the insurer to have relied on the dishonest information or acted on it in any way.[59] But what if, to prod the insurers into payment or bolster a debatable claim, you make a false statement as to the circumstances of the accident, knowing it is untrue or reckless as to its truth or falsity, when, as it turns out at trial, the claim was entirely valid.

52 That is what happened in *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG*[60] ("*Versloot*"). The facts were complicated. It is sufficient to say that the judge – Mr Justice Popplewell – found that the insured's representative had told a reckless untruth relating to the accident. With manifest reluctance he disallowed the claim for €3.2m on account of what the Supreme Court classified as a "collateral lie". The Court of Appeal dismissed the appeal. Once again it was necessary to peer into the murky pool of past cases to discover the answer to a not uncommon set of circumstances.

53 In the late 19th and early 20th centuries insurers under fire policies included clauses entitling them to avoid if the insured had used "fraudulent devices", a term which covered embellishments of claims of the type now in issue. In the reported cases the issue first appears in 1927 in *Lek v Mathews*.[61] Mr Lek had some stamps stolen. He claimed under a policy which provided that if the assured "shall make any claim knowing the same to be false and fraudulent, as regards amount or otherwise, the policy shall become void, and all claims thereunder shall be forfeited".[62]

54 Mr Lek dishonestly exaggerated his claim by pretending that some stamps had been stolen which he had never had. Somewhat surprisingly, Atkin LJ, as he then was, said that was all right so long as he genuinely believed in his entitlement to the sum claimed. He gave an example of the owner of a stolen picture who gave underwriters a false account of its purchase and said that "such a falsehood, however blameworthy, seems to me on the supposed facts to afford no evidence of a fraudulent claim".[63] In the House of Lords, Lord Sumner said of this statement that he thought that Atkin LJ had in mind "mis-statements on a purely collateral question" adding that "even so I could not agree".[64]

59 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [28].
60 [2016] 3 WLR 543; [2016] UKSC 45.
61 (1927) 29 Ll L Rep 141.
62 *Lek v Mathews* (1927) 29 Ll L Rep 141 at 141.
63 *Lek v Mathews* (1926) 25 Ll L Rep 525 at 544.
64 *Lek v Mathews* (1927) 29 Ll L Rep 141 at 164.

The other two members of the House expressed their concurrence with these remarks.

55 In 1930 when civil cases where still tried by juries, Roche J in *Wisenthal v World Auxiliary Insurance Corp Ltd*[65] said in his summing up that:

> Fraud … was not mere lying. It was seeking to obtain an advantage, generally monetary, or to put someone else at a disadvantage by lies and deceit. It would be sufficient to come within the definition of fraud if the jury thought that in the investigation deceit had been used to secure easier or quicker payment of the money than would have been obtained if the truth had been told.

Roche J had one of the largest commercial practices as a Silk and became Lord Roche.

56 Subsequent cases[66] showed the Court of Appeal to have misgivings about allowing forfeiture for collateral lies. But the position changed with *Agapitos v Agnew (The Aegeon)*,[67] in which, in a seminal judgment, Mance LJ as he then was, disagreeing with Toulson J, as he then was, decided, technically *obiter*, and accepting the submission of Mr Andrew Popplewell, QC the future Popplewell J, that a collateral lie in the presentation of the claim was as much subject to the fraudulent claims rule as a dishonest exaggeration. He tentatively suggested that the fraudulent claims rule should apply:[68]

> … to the use of fraudulent devices or means which would, if believed, have tended, objectively but prior to any final determination at trial of the parties' rights, to yield a not insignificant improvement in the insured's prospects – whether they be prospects of obtaining a settlement, or a better settlement, or of winning at trial.

57 That approach was assumed to represent the law in a number of later cases; it was applied in the Privy Council[69] and at first instance[70] (including in a case upheld on appeal[71]) and referred to without comment in a Supreme Court case.[72] But in none of these cases was any

65 (1930) 38 Ll L Rep 54.
66 *Royal Boskalis Westminster NV v Mountain* [1999] QB 674; [1997] 1 Lloyd's Rep 523; *K/S Mrec-Scandia XXXXII v Underwriters of Lloyd's Policy No 25T 1054 (The Mercandian Continent)* [2001] 2 Lloyd's Rep 503.
67 [2003] QB 556.
68 *Agapitos v Agnew* [2003] QB 556 at [38].
69 *Stemson v AMP General Insurance (NZ) Ltd* [2006] UKPC 30.
70 *Sharon's Bakers (Europe) Ltd v AXA Insurance UK plc* [2011] EWHC 210 (Comm).
71 *Bate v Aviva Insurance UK Ltd* [2014] EWCA Civ 334
72 *Summers v Fairclough Homes Ltd* [2012] 1 WLR 2004; [2012] UKSC 26.

issue taken about its correctness. Case law in Australia showed a difference in judicial opinions.

58 The Court of Appeal was thus not formally bound by any previous decision. It dismissed the appeal whilst proposing a modification of the test so as to substitute "significant" for "not insignificant" improvement.

59 The question then came – for the first time – before the Supreme Court in March of this year. The court by a four to one majority (including Lord Toulson) decided that the rule did not apply to justified claims supported by collateral lies. That was, they held, a step too far. A policy of deterrence did not justify the application of the rule in those circumstances.[73] In relation to fraudulently exaggerated claims the logic of deterrence was said to lie in the oft-repeated refrain – the one-way bet analysis – that "the fraudulent insured must not be allowed to think that if the fraud is successful, then I will gain, if it is unsuccessful I will lose".[74] But, if, so the court held, the claim was in fact wholly justified the insured gained nothing from the lie to which he was not entitled and the underwriter lost nothing if he met a liability that he had anyway.[75] The court rejected the materiality test suggested by Lord Mance on the ground that, if inducement was not a requirement, it was difficult to see what relevance any test of materiality had. Further, the collateral lie was immaterial to the liability of the insurer, which, *ex hypothesi*, existed, albeit it was material to his behaviour.[76]

60 It is apparent from the judgments that the question, which the court was free to decide either way, was a policy one. The majority recognised the justification of the fraudulent claims rule, despite its severity, as a necessary deterrent against fraud. But to apply it to fraudulent devices was, they thought, disproportionate – a step too far and a legal sledgehammer to a nut.[77] They took account of the fact that to tell a collateral lie was, itself, not without prejudicial consequences.[78]

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73 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [26].

74 *The Star Sea* [2003] 1 AC 469 at [62], *per* Lord Hobhouse.

75 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [26].

76 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [91] and [92].

77 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [100].

78 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [98].

61 Not entirely surprisingly, in a powerful dissenting judgment, Lord Mance, in fundamental disagreement with the others, regarded lies told in order to promote settlement of a claim as attracting the same consequences as lies about the size of the claim.[79] The reasoning of the majority, he said, approached the question with the benefit of hindsight – from the wrong end of the telescope – whereas the fraudulent device operated when the claim was pending. The fraudulent devices rule meant that a claimant could not safely distort the claims process to his advantage and hope to prevent the insurer identifying, relying on or investigating the weakness which led to the insured telling the lie in the first place.[80] Such lies might lead to the recovery of bad or exaggerated claims.[81] Lord Hobhouse's one-way bet analysis was equally applicable to devices. The obvious reality was that lies were told for a purpose which was almost invariably to obtain the uncovenanted advantage of having the claim met on a false premise.

62 Not surpassingly the decision has not met with the approval of insurers. The Association of British Insurers has said that the decision risks increasing the cost of insurance, "flies in the face of the work the insurance industry and government have been doing to crackdown on the cheats and fraudsters" and is a "blow for honest customers". In his last paragraph, Lord Mance in effect suggested that they might care to include a term in their contracts which reinstated the fraudulent devices rule. The doctrine may be not dead but sleeping.

V. Conclusion

63 It is, I think, possible to discern a common thread in this trio of cases. Freed from the shackles of prior authority, the highest court can reach decisions based on broad considerations of policy, proportion and justice. Thus in *The Achilleas* the court limited recoverable loss to the kind of loss for which the contract breaker ought, in its view, fairly to have accepted responsibility. In *Makdessi* the court upheld an agreed clause which visited very harsh consequences on breach because it was, the court thought, not disproportionate to the legitimate interest of the innocent party. In *Versloot* the majority thought it was disproportionate to deny the insured recovery when his untruth did not affect the validity of his claim.

79 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [111].

80 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [127].

81 *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG* [2016] 3 WLR 543; [2016] UKSC 45 at [128].

64 What policy, proportionality and justice require is inevitably debatable and I have no idea whether the Singaporean courts will reach the same conclusions in any of these fields. But who better to determine these questions than an independent judiciary – that great benefit which makes our respective countries the envy of less happy lands.

65 You may have noticed a gap in what I have been saying in so far as it omits reference to the judge at first instance in *The Achilleas*, and the judges in the Court of Appeal in the other two cases. I now confess that the first instance judge was me; and that I was the only judge to give a reasoned judgment in the last two cases. I had, therefore, considered labelling this talk "Where I went wrong". But I prefer to retain the no doubt fond illusion that it was the highest court, which, being fully entitled so to do, changed course.