In Re Amble Assets LLP (in administration)

And In Re Northumberland Foods Ltd (in administration)

[2011] EWHC 3774 (Ch)

Background

1. The essential background facts of this case can be simply stated. A company called Longbenton Foods Limited paid a lot of money as non-refundable deposits in contracts to purchase land and equipment from Amble and Northumberland, which it was then unable to complete. The sums paid amounted in effect to 60% of the purchase price. Amble and Northumberland's affairs were being managed by administrators, and the contracts arose in what would be described as a "distressed insolvency sale", and where there was a strong rival purchaser which gave impetus to Longbenton's willingness to pay a large amount of money up front.

2. There is not a great deal to be gained by setting out the more detailed background, or the Insolvency Act 1986 bases on which this matter came before the court. Suffice to say that this case was heard by Sutcliffe QC J on a summary application basis, and while he gave judgment on the various legal issues raised it was only a partial decision on the facts leaving over a couple of questions the judge held could not be answered on a summary basis. In essence the facts of the case to which the law he had ruled upon needed to be applied required a proper trial on tested evidence. To the best of my knowledge that further trial has not been listed, and this decision has not been appealed. It is assumed therefore that the parties settled the remaining issues without further input from the court.

The issues raised

3. The topic of interest for practitioners that was the focus of this litigation was the relationship between penalty clauses and the forfeiture of deposits. On the surface they appear similar – in both cases the defaulting party loses a sum of money for default. On

the other hand a deposit is paid in advance as an earnest for performance, and to that extent at least is different in character from the punitive nature of a penalty clause that arises on a breach of contract. It is also well known that a penalty clause, or liquidated damages clause, will be struck down at common law if it not a genuine pre-estimate of damage. Could the same be said in the case of an unreasonably large deposit? Or is there some other mechanism that needs to be relied upon when trying to claw back or protect a deposit? If the sum paid under a deposit it unreasonable, and more than could properly be considered an earnest for performance, does it make a difference that it has been paid in advance? These points, in one form or another were raised and considered in this case.

Analysing the argument

4. Mr Cawson QC for the vendor argued that "*where the monies already paid over are properly to be treated as a deposit* [*cf* where they amount to a penalty] *then apart from section 49(2) re contracts for land the deposit does not need to bear reference to the anticiparted loss flowing from the breach of contract, and there is no equitable right to relief from forfeiture of the sum paid*".

5. He cited Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd [1993] AC 573 (PC), in which the winning party at an auction for the sale of land in Jamaica paid a 25% deposit, and was then unable to complete. The Court of Appeal of Jamaica allowed him to recover the 15% which was in excess of the usual 10% deposit. In the Privy Council Lord Browne-Wilkinson treated a forfeited deposit as a class of penalty, albeit one that was permissible if it was a genuine deposit. He said that a customary earnest for performance, being 10% of the purchase price does not fall within the general rule of unlawful penalties and can be validly forfeited even though the amount of the deposit bears no relationship to the anticipated loss to the vendor flowing from the breach of contract. However it is necessary that the payment must in itself be a genuine deposit, and not a penalty.

6. My understanding of this is that on this analysis the following distinction needs to to be made. Say for example the purchase price under a contract is £200,000, and a deposit of

£20,000 is paid. The level of loss that might result to the vendor for a failure to complete is however only £10,000. *Prima facie* the payment of £20,000 ought to be a penalty, but because it is paid as a genuine deposit as per the customary 10% it is treated as a proper deposit (and paid over in advance as an earnest for performance) and not an unlawful penalty, if however £40,000 had been paid over in advance the payment would have moved out of the zone of deposit and back into the zone of penalty. In other words £20,000 although technically a penalty, is a permissible penalty. Where exactly one draws the line may be difficult to judge, as arguable it requires the court to consider the circumstances of the sale, the expectations of the sale, and market practice.

7. According to Workers Trust the test is whether the payment of the sum in question is reasonable as earnest monies [at 580a-c per Lord Browne-Wilkinson]. He did indeed say it was hard to a draw a line between permissible and impermissible amount of penalty, but by long continued usage in the United Kingdom (and pertinently for that case, in Jamaica) 10% was customary and would not be classed an unlawful penalty.

8. Workers Trust was concerned with a contract for the sale of land. In this case Sutcliffe said that "*he could see no reason in principle for limiting the rules about deposits to land contracts*". He quoted 19th century case of Howe v Smith (1889) 27 Ch D 89, describing a deposit as "an earnest so as to bind the bargain so entered into". It has the same purpose and therefore should be treated in the same way whether the subject matter of the claim is chattels or property.

9. However Mr McGhee QC, for the purchaser, argued that on the facts of this case paying over in advance a sum that was in effect 60% of the purchase price took it out of the realm of an earnest for performance and transformed it into an unreasonable deposit. The questions that flowed were as follows [and this was on a summary basis]:

    9.1. On the facts of this case was a payment of 60% of the purchase an unreasonable deposit?

9.2. If it was should they be treated as an unlawful penalty or as subject to the court's power to grant relief against forfeiture?[1]

9.3. Does section 49(2) add anything to the mix and should court exercise its discretion under this statutory provision?[2]

9.4. The effect of clause 9.13(d) of the agreement for sale – this question is not relevant to tonight's talk and not considered further as it relates to question of secured creditors and priority on an administration.

Whether 60% was a reasonable deposit

10. The administrators pleaded special circumstances. It was argued that in the case of a distressed insolvency sale such as this there was a risk of substantial losses in the event of any failure to complete, in particular where the purchaser had been allowed into possession prior to completion. Without substantial deposits the administrators would 9or could) have been unsecured creditors against an insolvent purchaser. Furthermore there was an alternative purchaser available who was in funds and Longbenton was determined to get in ahead. That explained urgency and size of earnest.

11. Longbenton complained that the deposit was not reasonable, primarily because it said that the real reason the adminsitrators were able to force such payment was threat to sell to rival, and not because of fear of loss of value.

12. Sutcliffe QC J expressed the strong view that he preferred the vendor's submissions, and he especially stressed that these were commercial parties agreeing a deal in a commercial context and there was no reason why they should not be held to the terms of their bargain.

[1] For an explanation of the difference this makes, see para.13 below.

[2] The way in which this question was dealt with is explained in the Conclusion section below. Note that in this case the parties were agreed that section 49(2) was relevant even though the agreement related in part to plant and equipment and not just land. See also Midill (97PL) Ltd v Park Lane Estates [2008] EWCA Civ 1227; [2009] 1 WLR 2460 where parties agreed that it applied to an SPA for shares in a company whose sole asset was property, and the court expressed no view on the correctness of the concession (at 2468A).

However he was ultimately unwilling to decide this question on a summary basis because there was a conflict of expert evidence as to market practice he could not reach a definitive conclusion on whether 60% was too much in an insolvency situation.

If 60% is unreasonable, is it an unlawful penalty or is it a deposit subject only to court's power to relieve against forfeiture

13. Although the judge left it open as a matter of fact whether the 60% in this case was unreasonable or not, he went on to consider whether, if it was in the end held to be unreasonable, its payment made it an unlawful penalty or whether it was still a lawful deposit but subject to power of court to grant relief. The big difference is that the rule that a penalty is unlawful is rigid – the amount is not payable, and if it was paid over the payer would have a proprietary claim for its return. In addition the question whether or not it is unlawful is asked by reference to the time the contract was made, and whether it was a genuine pre-estimate of damage. If it was not then the court has little or no discretion. But if the question is whether or not, the money having been paid over and forfeited, the court should order relief from that forfeiture, that is a matter of equitable jurisdiction and the court may take all the circumstances into account at the time the paying party applies for relief.

14. When one considers the way in which it was put in Workers Trust, and the example I gave at paragraph 6 above, one would be right to think that it is simply an unlawful penalty. Longbenton argued that Workers Trust made it clear that a deposit was in fact penalty, but that so long as it was in the reasonable or customary range it was a permissible penalty. It would follow then that once the deposit paid fell into the unreasonable range it was nothing more than an unlawful and impermissible penalty, and the court should order its repayment. So, in the example given above, the £40,000 payment simply ought not to be allowed to remain in the hands of the vendor.

15. However, the problem is that Workers Trust, despite being a Privy Council decision – and in my view a tidy piece of reasoning – is somewhat out of kilter with a traditional distinction long maintained between penalties and deposits, which is supported by a

wealth of academic commentary and various authorities over the years, including at least one Court of Appeal.

16. In terms of academic treatment Workers Trust has been criticised in *Chitty on Contracts*, *Goff & Jones on Restitution*, *Jones & Goodhart on Specific Performance*. *Chitty* 30th Ed, at 26-146 said:

> "*English court have always treated such a forfeiture clause as different from a sum payable on breach…It is true that in Workers Trust the Privy Council said, in general terms, that the law on penalties applies to* [forfeiture of sums paid] *however the rules applied in that case differ from the penalry rules; and modern English courts do not appear to apply the penalty rules to deposits or clauses providing for the forfeiture of sums paid.*"

Jones & Goodhart, 2nd Ed. put it this way:

> "*Logically, these two situations* [penalties and forfeiture of deposits] *are similar and should be covered by a single set of principles. However, in spite of the alleged fusion of law and equity, they are still governed by different principles. In the case of the retention of money already paid, the courts enjoy an equitable power to relieve against forfeiture. In the case of a demand for money due in the event of a breach, the courts apply the rule that penalties are unlawful. Unfortunately, the distinction between these principles was ignored by the Privy Council in Workers Trust.*"

17. In addition at least two authorities prior to Workers Trust which pointed up the distinction were Stockloser v Johnson [1954] 1 QB 476 CA, and Jobson v Johnson [1989] 1 WLR 1026. Stockloser v Johnson was cited and considered in Workers Trust; Jobson v Johnson was not. In Stockloser Denning and Somervell LJJ's supported the distinction, and said that for relief against forfeiture the claimant had to show (a) that it was an unreasonable penalty, and (b) that it was unconscionable in the circumstances for the seller to retain it. In other words there has to be what one might call a "penalty plus" before a pre-paid sum of money had to be returned. But Lord Browne-Wilkinson distinguished that case on the facts and said that since the 25% deposit in Workers Trust was plainly not a true deposit by way of earnest it was plainly an unlawful penalty instead.

18. Ten weeks after Workers Trust was decided the Court of Appeal rules in Else (1982) Ltd v Parkland Holdings Ltd [1994] 1 BCLC 130. Workers Trust was not cited to the Court of Appeal. Hoffman LJ made very clear and upheld the traditional distinction between penalties and forfeited deposits, citing Jobson v Johnson. He said:

> *In my judgment, the provision by which [the claimant] could recover the shares was not a penalty but a forfeiture. The jurisdictions to relieve against penalties and forfeitures have a common equitable origin but the modern law distinguishes between them. The distinction has probably arisen because the common law developed its own doctrine of not enforcing penalties at a time when relief against forfeiture was still the exclusive province of equity. The penalty rule looks at the position when the contract is made and asks whether the clause is a stipulation for payment on breach intended to operate in terrorem or whether it is a genuine pre-estimate of damage. If the latter, the clause is enforceable only to the extent of the actual damage: see Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79, [1914-15] All ER Rep 739. The rule is mechanical in effect and involves no exercise of discretion at all. The forfeiture rule looks at the position after the breach when the innocent party is enforcing the forfeiture. It asks whether in all the circumstances it would be unconscionable to allow the forfeiture to take effect. This is an exercise of discretion to grant equitable relief. The essence of a penalty is the imposition of an additional or different liability on breach of a contractual term. Jobson v Johnson [1989] 1 All ER 621, [1989] 1 WLR 1026 shows this may include having to transfer property, as well as a more common case of having to pay a sum of money. But the condition entitling [the claimant] to retake the shares if the £860,000 was not paid on the due date was in my judgment no more than an express statement of what in any event would have been his right to rescind the contract for breach of an essential term. This may result in a forfeiture but has never been regarded as a penalty.*

19. In this case Sutcliffe QC J declined to follow Workers Trust – he held that it ignored the clear distinction between penalties and forfeiture. Having decided the law he found himself once again unable to apply it to the facts on the basis of the untested evidence before him, for example on the question of relative values and the potential size of the windfall the vendor might enjoy. The question therefore of whether or not the court ought to grant relief from forfeiture on the facts of this case required consideration at trial.

Conclusion

20. The result is as follows – at least according to this latest decision:

    20.1. If the money has not yet been paid over and is not a genuine pre-estimate of damage it is a penalty clause and is unenforceable. The court will consider the question at the time of the formation of the contract.

    20.2. If the money has already been paid over and is a reasonable sum for a deposit (traditionally 10%) then it is a reasonable deposit and will be forfeit at common law.

    20.3. If the money has already been paid over and is not a reasonable sum for a deposit then it does not automatically become an unlawful penalty. The court has an equitable jurisdiction to relieve against forfeiture and will consider the prevailing circumstances at the date of trial. As it is not a penalty the purchaser has no proprietary claim for the money paid over.

21. This discussion has focussed on the court's power at common law to relieve against forfeiture and needs to treated as separate from the court's statutory discretion under section 49(2) of the Law of Property Act 1925, which arises in the case of any deposit whether reasonable or unreasonable. However it is hard to imagine circumstances where the court would be satisfied that it was equitable for the purposes of common law for the landlord to retain a deposit but reach a different conclusion when considering the question through the prism of section 49(2).

22. This seems to be especially so in light of the way case law has clarified the scope of section 49(2) – most importantly in Midill (97PL) Ltd v Park Lane Estates [2008] EWCA Civ 1227 – that it is not an open ticket. There has to be something special or exceptional to justify overriding the ordinary contractual position that a deposit it forfeit. In fact Sutcliffe said so expressly at paragraph 88 – "*I do not consider that the statutory jurisdiction conferred by section 49(2) enabling the court to order the repayment of all or part of the deposits gives rise to any additional considerations to those which apply to the equitable jurisdiction to relieve against forfeiture*".

23. Bringing the strands together it seems to me that the main effect of section 49(2), in the context of land contracts, is that it removes one of the obstacles to the exercise of the court's jurisdiction. In other words it gives the court the power to order the return of a deposit is engaged even if that deposit was perfectly reasonable earnest for performance, and there is no question of it being akin to a penalty, which was Denning LJ's first requirement in Stockloser. The court only needs to be satisfied, in Midill terms, that a special or exceptional factor justifies the return of the deposit, or in common law language, it would be inequitable to allow the vendor to retain the deposit.