



MONASH University

**Liquidated Damages and Penalties:
A Comparison of the Common Law and
Certain International Approaches**

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Abstract

In 1915 Lord Dunedin set out four propositions which provided a dichotomy between an enforceable liquidated damages clause and an unenforceable penalty clause. A stipulation is enforced as liquidated damages if it amounts to a genuine pre-estimate (calculated as at the date of the contract) of the greatest loss the non-breaching party would suffer from a breach of contract. Thus if the stipulated sum is extravagant and unconscionable it is not likely to be enforced on the basis that it is a penalty.

Three recent decisions by the highest appellate courts in Australia and England effected radical change to that century old precedent thus raising three issues. Firstly, for Australian conditions, an otherwise dormant jurisdiction in equity was enlivened which engages the penalty doctrine in circumstances where there has been a failure of a primary stipulation. This extension to the penalty doctrine was soundly rejected by the UK Supreme Court but with the suggestion that if it were to be enlivened then legislation would be required. In practice, the jurisdiction in equity is of little practical effect as historically it has rarely been invoked. Secondly, application of Lord Dunedin's four propositions have been limited to straightforward stipulations for payment of money upon breach. However, for commercial contracts a new test was formulated which focuses on the legitimate interests of the non-breaching party in contract performance. In the absence of guidance to distinguish between the two types of clause/contract ie: simple/complex there will be commercial uncertainty about which test is to be applied. However, by judicious case management of litigation, courts are encouraged to use the Rules of Court to make a preliminary determination on this issue of characterisation well prior to trial so that litigants know whether to apply Lord Dunedin's four propositions or the legitimate interests test. The determination of this question is relevant to the content of the pleadings used in the case as well as the expert evidence. Determination of the question of characterisation is important because application of the different tests to the same facts can produce different results. Finally these three decisions have confirmed the rationale for the penalty doctrine is that stipulations which aim to punish are not enforced.

This thesis analyses the common law in Australia and England and critiques the recent decisions that have effected change. By way of comparative methodology, the thesis examines the treatment of penalty clauses in South Africa, where the Conventional Penalties Act 1962 enshrines Roman – Dutch legal principles which treat penalty clauses as valid and enforceable but subject to a discretion only in circumstances where there has been a breach of contract to reduce excessive stipulations to a reasonable sum. In 1997, the Scottish Law Commission commenced a wide ranging study of penalty clauses, and as part of its reform process produced the *Penalty Clauses (Scotland) Bill 2010* which proposes the penalty doctrine is to apply where there has not been a breach of contract and permits the court to reduce grossly excessive stipulations. The Scottish proposal has been put on hold to await further consideration of any future effects that may arise from the recent changes to the common law and then determine whether statutory intervention is required. The comparative analysis concludes with an examination of five international initiatives and three instruments originating from Europe and provide for the treatment of agreed sums, in a manner consistent

with the approach permitting judicial reduction.

The thesis concludes that the recent changes to the common law operate to make the law in Australia and England more certain on the basis that it is difficult to set aside stipulations in commercial contracts. Recommendations are made about how the courts might set boundaries or limits to legitimate interests and suggestions are proposed for careful case management of litigation. Judicial suggestions of statutory control of the penalty doctrine are rejected as unnecessary.

Declaration

This thesis contains no material which has been accepted for the award of any other degree or diploma at any university or equivalent institution and to the best of my knowledge and belief, this thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

Research for this thesis is current up to February 2019.

The thesis contains 95,985 words

Some of the arguments in this thesis have been developed through publication during the course of my candidature, which include:

- i) Matthew Bell and Richard Manly, 'Liquidated Damages and the Doctrine of Penalties: Rethinking the War on Terrorem' (2012) 29 *International Construction Law Review* 386.
- ii) Richard Manly, 'The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages' (2012) 28 *Building and Construction Law* 246.
- iii) Richard Manly, 'The Use of Formulae to Calculate Liquidated Damages and Stipulated Sums' (2013) 29 *Building and Construction Law* 127.
- iv) Richard Manly, 'Breach No Longer Necessary: The High Court's Reconsideration of the Penalty Doctrine' (2013) 41 *Australian Business Law Review* 314.
- v) Richard Manly, 'The *Conventional Penalties Act 1962* (South Africa): Comparative Observations with Recent Developments in the Common Law' (2017) 34 *International Construction Law Review* 155.

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Some of the arguments in this thesis have been developed through publication during the course of candidature. My interest in the treatment of liquidated damages and penalties arose professionally during a long trial of a road construction dispute in which I appeared in the Tasmanian Supreme Court for six months in 2004 (*Tasmania v Leighton Contractors Pty Ltd [No 3]* [2004] TASSC 132 (16 November 2004)). Throughout candidature I have had the advantage of presenting a seminar on liquidated damages and penalties in the Master of Construction Law program conducted by Matthew Bell, Wayne Jovic and David Bennett QC in the Faculty of Law at the University of Melbourne.

I thank my chambers colleague and friend Michael Whitten QC for reading and commenting on drafts of all chapters of this dissertation and for the conversations we have had as the thesis developed. Monash University has been generous in providing me with the helpful assistance of Fiona McCook and Claire Kaylock from time to time. The staff at the Law Library, and in particular Kay Tucker, were always helpful in locating obscure references. To all of them I say, thank you.

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Chapter 1

Introduction

1.1 Introduction to the Penalty Doctrine at Common Law

The penalty doctrine is an ancient¹ doctrine of contract law which permits a court to determine when contractual stipulation will or will not be enforced. The issue whether a stipulation is an unenforceable penalty arises in the context of agreed remedies,² which stipulate what is to occur when the breaching party fails to perform a contractual obligation which in the usual case requires the payment of money. In the absence of an agreed remedy clause, the question of which sums are payable to the non-breaching party following breach are determined by the principles of the law of damages for breach of contract which operate by default. Agreed remedy clauses providing a genuine pre-estimate of the loss the non-breaching party suffers due to a breach of contract are enforceable. However, agreed remedy clauses drafted with the aim or purpose of punishing the breaching party, for example by requiring payment of a sum of money which is “out of all proportion”³ to the losses likely to be suffered by the non-breaching party are not enforced.

The award of liquidated damages is the enforcement of a remedial term agreed inter partes and loss does not have to be proved as the stipulated sum is in law regarded as a debt.⁴ The stipulation is self-enforcing and mitigation is not relevant after breach⁵ however it is relevant at the date of the contract when the stipulation is agreed.⁶ Furthermore, if the amount of recoverable damages sustained by the non-breaching party exceeds the sum stipulated then the non-breaching party is confined to recovery of the sum stipulated.⁷ Similarly, if the sum stipulated exceeds the amount of recoverable damages the non-breaching party could have recovered in the absence of a liquidated damages clause, then the non-breaching party can recover the sum stipulated,⁸ but only subject to it not being exorbitant or unconscionable.

The common law protects the rights of contracting parties to freely agree upon contractual stipulations pre-estimating the loss payable upon a breach of contract. Stipulations of this nature are a common feature of commercial contracts and in particular contracts used in the construction industry. However, this freedom to contract is circumscribed by the penalty doctrine.⁹ Where there has been a breach of contract the principles of law regulating the dichotomy between an enforceable liquidated damages clause and the unenforceable penalty clause were settled by the House of Lords decision in *Dunlop Pneumatic Tyre Co Ltd v New Garage*

¹ See *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1192, [3] where Lords Neuberger and Sumption said “The penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well ...”

² Solene Rowan, *Remedies for Breach of Contract: A Comparative Analysis of the protection of Performance* (Oxford University Press, 2012) 207-236.

³ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170.190; *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656.669, [32].

⁴ *Pigram v A-G (NSW)* (1975) 132 CLR 216.

⁵ Justice James Edelman, *McGregor on Damages* (Sweet and Maxwell, 20th ed, 2018) 509 [16.022].

⁶ Hugh Beale, ‘Damages’ in Hugh Beale (gen ed), *Chitty on Contracts* (Sweet and Maxwell, 32nd ed, 2015) vol 1, 1797, 1922 [26.187].

⁷ *Diestal v Stevenson* [1906] 2 KB 345; *J-Corp Pty Ltd v Mladenis* [2009] WASCA 157 (28 August 2009) [35]–[37].

⁸ *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] BLR 271, 279, [45].

⁹ See generally Julian Bailey, *Construction Law* (Informa Law, 2nd ed, 2016) vol II, 1185–95 [13.129]–[13.145].

and *Motor Co Ltd*¹⁰ where Lord Dunedin provided four propositions which constitute the penalty doctrine ie: the *Dunlop* formulation. These propositions are based on a summation of the existing body of case law which Christopher J Rossiter¹¹ describes as ‘a product of centuries of equity jurisprudence’. Lord Dunedin’s primary proposition was that to be enforceable as liquidated damages, the stipulated sum needed to be a genuine pre-estimate of the non-breaching party’s loss calculated as at the date of entry into the contract and payable upon breach. However, if the stipulated sum was extravagant and unconscionable in amount in comparison to the greatest loss that could conceivably be proved to have followed from the breach of contract then it is an unenforceable penalty. For nearly a century, *Dunlop* was the bedrock of the common law penalty doctrine applied in Australia, England and throughout the common law world.¹²

The penalty doctrine has a long history dating back to the ‘*stipulatio poenae*’ in early Roman law.¹³ It has been described¹⁴ in derogatory terms by jurists and academics alike as, for example, ‘an anomaly within the law of contract’,¹⁵ “... maybe a hopeless anachronism”¹⁶ ‘pragmatic rather than principled’,¹⁷ ‘an irrational aberration, to be acquiesced in rather than explained’,¹⁸ ‘a major unexplained puzzle in the economic theory of the common law’,¹⁹ and ‘an oddity in the law of contract’.²⁰ The most recent criticism is provided by Lords Neuberger and Sumption of the UK Supreme Court in *Cavendish Square Holding BV v Makdessi*²¹ where they said, ‘the penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well, and which in the opinion of some should simply be demolished, and in the opinion of others should be reconstructed and extended ... the application of the rule is often adventitious.’²²

The penalty doctrine has, until recently in Australia and England, remained a constant with the courts applying the *Dunlop* formulation. Jurists in Australia and England applied Lord Dunedin’s four propositions and practitioners provided advice to clients and drafted contracts comfortably in the knowledge that the four propositions represented the law. The UK Supreme Court recently heard an argument in *Cavendish* where the appellant sought judicial abolition of the penalty doctrine²³ on the basis it is ‘antiquated, anomalous and unnecessary’.²⁴ This application was refused as the doctrine was of long standing and a common feature of most international legal systems and furthermore, the court referred approvingly to reports of various law

¹⁰ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79 (*‘Dunlop’*).

¹¹ Christopher J Rossiter, *Penalties and Forfeiture: Judicial Review of Contractual Penalties and Relief against Forfeiture of Proprietary Interests* (Law Book Co, 1992) 33; cited with approval by Kiefel J in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 542–3 [16] (*‘Paciocco’*).

¹² *Cavendish* [2016] AC 1172, 1252–3 [166].

¹³ Roger Halson, *Liquidated Damages and Penalty Clauses* (Oxford University Press, 2018) 6 [1.06]; Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Oxford University Press, 1996) 95–113.

¹⁴ Matthew Bell and Richard Manly, ‘Liquidated Damages and the Doctrine of Penalties: Rethinking the Law on Terrorem’ (2012) 29 *International Construction Law Review* 386, 387.

¹⁵ *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] BLR 271, 279–280, [48].

¹⁶ Robert Stevens, “Rights Restricting Remedies” in Andrew Robertson, Michael Tilbury (eds), *Divergences in Private Law* (Bloomsbury, 2016) 159.175.

¹⁷ *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005) [29].

¹⁸ *Wallis v Smith* [1882] 21 Ch D 243, 261.

¹⁹ Richard A Posner, ‘Some Uses and Abuses of Economics in Law’ (1978–9) 46 *University of Chicago Law Review* 281, 290.

²⁰ Mindy Chen-Wishart, ‘Controlling the Power to Agree Damages’ in Peter Birks (ed), *Wrongs and Remedies in the Twenty-First Century* (Clarendon Press, 1996) 271, 299.

²¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172 (*‘Cavendish’*).

²² *Ibid* 1192 [3].

²³ *Cavendish* [2016] AC 1172.

²⁴ *Ibid* 1206 [36].

reform organisations which had recommended legislation expanding the scope of the penalty doctrine,²⁵ rather than advocating for its abolition or curtailment.

The settled position, represented by *Dunlop* was altered for Australian conditions by two important High Court decisions handed down during the writer's candidature. Firstly *Andrews v Australia and New Zealand Banking Group Ltd*²⁶ recognises an otherwise dormant jurisdiction in equity to grant relief against a penalty stipulation where there has been a failure of a primary obligation rather than a breach of contract. The relief equity provides is partial enforcement or scaling down of the stipulated sum to provide compensation limited to the level of recoverable loss. Secondly in *Paciocco v Australia & New Zealand Banking Group Ltd*,²⁷ the High Court provides a further alteration to the settled position and recasts the test for a penalty at common law, where there has been a breach of contract, as one requiring the court to consider the legitimate interests of the non-breaching party in performance of the contract. As a result the breaching party must establish the stipulated sum or performance obligation sought to be enforced by the non-breaching party is extravagant or unconscionable compared to the legitimate interests it protects. The UK Supreme Court has adopted a similar legitimate interests test through its decision in *Cavendish*.

1.2 Introduction to the International Approaches

The *South African Conventional Penalties Act 1962*, the Scottish Law Reform initiative represented by the *Penalty Clauses (Scotland) Bill 2018*, and the international instruments and initiatives analysed in Chapters 7, 8, and 9 respectively all operate on the basis that proof of loss is not required,²⁸ and penalty clauses are treated as valid and enforceable subject to a judicial discretion which permits modification or reduction if the stipulated sum is manifestly or grossly excessive. Common law systems recognise no such mechanism.²⁹ However, in Australia in equity a stipulation found to be a penalty can be scaled down by the court.

The importance of these international approaches became more apparent during the writer's candidature as suggestions by Lords Neuberger and Sumption in *Cavendish*³⁰ that any extension to the penalty doctrine consistent with *Andrews* should be by "legislative decision making". Furthermore in the same decision, Lord Hodge³¹ said, in reference to *Andrews*, that "such an innovation would, if desirable, require legislation". This was followed by comments made by French CJ in *Paciocco*³² and the New South Wales Court of Appeal which held that legislative intervention may be the best way to deal with the penalty doctrine given the differences of opinion between Australia and England as to the legitimacy of *Andrews*.

1.3 Recent Changes to the Common Law Make the Thesis Topic Relevant

Traditionally, the common law distinction between an enforceable liquidated damages clause and an

²⁵ See for example, Law Commission, *Penalty Clauses and Forfeiture of Monies Paid*, Working Paper No 61 (1975); Scottish Law Commission, *Report on Penalty Clauses*, Report No 171 (1999); *Cavendish* [2016] AC 1172, 1206–7 [38].

²⁶ (2012) 247 CLR 205 ('*Andrews*').

²⁷ (2016) 258 CLR 525 ('*Paciocco*').

²⁸ See generally Pascal Hachem, *Agreed Sums Payable upon Breach of an Obligation* (Eleven International Publishing, 2011) 30–3.

²⁹ *Multiplex Constructions Pty Ltd v Abgarus Pty Ltd* (1992) 33 NSWLR 504, 519.

³⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, [43].

³¹ *Ibid* 1209–1210, 1274 [241].

³² See French CJ in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 541–2 [10]; see also *Arab Bank Australia Pty Ltd v Sayde Developments Pty Ltd* (2016–2017) 93 NSWLR 231.234, [11].

unenforceable penalty clause was governed by the *Dunlop*³³ formulation. In 2005, this position was confirmed for Australian conditions by the High Court decision in *Ringrow*.³⁴ However, when the topic for this thesis was being formulated in 2010, in a line of English cases commencing in 2004, the Commercial Court³⁵ and then the Court of Appeal³⁶ had begun to shift away from strict adherence to the *Dunlop* formulation, and adopted a test which considered the 'commercial justification' of the stipulation to determine whether it was enforceable.³⁷

The common law in Australia and England fragmented during the period of the writer's candidature. In 2012, the High Court in *Andrews*³⁸ reformulated the Australian position (in equity) which potentially expanded the operation of the doctrine into new territory.³⁹ This development was the subject of sustained criticism. *Andrews* introduced inconsistencies between the Australian and English approaches. However, the *Dunlop* formulation continued to apply in situations where there had been a breach of contract. In 2015, the *Cavendish*⁴⁰ appeal presented the UK Supreme Court with the opportunity to settle the inconsistency and bring the English approach into conformity with the Australian approach or to proceed in another direction. It elected to pursue the latter course and confirmed breach of contract was a necessary limiting factor before the penalty doctrine could be engaged. The *Andrews* extension to the penalty doctrine in equity was robustly rejected by the UK Supreme Court which also endorsed the *Dunlop* formulation for straightforward contract clauses stipulating for payment of money upon breach of contract,⁴¹ and pronounced a fresher approach via a reformulated test for commercial contracts focusing not on commercial justification but instead on the 'legitimate interests' of the non-breaching party in performance of the contract. This test applies to complex contracts and hereafter this dichotomy is referred to as the simple-complex distinction. Following *Cavendish* the High Court heard the appeal in *Paciocco* and adopted the legitimate interests test for Australian conditions. These developments enhanced the utility of an inquiry into the changes to the law and an investigation whether the law had taken a wrong turn. The research question arising from these recent events is whether the changes to the penalty doctrine in Australia and England have made application of the doctrine more or less certain, and whether the legitimate interests test requires further consideration to set some limits or boundaries to its operation.

1.4 The Goal of the Thesis: Clarifying the Certainty of the Modern Approach

The main objective of this thesis is to analyse the traditional common law penalty doctrine formulated in *Dunlop*, and to explain and critique the recent developments in Australia and England which have

³³ *Dunlop* [1915] AC 79, 86.

³⁴ *Ringrow* (2005) 224 CLR 656, 663 [12].

³⁵ *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752.

³⁶ See *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 (21 November 2003) [13]; *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005) [54]; *Euro London Appointments Ltd v Claessens International Ltd* [2006] 2 Lloyd's Rep 436; *Makdessi v Cavendish Square Holding BV* [2013] EWCA Civ 1539 (26 November 2013).

³⁷ *CMC Group Plc v Zhang* [2006] EWCA Civ 408 (14 March 2006); *Lansat Shipping Co Ltd v Glencore Grain BV* [2009] EWCA Civ 855 (31 July 2009); *Makdessi v Cavendish Square Holding BV* [2013] EWCA Civ 1539 (26 November 2013).

³⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216–17 [10]. The High Court continued the *Andrews* approach in *Paciocco* (2016) 258 CLR 525.

³⁹ Richard Manly, 'Breach No Longer Necessary: The High Court's Reconsideration of the Penalty Doctrine' (2013) 41 *Australian Business Law Review* 314.

⁴⁰ *Cavendish* [2016] AC 1172.

⁴¹ See in particular, *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199 [22], 1204-5 [32]; and in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 628 [321].

reformulated the test. *Dunlop* was not overruled by these recent decisions but merely re-interpreted. Chapters 2, 3, 4 and 5 analyse the developments to the common law and raise a number of issues which are answered in this thesis. Firstly the practical effect of the *Andrews* extension of the penalty doctrine in equity⁴² has little effect as it is a jurisdiction that is rarely enlivened and the thesis rejects the critical commentary which followed the decision. Secondly the thesis argues the changes brought about by *Cavendish* and *Paciocco* have the practical effect of protecting freedom of contract, enhancing party autonomy and operate to heighten enforcement of liquidated damages clauses where there has been a breach of contract and thus ensure greater certainty to contracting parties that their bargains will be enforced. Thirdly, the thesis contends that some boundaries need to be applied to legitimate interests. Finally, procedural directions from the court as to the way litigation is to be conducted⁴³ is required due to the simple-complex distinction. The question of characterisation is important due to the application of different tests ie: the *Dunlop* formulation for straightforward clauses and the legitimate interests test for complex contracts. Chapter 4 discusses this question of characterisation is important for the pleadings, as well as the content of the expert evidence and because application of the two tests to the same facts can lead to different outcomes.⁴⁴ In addition to the issues above, a further objective of the thesis is to engage with the treatment of penalty stipulations provided in South Africa, the Scottish Bill and the international initiatives and instruments (when compared to the common law) for comparative purposes. It is envisaged that this will assist in determining whether the different treatment of penalty clauses can provide guidance for the future incremental development of the common law which this thesis argues will be necessary. This thesis considers whether this different treatment of penalty clauses provides a more or less certain outcome than the common law and concludes that although the remedies are different the rationale for the doctrine is the same.

1.5 Methodology: Doctrinal and Comparative Approaches

This thesis adopts a doctrinal research approach based upon primary and secondary sources. The research data includes a mixture of primary source material from multi-jurisdictional case law and statute, together with secondary source material including texts, journal articles, conference presentations and seminar papers. This research was utilized as the basis for publication of a number of articles in which a variety of the arguments presented in this thesis are developed, and which form the basis of chapters 2, 3 and 7 in particular. The doctrinal research is described by Dennis Pearce, et al as one which ‘provides a systematic exposition of the rules governing a particular legal category, analyses of the relationship between rules, explains areas of difficulty and, perhaps predicts future developments’.⁴⁵ In this manner chapter 2 includes an analysis of the law and economics arguments as to the utility of liquidated damages clauses and refers to various law and economics theories relevant to a determination of law’s effects on society.⁴⁶ Chapter 7 provides the analysis of the history and development of the penalty doctrine in the mixed jurisdiction of South Africa including the enactment of the *Conventional Penalties Act 1962* (South Africa) which provides for the treatment of penalty clauses in a manner consistent with Roman-Dutch law which endorses a judicial discretion to reduce excessive penalty clauses where the stipulation is prejudicial to the non-breaching party.

⁴² *Paciocco* (2016) 258 CLR 525, 569 [124]–[125].

⁴³ See the argument advanced in Chapter 5 at [5.2.8].

⁴⁴ This is explained in Chapter 4 at [4.6.6.1].

⁴⁵ Dennis Pearce, Enid Campbell and Don Harding, *Australian Law Schools: A Discipline Assessment for the Commonwealth Tertiary Education Commission* (Australian Government Publishing Service, 1987) 312.

⁴⁶ Terry Hutchinson, *Researching and Writing in Law* (Law Book Co, Sydney, 3rd ed, 2010) 60.

Chapter 8 analyses of the reports and discussion papers produced by the Scottish Law Commission that led to a draft Bill and consider how the reform initiative has coped with changes to the common law brought about by *Andrews*, *Cavendish* and *Paciocco*. Finally in chapter 9 five international initiatives and three instruments published in Europe between 1973 and 2016 provided for the treatment of penalty clauses by permitting reduction of excessive sums.

1.6 Structure of the Thesis

The thesis is comprised of ten chapters. Chapter 2 provides a contextual analysis of the penalty doctrine which assists with an understanding of the formative decisions in *Andrews*, *Cavendish* and *Paciocco* that follow. The chapter argues that over time, the *Dunlop* formulation was elevated to a set of legal rules or a “quasi statutory code”⁴⁷ which was an incorrect characterisation aptly described in *Cavendish* by Lord Hodge as ‘straightjacketed’.⁴⁸ The operative distinction between rules and standards confirms that Lord Dunedin’s four propositions are not a set of rules to be rigidly followed. This was confirmed by the UK Supreme Court in *Cavendish* and which was decided during the period of candidature. The *Dunlop* formulation was applied by the courts by two distinct approaches whereby some courts applied the *Dunlop* formulation in a ‘mechanical’ or mathematical fashion and others adopted an ‘equitable’ approach involving discretionary considerations. Both approaches are problematic and operate to detract from Lord Dunedin’s four propositions. The utility of liquidated damages clauses from a law and economics perspective concludes that the use of such clauses are an efficient mechanism⁴⁹ as they operate to reduce the transaction costs which typically follow from a breach of contract in terms of negotiating damages payable for breach or, in the worst case, the issuing of legal proceedings for recovery of damages to be assessed by the strictures of the common law. They are therefore beneficial to contracting parties.⁵⁰

Chapters 3, 4 and 5 address the recent changes to the penalty doctrine in equity and at common law brought about by *Andrews*, *Cavendish* and *Paciocco* which were all handed down during the period of candidature. Chapter 3 analyses the High Court decision in *Andrews* and explains how it affects the long established common law rule for the determination of when contractual stipulations are enforceable liquidated damages provisions or unenforceable penalties. Following the decision commentators argued it would cause significant disruption to the operation of commerce.⁵¹ The chapter argues this has not proved to be so as the enlivening of a jurisdiction in equity which will relieve against penalty stipulations is rare. However should it arise, the remedy equity provided is scaling down of the stipulated sum to the amount of recoverable loss ie: to the level that represents the amount of damages for breach of contract. The chapter further contends that *Andrews* did not propose a unitary penalty doctrine which originated in equity. Rather, it supports a general penalty doctrine theory which recognizes two jurisdictions operating side by side to relieve against penalties ie: one in equity and the other at common law.

Chapter 4 analyses the UK Supreme Court decision in *Cavendish* which was critical of *Andrews* as being ‘a

⁴⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199 [22].

⁴⁸ *Ibid* 1270 [225].

⁴⁹ Halson, above n 13, 116-122, [4.34]-[4.41].

⁵⁰ See generally Manly, ‘The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages’ (2012) 28 *Building and Construction Law* 246.

⁵¹ See, eg, Richard Manly, ‘Breach No Longer Necessary: The High Court’s Reconsideration of the Penalty Doctrine’ (2013) 41 *Australian Business Law Review* 314.

radical departure from the previous understanding of the law'.⁵² *Cavendish* significantly recast the test for the penalty doctrine at common law. In the end result the Court approved the *Dunlop* formulation for what it referred to as "simple damages clauses in standard contracts",⁵³ "standard damages clauses in consumer contracts",⁵⁴ and "straightforward damages clauses"⁵⁵ where the stipulation provides for payment of money upon breach, ie: the standard application of the penalty doctrine. The chapter argues stipulations fitting this description would include the typical liquidated damages clause in a standard form construction contract providing for the payment of \$X per day or week or month for late completion. For "more complex cases",⁵⁶ or "less straightforward cases",⁵⁷ the UK Supreme Court held that the *Dunlop* formulation no longer applies. In its place is a threshold test based on a determination of whether the impugned stipulation exceeds the 'legitimate interests' of the non-breaching party in contractual performance. The chapter contends the effect of the legitimate interests test is that future engagement of the penalty doctrine is reduced and contracting parties are thereby provided with greater certainty as to the enforcement of their bargain. This new test is 'motivated by a concern to promote freedom of contract'⁵⁸ and is premised on the central idea that the purpose of the contract is to satisfy the expectations of the party entitled to performance.⁵⁹ However, the chapter provides some cautionary suggestions regarding boundaries that the courts may wish to consider for legitimate interests.

Chapter 5 focuses on the High Court decision in *Paciocco*, and argues this decision confirms the rationale for the penalty doctrine outlined in chapter 2 that stipulations which aim to punish will not be enforced. The *Cavendish* legitimate interests test was adopted for Australian conditions and that test is to be used in place of the *Dunlop* formulation when considering impugned stipulations in complex commercial arrangements. The High Court also analyses the appellant's reliance on statutes aimed at protecting against unconscionable conduct and unfair contract terms. None of the statutory claims succeeded due to the customers' failure to establish improper practice by the bank; the customers' awareness of the fees, the customers' decision to operate credit cards in a manner which exposes them to the risk of having to pay fees and in any event the bank's contracts were not in all the circumstances unfair or unjust. Specifically, Chapter 5 argues there is a need for judges and litigation practitioners (solicitors and barristers) to recognise that compliance with the 'overarching purpose'⁶⁰ of the *Civil Procedure Act 2010 (Vic)* for example, in proceedings involving pleadings which invoke the penalty doctrine require proper case-management. It is essential for the courts to provide a ruling in the early stages of the litigation as to the 'separate trial of a question'⁶¹ which on the question of characterisation determines whether the impugned stipulation is part of a complex contract, in which case the legitimate interests test applies or whether it is a straightforward

⁵² *Cavendish* [2016] AC 1172. That criticism was brushed aside by the High Court in *Paciocco* (2016) 258 CLR 525, 539–40 [8]–[10], 568–70 [121]–[127].

⁵³ *Ibid* 1199 [22].

⁵⁴ *Ibid* 1201 [25].

⁵⁵ *Ibid* 1204–5 [32].

⁵⁶ *Ibid* 1199 [22].

⁵⁷ *Ibid* 1201 [25].

⁵⁸ John W Carter, Wayne Courtney and Greg J Tolhurst, 'Assessment of Contractual Penalties: *Dunlop* Deflated' (2017) 34 *Journal of Contract Law* 4, 5.

⁵⁹ *Cavendish* [2016] AC 1172, 1203–4 [30], citing *Co-Operative Insurance Society Ltd v Argyll Stores (Holdings) Ltd* [1998] AC 1, 15. See also *Cavendish* [2016] AC 1172, 1274 [243] (Lord Hodge).

⁶⁰ *Civil Procedure Act 2010 (Vic)* s1(1)(i), ie: "facilitate the just, efficient, timely and cost effective resolution of the real issues in dispute".

⁶¹ *Supreme Court (General Civil Procedure) Rules 2015 (Vic)*, Order 47, Rule 47.04; and see the discussion in David L Bailey, John K Arthur, *Civil Procedure Victoria*, LexisNexis Butterworths, Vol 1 [47.04].

damages clause to which the *Dunlop* formulation applies. A decision on the question of characterisation has important consequences for the way the trial is conducted including, the pleadings and the management of the expert evidence. This chapter argues that a decision on the question of characterisation is paramount as the two case examples provided establish that application of the different tests to the same facts can lead to different results.⁶² Additionally this chapter raises a number of suggestions for future limits that the High Court could apply to the legitimate interests test.

Chapter 6 examines ‘unconscionability in the *Dunlop* sense’ and argues it is a narrow concept which concentrates on the disproportionate nature of the sum stipulated for and that it overlaps with substantive unconscionability in equity as this latter concept considers dissatisfaction with the outcome of the contract where it is too one-sided. This chapter contrasts this narrow concept with common law unconscionability, as well as other related doctrines (otherwise referred to as vitiating factors) including duress, undue influence, unilateral mistake and estoppel. This analysis is relevant as it was submitted by the appellant in *Cavendish* that the penalty doctrine should be limited to confining *Dunlop* unconscionability to procedural misconduct involving duress, undue influence and misrepresentation with Lord Mance rejecting this submission outright. This Chapter argues that limiting the discrete penalty doctrine and leaving litigants to pursue their grievances by reliance on some unified concept of unconscionability involving the vitiating factors is not acceptable primarily due to the difficulty in formulating an effective test which according what was presented to the court. This chapter further contends that unconscionability in the *Dunlop* sense concentrates on the amount of the sum stipulated for ie: is it unconscionable whereas unconscionability in equity focuses on the conduct and behaviour of the parties as regards contract formation. On this basis they are separate and discrete concepts.

In chapters 7, 8 and 9, the modern penalty doctrine developed in Australia and England is compared with some examples of the treatment of penalty clauses internationally. These three chapters provide comparative analysis and are important as ‘in becoming more knowledgeable about the laws of their geographic neighbours and trading partners, lawyers will be more able to practice law within a broader commercial framework’.⁶³ Those international instruments and initiatives were drafted to operate only where there is a breach of contract and in the event a stipulation is found to be a penalty it can be reduced by the exercise of a judicial discretion. However reduction is not to the level of damages for breach of contract but rather to an ‘intermediate figure’. Chapter 7 expands on an article published in 2017⁶⁴ and examines the system in South Africa where penalty clauses are regulated by the *Conventional Penalties Act 1962* which empowers the court to reduce the stipulated sum payable upon breach where it is ‘out of proportion to the prejudice suffered’ by the non-breaching party to the extent the court considers equitable. The examination of the South African statute is significant as the matters courts take into account on the question of ‘prejudice’ can be equated with the matters common law courts take into account to determine the legitimate interests of the non-breaching party. Furthermore, its approach to penalty clauses is consistent with the common law rationale for the penalty doctrine advocated in chapter 2.

⁶² See Chapter 4 at [4.6.6.1].

⁶³ Ibid.

⁶⁴ Richard Manly, ‘The *Conventional Penalties Act 1962* (South Africa): Comparative Observations with Recent Developments in the Common Law’ (2017) 34 *International Construction Law Review* 155.

Chapter 8 analyses the significant law reform initiatives proposed for Scotland, which is a mixed civil law/common law jurisdiction applying *Dunlop* and *Cavendish*. Between 1997 and 2018 the Scottish Law Commission published a number of discussion papers and reports as well as a draft *Penalty Clauses (Scotland) Bill 2010* which provides a radical overhaul of the penalty doctrine.⁶⁵ The recommendations include that the penalty doctrine should operate in circumstances other than where there has been a breach of contract the stipulated sum is to be assessed in light of circumstances arising after entry into the contract ie: an ex post analysis and a manifestly excessive stipulation can be modified by a judge to the extent necessary to make it enforceable. After wide consultation the law reform measures have stalled due to objections from various consultees which predominantly complain about a lack of certainty due to the nature of the proposed reforms and in particular the unconstrained judicial discretion to reduce. Furthermore the Commission resolved to adopt a 'wait and see' approach and consider how *Cavendish* is applied in future at which time it will review the situation.

Chapter 9 analyses five international initiatives and three instruments including the *Benelux Convention Relating to Penalty Clauses* (1973); the Council of Europe: *Resolution (78)3 Relating to Penal Clauses in Civil Law* (1978); the UNCITRAL 'Report on Liquidated Damages and Penalty Clauses' (1979); the UNCITRAL *Uniform Rules on Contract Clauses for an Agreed Sum Due Upon Failure of Performance* (1983); and the UNCITRAL *Draft United Nations Convention on Contract Clauses Due Upon Failure of Performance* (1983). Thereafter, it analyses three international instruments: the *Principles of European Contract Law 2000* ('PECL'); the *Draft Common Frame of Reference (Principles, Definitions and Model Rules of European Private Law)* 2009 ('DCFR') and the UNIDROIT *Principles of International Commercial Contracts* 2016 ('UPICC'). All of these measures operate consistently with the practices of continental European legal systems by treating penalty clauses as valid and enforceable and provide the court with a discretion to reduce 'grossly excessive' stipulations to 'a reasonable amount'. The chapter provides a wide ranging study demonstrating there is an 'interconnectedness'⁶⁶ between what these various measures provide when compared to the common law.

Chapter 10 supports a number of findings including that the developments in the common law following upon the analysis provided in Chapters 2, 3, 4 and 5 confirms that the law has become more certain on the basis that it is more difficult to successfully challenge liquidated damages clauses. This will stimulate their use in commercial contracts. However as suggested in chapter 5 there are some limitations the court could consider in future to provide some boundaries to the ambit of legitimate interests. This thesis has also argued it will be important for litigation practitioners to obtain an early ruling from the court on the question of characterisation of the stipulation or contract so that the appropriate legal test can be applied. Furthermore the way in which agreed sums payable upon breach are treated in a number of other systems is compared with the common law discussed in Chapters 7, 8 and 9 where it was demonstrated it is not only common law

⁶⁵ Scottish Law Commission, *Discussion Paper on Penalty Clauses*, Discussion Paper No 103 (1997); Scottish Law Commission, *Report on Penalty Clauses*, (1999) above n 25; *Penalty Clauses (Scotland) Bill 2010* (Scot (contained as annex A to Scottish Government, 'Consultation on Penalty Clauses (Scotland) Bill' (Consultation Paper, Scottish Government, 8 July 2010)); Scottish Law Commission, *Review of Contract Law: Discussion Paper on Penalty Clauses*, Discussion Paper No 162 (2016).

⁶⁶ Hutchinson, above n 46, 118.

systems which continue to be reticent about interfering with contracts which include stipulations allocating risk and providing for an agreed remedy upon breach.

1.7 Overall Outcome

Overall, this thesis supports a 'steady as it goes' approach in common law systems. *Cavendish* and *Paciocco*, in particular, have the practical effect of making the law more certain for commercial parties who settle their contractual risk allocations by their contracts which include liquidated damages provisions. This thesis offers some important insights into the application of the legitimate interests test and suggests it will result in increased contractual enforcement of agreed damages stipulations. It is on this basis that the thesis does not support the suggestion of legislative control raised in *Cavendish* and *Paciocco*. However, some limitations may be appropriate to set some boundaries for application of the new test. The outcomes to be expected from application of the common law test is consistent with the approaches adopted in South Africa, changes mooted for Scotland and the subject matter of the international initiatives and instruments considered in Chapter 9. This is largely due to the fact in all of those measures the sum stipulated is not reduced unless it is grossly excessive. Accordingly, the freedom of contract enjoyed by contracting parties is respected and enforced as reduction is to occur only if there is gross excess thus setting the bar high. This suggests that although the various measures analysed in chapters 7, 8 and 9 when compared to the common law adopt different tests the end results may well be similar. It is apparent that the rationale for the penalty doctrine outlined in Chapter 2 can be seen to run through *Andrews*, *Cavendish* and *Paciocco*. The common law position is that stipulations which aim to punish or have the purpose of punishment of the non-breaching party is not likely to be enforced. This rationale can be observed in the *Conventional Penalties Act 1962* (South Africa) which uses the expression 'prejudice' rather than punishment. It is also consistent with the Scottish law reform proposals and the international initiatives and instruments where stipulated sums can be reduced where they are grossly excessive. The thesis confirms that the common law rationale resonates through all of the measures analysed.

Chapter 2

A Rationale for the Penalty Doctrine and Other Considerations

2.1 Introduction

A liquidated damages clause is an agreed remedy and is a phenomenon of most commercial contracts¹ and, in particular, construction contracts.² Stipulations of this nature constitute an agreement either absolutely or by a formula³ fixing the measure of compensation payable in the event of all or of some breaches of a contract. The benefits provided by a stipulation include that the non-breaching party can sue for recovery of the stipulated sum as a debt without having to prove loss,⁴ and the rules of civil procedure enable the non-breaching party to adopt a speedy court process to obtain summary judgment.⁵

The overriding utility of liquidated damages clauses is captured by the expression 'difficulty, uncertainty, delay and expense are avoided'.⁶ However the validity of an agreed remedy clause is not unqualified as it may for public policy reasons⁷ be impugned as an unenforceable penalty on the grounds of disproportion where the aim or purpose of the provision is punishment of the breaching party. Before the court can find disproportion, it must first establish that the sum stipulated for is extravagant, exorbitant, unconscionable, and out of all proportion.

As was observed in Chapter 1, the rationale for the penalty doctrine has proven to be elusive⁸ and its most recent critics include Lords Neuberger and Sumption from the UK Supreme Court.⁹ Despite their concerns, this Chapter argues the rationale for the penalty doctrine is one based on the prevention of enforcement of stipulations, the aim or purpose of which is to punish. In this respect, the stipulated sum will exceed the legitimate interests of the non-breaching party in performance of the contract as it placed an unreasonable or punitive burden on the breaching party. This rationale pays due respect to Lord Dunedin's four propositions in *Dunlop* and also reflects the modern approach to the penalty doctrine¹⁰ which concentrates on the legitimate interests of the non-breaching party in contractual performance rather than an inquiry into whether

¹ Empirical data is scarce, but see Roger Halson, *Liquidated Damages and Penalty Clauses* (Oxford University Press, 2018) 99 [4.11].

² See generally J Sharkey et al, 'Standard Forms of Contract in the Australian Construction Industry' (Research Report, Melbourne Law School, June 2014) <<https://law.unimelb.edu.au/news/MLS/forms-of-contract-in-the-construction-industry>>; John Sharkey, Matthew Bell and Wayne Jovic, 'Standard Forms of Contract in the Australian Construction Industry: How Are They Being Used?' (2014) 30 *Building and Construction Law* 302.

³ Richard Manly, 'The Use of Formulae to Calculate Liquidated Damages and Stipulated Sums' (2013) 29 *Building and Construction Law* 127.

⁴ *Boucaut Bay Co Ltd (in liq) v Commonwealth* (1927) 40 CLR 98, 106–7; *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1447; see also Richard Manly, 'The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages' (2012) 28 *Building and Construction Law* 246.

⁵ Hugh Collins, *The Law of Contract* (Cambridge University Press, 4th ed, 2003) 368.

⁶ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 11.

⁷ *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1447; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1193–4 [7], 1194–5 [9], 1274 [243], 1276 [250].

⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1192 [3]; Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 91–145 [4.01]–[4.74]; Nicholas Tiverios, 'Doctrinal Approaches to the Law of Penalties: A Post-Andrews Intention-Based Defence of Relief against Fixed Contractual Penalties' in Simone Degeling, James Edelman and James Goudkamp (eds), *Contract in Commercial Law* (Thomson Reuters, 2016) 457.

⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1192 [3].

¹⁰ For the UK see *ibid*; and for Australia see *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

the stipulated sum is a genuine pre-estimate.

This Chapter is divided into three Parts.

Part I provides an introduction to the traditional distinction recognised in common law systems between an enforceable liquidated damages clause and unenforceable penalty clause. This includes Lord Dunedin's classic formulation of the penalty doctrine found in his speech in *Dunlop*.¹¹ Traditionally, when judges have sought to identify if a stipulated sum is a penalty they have on the one hand adopted either a mechanical approach to the application of Lord Dunedin's four propositions and focused on the disproportion between the sum stipulated and the greatest loss that could possibly arise from the breach of contract. On the other hand other judges have adopted what has been described as the equitable approach which inquires whether the nature of the relationship between the contracting parties could make the stipulation (or reliance on it) unconscionable. Lord Dunedin's four propositions had been elevated to the status of legal rules in numerous decisions and textbooks and in *Cavendish* the relative importance of the propositions was criticised on the basis they had 'achieved the status of a quasi-statutory code',¹² and that *Dunlop* presented a 'straightjacket'¹³ approach. The law distinguishes between rules and standards and an appreciation of this distinction explains why Lord Dunedin's four propositions should not be treated as rules to be strictly followed. The penalty doctrine is an interference with freedom of contract.¹⁴ As a matter of public policy the law will prohibit enforcement of stipulated sums that are in the nature of a punishment. In the same vein a stipulation in the nature of exemplary damages will not be enforced. The penalty doctrine is not automatically engaged where there is evidence of inequality of bargaining power as more is required. Finally this Part confirms there is a remedy available to the non-breaching party where a stipulation is found to be a penalty.

Part II analyses a variety of arguments distilled from the law and economics literature. That analysis supports the use of liquidated damages clauses as beneficial including that they are efficient as they avoid difficulties of proof of loss and damage, uncertainty of litigation outcome, and reduce delay and expense.¹⁵ Other arguments examined include the notion that the use of liquidated damages clauses may increase pre-breach transaction costs but reduce post-breach transaction costs which should lead to an overall reduction in total transaction costs.¹⁶ Clauses of this nature operate to avoid what economists refer to as 'adverse selection problems';¹⁷ and they serve to protect risk allocation.

Part III argues that the rationale for the penalty doctrine advocated in this Chapter is supported by the

¹¹ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86–8; see generally Manly, 'The Use of Formulae to Calculate Liquidated Damages and Stipulated Sums', above n 3.

¹² *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199 [22].

¹³ *Ibid* 1270 [225].

¹⁴ *Ibid* 1205 [33].

¹⁵ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 11; *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1445; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 616 [284]. See generally Halson, *Liquidated Damages and Penalties*, above n 1, 91–145 [4.01]–[4.74]; Manly, 'The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages', above n 4.

¹⁶ I MacNeil, 'Efficient Breach of Contract: Circles in the Sky' (1982) 68 *Virginia Law Review* 947, 968–9.

¹⁷ Adverse selection is a term used in economics that refers to a process by which undesired results occur when buyers and sellers have access to different/imperfect information, also known as asymmetric information. Asymmetric information causes an imbalance in power. See Robert Cooter and Thomas Ulen, *Law and Economics* (Addison-Wesley, 6th ed, 2012) 48–9.

reinterpretation of *Dunlop* which has been carried out by the peak appellate courts in Australia and England.

PART I

2.2 Liquidated Damages v Penalty

In 1915 in *Dunlop*¹⁸ Lord Dunedin provided guidelines for determination of whether a stipulated sum is liquidated damages or a penalty in four propositions which he had sourced from earlier decisions. The facts of the decision are that Dunlop was a manufacturer of motor tyres, covers, and tubes. It supplied goods to its customers, including New Garage, under a price maintenance agreement.¹⁹ In consideration of certain trade discounts, New Garage agreed not to sell or offer the goods (without the consent of Dunlop) to any private customer at less than Dunlop's current list prices. In the event of breach the agreement stipulated for payment by New Garage of £5 'by way of liquidated damages' for every tyre, cover or tube sold or offered. Dunlop established that substantially the whole of its business in selling goods was conducted through the trade. In order to prevent underselling Dunlop insisted all of its trade customers sign agreements containing the restraint.

In breach of the agreement, New Garage sold a tyre cover below the current list price. Dunlop commenced an action seeking equitable relief by way of an injunction to restrain further breaches of the agreement, and also damages. One of the defences raised by New Garage was that the £5 stipulation was an unenforceable penalty. The action was tried before Phillimore J without a jury. His Honour granted Dunlop an injunction to restrain any further breach of the agreement and directed an inquiry before a Master for an account to be taken of the goods improperly sold by New Garage since the date of the agreement, the prices at which those goods had been sold and to calculate the amount of damages sustained by Dunlop. Thereafter, the Master found the stipulated sum of £5 was liquidated damages and not a penalty. Dunlop's damages were assessed at £250.²⁰ New Garage appealed to the Court of Appeal on the ground the Master erred in finding the stipulated sum of £5 was liquidated damages and not a penalty and sought an order setting aside the judgment that had been entered for damages.²¹ The Court of Appeal²² held the £5 was a penalty and as there was no other evidence presented to support a claim for unliquidated damages *Dunlop* was only entitled to recover nominal damages.

On appeal the House of Lords found the stipulated sum of £5 was liquidated damages. The basis for this finding was that although there were several ways in which Dunlop's products could be sold or offered in breach of the agreement the presumption that 'it is a penalty when a single lump sum is made payable by way of compensation on the occurrence of one or more or all of several events, some of which may occasion

¹⁸ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86. The course of the *Dunlop* litigation is set out in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 234–6 [69]–[77].

¹⁹ The full text of the agreement is recorded in the decision of the House of Lords reported in the Law Journal Reports; *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1914] 83 LJ KB 1574, 1575.

²⁰ To arrive at such a finding the Master must have been satisfied there had been fifty incidents of breach.

²¹ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1913] 2 KB 207, 208.

²² Vaughan-Williams LJ and Swinton Eady LJ; Kennedy LJ dissenting. See the case note in (1915) 59 *Solicitors' Journal and Weekly Reporter* 362–3.

serious and others but trifling damage²³ was rebutted. This was because in the circumstances the loss likely to result to Dunlop from any breach of the agreement was difficult to assess²⁴ and £5 represented a genuine attempt to pre-estimate the loss. Accordingly the judgment at first instance of Phillimore J was restored.

2.2.1 Lord Dunedin's Four Propositions

In *Dunlop*, although the four Law Lords delivered separate speeches,²⁵ it is the speech of Lord Dunedin which gained fame and is cited as providing rules that, in effect, codifies the penalty doctrine at common law. The speech is referred to as the 'locus classicus'.²⁶ His Lordship formulated four 'propositions' from the available authorities, and stated he would 'content myself with stating succinctly the various propositions which I think are deducible from the decisions which rank as authoritative'.²⁷

Those four propositions are as follows:²⁸

1. Though the parties to a contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages ...
2. The essence of a penalty is 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 ...²⁹
3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach ...³⁰
4. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:
 - (a) It will be held to be penalty if 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 ...³¹
 - (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid ...³²
 - (c) There is a presumption (but no more) that it is penalty when 'a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage ...'³³

²³ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87–8. Lord Dunedin's proposition 4(c).

²⁴ Roger Halson notes that the presumption must have been intended to apply with some latitude as New Garage undertook 27 distinct obligations in respect of which liquidated damages of £5 for each infringement was payable. See Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 27 [1.34].

²⁵ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87–8, 85–90 (Lord Dunedin), 90–7 (Lord Atkinson), 97–9 (Lord Parker), 99–105 (Lord Parmoor).

²⁶ *Makdessi v Cavendish Square Holdings BV* [2013] EWCA Civ 1539 (26 November 2013) [55]; *Edgeworth Capital (Luxembourg) SARL v Ramblas Investments BV* [2015] EWHC 150 (Comm) (30 January 2015) [61].

²⁷ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86.

²⁸ *Ibid* 86–8 (citations omitted).

²⁹ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6.

³⁰ *Commissioner of Public Works v Hills* [1906] AC 368; *Webster v Bosanquet* [1912] AC 394.

³¹ See the illustration given by the Earl of Halsbury LC in *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 10.

³² *Kemble v Farren* (1829) 6 Bing 141; 130 ER 1234.

³³ *Lord Elphinstone v Monkland Iron and Coal Co* (1886) 11 AC 332.

On the other hand:

- (d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties ...³⁴

2.2.2 Lord Dunedin's Four Propositions That 'May Prove Helpful, or Even Conclusive'

Propositions 4(a) to (d) were provided by Lord Dunedin to assist the task of construction of an impugned stipulation for the purposes of determining whether it was liquidated damages or a penalty. Each of propositions 4(a) to (d) is analysed below.

2.2.2.1 Proposition 4(a): Stipulated Sum That Is Extravagant and Unconscionable Will Be a Penalty

Lord Dunedin's test for a penalty is based on a comparison between the sum stipulated and the greatest loss which could be expected to follow from the breach of contract. This is referred to as the disproportion test. Lord Dunedin cited *Clydebank Engineering and Shipbuilding Company Ltd v Yzquierdo y Castaneda*³⁵ as the exemplar of this proposition and it concerned a shipbuilding contract with a stipulation, described as a 'penalty' providing for payment of £500 per week for delayed delivery. The stipulation was held to be a valid liquidated damages clause and not a penalty. The Earl of Halsbury LC³⁶ said the distinction between the two depended on 'whether it is, what I think gave the jurisdiction to the Courts in both countries [ie: England and Scotland] to interfere at all in an agreement between the parties, unconscionable and extravagant, and one which no Court ought to allow to be enforced'. The Lord Chancellor³⁷ declined to lay down any 'abstract rules' for determining what was unconscionable or extravagant, saying only that it must depend on 'the nature of the transaction, the thing to be done, the loss likely to accrue to the person who is endeavouring to enforce the performance of the contract, and so forth'.

This formulation was influential and the two other members of the court (Lord Davey and Lord Robertson) agreed with it. However, in his speech, Lord Robertson³⁸ made an observation which points to the principle underlying the contrasting expressions 'liquidated damages' and 'penalty' when he said:

now, all such agreements, whether the thing be called a penalty or be called liquidate damage [sic], are in intention and effect what Professor Ball³⁹ calls 'instruments of restraint', and in that sense penal. But the clear presence of this element does not in the least degree invalidate the stipulation. The question remains, had the respondents no interest to protect by that clause, or was the interest palpably incommensurate with the sums agreed on? It seems to me that to put this question, in the present instance, is to answer it.

Additionally the Earl of Halsbury LC provided a somewhat extreme example of a penalty, when he referred to

³⁴ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 11; *Webster v Bosanquet* [1912] AC 394.

³⁵ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 10.

³⁶ *Ibid.*

³⁷ *Ibid.*

³⁸ *Ibid* 19–20.

³⁹ Professor George Joseph Ball (1770–1843) was a Scottish advocate and legal scholar. From 1822 to 1843 he was Professor of Scots Law at the University of Edinburgh.

an ordinary building contract for construction of a house at a cost of £50, containing a stipulation requiring payment by the builder of £1 million liquidated damages for failure to complete the work on time. This illustration is not to the point because it compares the sum stipulated with the contract price, rather than the loss which could flow from the breach.⁴⁰ Reliance on this example creates a difficulty because the contract price may not bear a direct relationship to the amount of damages that may be caused by a breach of the contract.⁴¹

A more modern example is *Jeancharm Ltd v Barnet Football Club Ltd*,⁴² where the Court of Appeal considered a stipulation in a contract which provided for payment of 5 per cent interest per week, in the event of late payment for goods supplied. Once the court determined the stipulated interest rate amounted to an annual rate of 260 per cent⁴³ it had no hesitation in declaring the stipulation a penalty.

2.2.2.2 Proposition 4(b): Failing to Pay a Sum of Money but the Sum Stipulated For Is Greater Than the Sum to Be Paid

Proposition 4(b) provides a subsidiary test for a penalty which arises from application of the disproportion test. Kiefel J⁴⁴ refers to this as ‘merely a corollary’ and is limited the case where the breach is constituted by a failure to pay a sum of money. Lord Dunedin cited *Kemble v Farren*⁴⁵ as authority for this proposition, and explained it was ‘one of the most ancient instances’⁴⁶ of when a stipulated sum would be found to be a penalty. The facts are that Farren, a comedian, agreed with Kemble (the manager of the Covent Garden Theatre) to perform for four seasons. In the event of breach of the agreement by either party, £1000⁴⁷ was stipulated to be payable as liquidated damages. In breach of the agreement, Farren refused to perform during the second season. Kemble sued for recovery of the £1000. Farren argued it was a penalty. The Court found the stipulated sum was a penalty and the jury awarded damages of £750 to Kemble. Kemble appealed. On appeal, the Court found that the £1000 was a penalty because it did not reflect an accurate assessment of loss that might result from any minute breach of the agreement and the jury verdict of £750⁴⁸ damages should stand.

There has been some judicial reluctance to applying this proposition too widely. For instance, it does not apply to an acceleration clause⁴⁹ in a contract providing for payment of the price by instalments, and

⁴⁰ See generally Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 26 [1.32].

⁴¹ For example, see *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 where the defendant undertook to provide security patrols at the plaintiff’s factory at a cost of 26p per visit, but the damage to the factory caused by a negligent patrol amounted to £615 000.

⁴² *Jeancharm Ltd v Barnet Football Club Ltd* [2003] EWCA Civ 58 (16 January 2003).

⁴³ *Ibid* [7].

⁴⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 549 [35].

⁴⁵ *Kemble v Farren* (1829) 6 Bing 141; 130 ER 1234. The proposition was applied in *Law v Local Board of Redditch* [1892] 1 QB 127, 130.

⁴⁶ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87.

⁴⁷ This would equate to £250 per season.

⁴⁸ This would equate to £250 per season for the three seasons that Farren refused to perform, ie: £750.

⁴⁹ A contract under which one party is to pay or repay money by instalments over a period of time may provide that, on the default in payment of one instalment, the whole of the amount of the unpaid instalments is now due and payable. This accelerated payment of future instalments is a penalty but if the contract provides for no more than the acceleration of payment of an existing or antecedent debt then the stipulation is not a penalty. See, eg, *O’Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359; see also the discussion in Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 165–166 [5.37]–[5.40].

stipulates that upon default, payment of the accrued debt plus interest is payable.⁵⁰ The proposition does also not apply to stipulations of the type operating upon breach of a loan agreement which provide for a modest increase in the rate of interest payable by a borrower. In *Lordsvale Finance Plc v Bank of Zambia*⁵¹ Colman J held that if there is a sound commercial reason for the increase in the interest rate then the clause will not be a penalty, so long as the amount is not extravagant.

Proposition 4(b) is best seen as reflecting the state of the common law in 1915 where awards of substantial damages were not available for a breach of contract which involved the late payment of money.⁵² It has limited application today⁵³ as it is not possible to assert that a sum stipulated is out of all proportion merely because it is 'a sum greater than the sum which ought to have been paid'. Kiefel J⁵⁴ determined that it has a 'narrow range of operation and is confined to the simplest cases'.

2.2.2.3 Proposition 4(c): Lump Sum Payable for a Variety of Breaches Is Presumed to Be a Penalty

Where the stipulated sum is payable for breach of a number of contractual provisions of varying importance this indicates it is unlikely to be a genuine pre-estimate of the loss which would flow from each breach. In *Commissioner for Public Works v Hills*,⁵⁵ a railway construction contract stipulated in the event of a breach by the contractor it was to forfeit 'as and for liquidated damages' certain monies retained by the Government of the Cape of Good Hope from money otherwise payable for work done. This retention fund was a security to be used to pay for rectification of defective work and the fund also contained certain other security money deposited with the Government by the contractor. The total amount of the retention fund depended on the progress of two other contracts not the subject of the litigation.

The Board⁵⁶ cited *Clydebank*⁵⁷ as authority for the applicable principle ie: the criterion of whether a stipulated sum was a penalty or liquidated damages was to be determined by considering 'whether the sum stipulated for can or cannot be regarded as a genuine pre-estimate of the creditor's probable or possible interest in the due performance of the principal obligation'. The Board⁵⁸ found the sum in question was not 'a genuine pre-estimate of loss' as it was liable to great fluctuation dependent on other events not connected with fulfilment of the contract. Lord Parker⁵⁹ observed a distinction needed to be drawn in the first instance between those cases in which the damage likely to accrue from each breach is of the same kind and in the second instance in those other cases in which the damage likely to accrue varies in kind for each breach. Cases which fall into the first instance were analogous to those of a single stipulation which can be breached in various ways and cause varying damages. It would be difficult for the court to hold that the parties had pre-estimated the damage if they had referred in their contract to the sum payable as a 'penalty'. In the second instance, Lord Parker observed there was a prima facie presumption against the parties having pre-estimated the damage

⁵⁰ *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359, 366–7.

⁵¹ *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752, 767.

⁵² *Williams v Reynolds* (1865) 6 B&S 495; 122 ER 1278.

⁵³ Elizabeth Peden, 'Penalty Clauses and What Would the High Court Have Made of *Interstar Wholesale Finance Pty Ltd v Integral Home Loans?*' (2009) 23(3) *Commercial Law Quarterly* 6, 10; *Hungerfords v Walker* (1989) 171 CLR 125.

⁵⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 549 [35].

⁵⁵ *Commissioner of Public Works v Hills* [1906] AC 368.

⁵⁶ *Ibid* 375.

⁵⁷ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 19.

⁵⁸ *Commissioner of Public Works v Hills* [1906] AC 368, 376.

⁵⁹ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 98.

even though the sum payable was referred to in the contract as 'agreed' or 'liquidated damages'. Because the damage likely to accrue from the various breaches would be different, a separate pre-estimate of damage in the case of each breach would be necessary. This is because it is most very unlikely that the same result would be arrived at in respect of each kind of breach.

2.2.2.4 Proposition 4(d): Precise Pre-Estimation of Damage Difficult or Impossible

A typical example of a breach of contract for which it may be difficult or impossible to pre-estimate the loss is delay in completion of a construction contract for a government. The law will not adopt a narrow or pedantic approach to the question of whether a government is capable of suffering a financial loss consequent upon an identified breach of obligation leading to the payment of liquidated damages.⁶⁰ That is because a government may not suffer any direct financial loss as a consequence of a breach of contract.

Lord Dunedin relied on *Clydebank* to explain this proposition. A more recent example is found in the decision of the Tasmanian Full Court in *Tasmania v Leighton Contractors Pty Ltd*⁶¹ in which a contractor had challenged the imposition of liquidated damages of \$8000 per day for delay to completion of a public highway. At first instance, Cox CJ determined the stipulated sum was a penalty⁶² and in arriving at his conclusion reasoned that "it did not appear that any estimation was made in respect of the principal's loss other than direct costs of supervising an over-run contract and it is my view that those costs are extravagant and exorbitant as they are totally disproportionate to the likely actual costs anticipated to be incurred. Furthermore, the evidence is that the costs of the project were fully funded by the Commonwealth Government and the State has not been exposed to either its capital cost or the costs incurred after the Date for Construction Completion. In those circumstances I am of the view that the estimate of \$8,000 for each calendar day of delay was not a genuine pre-estimate of the likely damage to the State resultant upon the late opening of the bypass and is unconscionable".⁶³

On appeal the Full Court set aside the finding of penalty and observed 'some components for loss of public utility or delay in access to infrastructure ought to have been considered [by the trial judge], not in the evaluation of the components of the direct costs, but as a separate matter'.⁶⁴ The approach adopted by the Full Court in this appeal proved to be a forerunner to the outcome in *Paciocco*⁶⁵ where the High Court endorsed a test for penalty which now considers the 'legitimate interests' of the non-breaching party in ensuring performance of the contractual obligation.

This Part will now move to examine how penalty stipulations were identified by courts, and consider two different approaches adopted by judges before the High Court, in *Ringrow*,⁶⁶ refocused the relevant inquiry

⁶⁰ Julian Bailey, *Construction Law* (Informa Law, 2nd ed, 2016) vol II, 1215 [13.180]; Nicholas Seddon, *Government Contracts: Federal, State and Local* (Federation Press, 6th ed, 2018) 12–15 [1.7].

⁶¹ *Tasmania v Leighton Contractors Pty Ltd* (2005) 15 Tas R 243.

⁶² *Tasmania v Leighton Contractors Pty Ltd [No 3]* [2004] TASSC 132 (16 November 2004) [232]–[244].

⁶³ *Ibid* [241].

⁶⁴ *Tasmania v Leighton Contractors Pty Ltd* (2005) 15 Tas R 243.

⁶⁵ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525. Note that Kiefel J refers to interests of a 'business or financial nature': at 547 [29], 'commercial interests': at 549 [35], 'financial interests': at 556 [65]; Gageler J refers to 'commercial circumstances': at 581 [166]; and Keane J refers to 'commercial interests': at 607 [256] and to 'legitimate interest': at 613 [271].

⁶⁶ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 669 [32] ('*Ringrow*').

back to consideration of the level of disproportion.

2.2.3 Identification of the Penalty

It is apparent from Lord Dunedin's four propositions and, in particular, proposition 2,⁶⁷ that the primary question for determination by a court is what amounts to a 'genuine covenanted pre-estimate of the damage'? Lord Dunedin provided the answer in proposition 4(a) where he set out the disproportion test stating that a stipulation will not provide for a genuine pre-estimate and will amount to a penalty 'if 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'.

The so-called '*Dunlop* Rules' have been applied by the courts by two different and distinct approaches. Some courts have applied a mechanical approach whereas others have applied an equitable approach. The two approaches were first acknowledged by Meagher JA in *PC Developments Pty Ltd v Revell* ('*PC Developments*')⁶⁸ where his Honour was of the opinion that the 'distinguished line of cases' in support of the former approach 'makes its adoption inevitable'. Each of these approaches will now be considered.

2.2.3.1 The Mechanical Approach

For some time, the *Dunlop* propositions were applied mechanically as rules⁶⁹ and judges considered the sum stipulated calculated from the date of entry into the contract (the *ex ante* approach) and compared it mechanically to the greatest loss recoverable by the non-breaching party as damages for breach of contract.⁷⁰ This approach had nothing to do with judicial discretion⁷¹ or any notion of unconscionability, but had regard to the substantive fairness of the transaction measured by the level of disproportion. By this approach, any sum stipulated as payable upon breach of contract which fell outside the widest possible definition of compensation that could have been envisaged by the parties at the time of contracting would be an unenforceable penalty. By way of illustration, the definition of penalty provided by Lord Diplock⁷² in 1962 is reflective of this approach: 'In the ordinary way a penalty is a sum which, by the terms of a contract, a promisor agrees to pay to the promisee in the event of non-performance by the promisor of one or more of the obligations, and which is in excess of the damage caused by the non-performance.'

Application of the mechanical approach is to be observed, for example, in the New South Wales Court of

⁶⁷ *Dunlop* proposition 2 provides, 'the essence of a penalty is 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.'

⁶⁸ (1991) 22 NSWLR 615, 650–1. The two approaches have also been considered in Elizabeth Lanyon, 'Equity and the Doctrine of Penalties' (1996) 9 *Journal of Contract Law* 234, 243–50; Paula D Baron, 'The Doctrine of Penalties and the Test of Commercial Justification' (2008) 34 *University of Western Australia Law Review* 42, 48–52.

⁶⁹ See, eg, *Cooden Engineering Co Ltd v Stanford* [1953] 1 QB 86; *Jobson v Johnson* [1989] 1 WLR 1026; *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1449; *Malouf (WT) Pty Ltd v Brinds Ltd* (1981) 52 FLR 442.

⁷⁰ The cases cited by Meagher JA in *PC Developments Pty Ltd v Revell* (1991) 22 NSWLR 615, 650–1 as exemplifying the equitable approach were *Forestry Commission of New South Wales v Stefanetto* (1976) 133 CLR 507, 519; and *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1.

⁷¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1194–5 [9], citing *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130, 144 (Hoffmann LJ).

⁷² *Philip Bernstein (Successors) Ltd v Lydiat Textiles Ltd* [1962] CA Transcript 238, reported *sub nom Sterling Industrial Facilities v Lydiat Textiles Ltd* (1962) 106 SJ 669, cited in *Euro London Appointments Ltd v Claessens International Ltd* [2006] 2 Lloyd's Rep 436, 439–440 [17].

Appeal decision in *Citicorp Australia Ltd v Hendry*⁷³ where the appeal concerned breach of chattel leases for default in payment. The financier sued the guarantors due to the insolvency of the lessee and the leases contained stipulations which provided a formula for calculation of the amounts payable upon default. The guarantors challenged the stipulations as penalties. In applying the mechanical approach, Clarke JA⁷⁴ said: 'upon a comparison of the amount resulting ... from the formula with the losses flowing from the breach one discerns a disparity which leads inevitably to the conclusion that the clauses are penal in nature'.

Lord Diplock and Clarke JA applied the mechanical approach and in each instance if the stipulated sum exceeded actual loss in its widest possible sense then the stipulation was characterised as an unenforceable penalty. The mechanical approach was adopted in England for example in *Anglo Auto Finance Co Ltd v James*⁷⁵ which considered breach of a hire purchase agreement for a car. The cash price for the car was £495 and the total hire purchase price was £652 payable over 48 months. The hirer paid instalments totalling £216 6s 6d and then defaulted and the financier terminated the agreement, repossessed the car, sold it and sued the hirer for £235 19s 6d made up of the balance due under the agreement less the resale price of the car £130 plus the expenses incurred in repossessing the car. The Court ruled the stipulation was a penalty because it provided that, at whatever time the default took place during the 48 month period of the agreement the financier could recover 100 per cent of the hire price. This could not be regarded as a genuine pre-estimate of the damage resulting from the breach and the stipulation was unenforceable and the financier was limited to recovery only of the arrears of rental at the date of termination plus repossession costs.

In adopting the mechanical approach courts focused on disproportionate compensation and the presumed fairness of the sum stipulated.⁷⁶ The character of the sum stipulated was treated as a function of arithmetic and formulae. The mechanical approach was criticised in *Cavendish*⁷⁷ by Lords Neuberger and Sumption in the following terms:

The law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions: between a penalty and genuine pre-estimate of loss, and between genuine pre-estimate of loss and a deterrent. These distinctions originate in an over-literal reading of Lord Dunedin's four tests and a tendency to treat them as almost immutable rules of general application which exhaust the field.

In his speech in *Dunlop* Lord Dunedin had attempted to inject greater certainty into the doctrine of penalties by the formulation of his four propositions. However as Gageler J noted in *Paciocco*⁷⁸ 'the unintended consequence of lucidity is sometimes rigidity'. That rigidity is what occurred when the courts adopted the mechanical approach.

⁷³ *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1; see also *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359; *IAC Leasing Ltd v Humphrey* (1972) 126 CLR 131.

⁷⁴ *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1, 14.

⁷⁵ *Anglo Auto Finance Co Ltd v James* [1963] 1 WLR 1042; see also *Campbell Discount Co Ltd v Bridge* [1962] AC 600.

⁷⁶ See, eg, Lord Denning in *Campbell Discount Co Ltd v Bridge* [1962] AC 600, 628.

⁷⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204 [31]. In the same decision, Lord Hodge referred at 1270 [225] to the mechanical approach as a 'straightjacket'.

⁷⁸ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 576 [152].

2.2.3.2 The Equitable Approach

Some courts took a different path and applied an equitable approach which proceeds on the basis that relief against penalties is discretionary and the nature of the relationship between the parties might make enforcement of the stipulated sum unconscionable. In those cases the judges considered disproportion amounted to evidence of oppression and the law is concerned to prevent one party from taking unfair advantage of the other.⁷⁹ In proposition 4(a), Lord Dunedin referred to a 'sum stipulated for that was extravagant and unconscionable'. That expression was adopted from the speech of Lord Davey in *Clydebank*⁸⁰ where he referred to a sum stipulated that was 'extravagant, exorbitant or unconscionable'. In turn, Lord Davey referred to the 1869 Scots decision of *Forrest v Henderson, Coulbourn and Co*⁸¹ where the expression 'exorbitant and unconscionable' was used to describe the sum stipulated. These expressions were treated as synonyms:⁸² 'unconscionable' was informed by 'extravagant' and 'exorbitant' as regards the amount of the sum stipulated. The sum stipulated will be a penalty if it provides for an unreasonable burden on the breaching party and enforcement of the stipulation will amount to punishment if the sum is 'out of all proportion' and hence it is oppressive to the breaching party for the stipulation to be enforced against it.⁸³

There are decisions applying the equitable approach which determined the expression 'unconscionable' in proposition 4(a) relates to the relationship between the parties and, in particular, whether there was any inequality in bargaining power between them at the date of contract⁸⁴ or some unfair compulsion of performance⁸⁵ or an amalgam of both.⁸⁶

In the *PC Developments* decision referred to above, Meagher JA cited the judgment of Mason and Wilson JJ in *AMEV-UDC Finance Ltd v Austin*⁸⁷ as the leading decision endorsing the equitable approach. The appeal in *AMEV-UDC* involved a hirer of equipment who had failed to pay instalments to a financier when due. The financier had terminated a lease on the ground the hirer had failed to pay one instalment of rental and sued the guarantor to recover its actual loss of \$291 857.40 which was made up of four components namely the unpaid rental instalments and interest plus the whole unpaid balance of the total rental charges plus the residual value specified under the lease and less the proceeds of sale of the equipment.

The financier conceded the component requiring the hirer to pay the whole unpaid balance of the total rental charges was a penalty⁸⁸ but otherwise it pursued the balance of its claims. The High Court determined the

⁷⁹ The case cited by Meagher JA in *PC Developments Pty Ltd v Revell* (1991) 22 NSWLR 615, 651 as exemplifying the equitable approach was *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193–4.

⁸⁰ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 17; Lord Davey referred to the earlier Scottish case of *Forrest v Henderson, Coulbourn and Co* (1869) 8 M 187.

⁸¹ (1869) 8 M 187, 194.

⁸² *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204 [31].

⁸³ *Ibid* 1285–6 [293]; *The Imperial Tobacco Company (of Great Britain and Ireland) Ltd v Parslay* [1936] 2 All ER 515, 521.

⁸⁴ *AMEV-UDC Finance Ltd v Artes Studios Thoroughbreds Pty Ltd* (1989) 15 NSWLR 564, 577: 'in protecting a weaker party from oppressive burdens or the unconscientious use of power by a stronger party'. Inequality of bargaining power was taken into consideration by the Full Court in *Tasmania v Leighton Contractors Pty Ltd* (2005) 15 Tas R 243, 256–9 [31], and by the Privy Council in *Philips Hong Kong Ltd v A-G (Hong Kong)* (1993) 61 BLR 41, 58–9.

⁸⁵ *Bartercard Ltd v Myallhurst Pty Ltd* [2000] QCA 445 (27 October 2000) [26].

⁸⁶ *Multiplex Constructions Pty Ltd v Abgarus Pty Ltd* (1992) 33 NSWLR 504, 509–10.

⁸⁷ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170.

⁸⁸ This concession was consistent with the principles explained in *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359.

financier was only entitled to recover the unpaid rental instalments plus interest. The additional claims were rejected as they were not recoverable as a result of the hirer's default but, rather, due to termination of the lease which the financier had brought about.

Mason and Wilson JJ observed⁸⁹ the principle enunciated in *Clydebank* and *Dunlop*, ie: an agreed sum is a penalty if it is extravagant, exorbitant or unconscionable, had, 'in the interests of greater certainty', been 'eroded' by the mechanical approach adopted in cases such as *Cooden Engineering Co Ltd v Stanford*.⁹⁰ Their Honours concluded⁹¹ the Court had long maintained a supervisory jurisdiction to relieve against stipulations 'which are so unconscionable or oppressive that their nature is penal rather than compensatory'. Their Honours⁹² considered the test of whether a stipulation is a penalty was one of degree which depended on a number of circumstances, including:

- 1) the degree of disproportion between the sum stipulated and the loss likely to be suffered by the non-breaching party which is said to be a factor relevant to the oppressiveness of the stipulation to the breaching party; and
- 2) the nature of the relationship between the contracting parties which is said to be a factor relevant to the unconscionability of the non-breaching party's conduct in seeking to enforce the stipulation.

This chapter argues the High Court's reference to the 'degree of disproportion'⁹³ in (1) above is consistent with 'unconscionable' in the narrow sense that expression is used in *Dunlop* and which is the subject of analysis in Chapter 6. The expression 'oppressiveness' is also consistent with unconscionability in the *Dunlop* sense because it is descriptive of the effect that payment of the amount of the sum stipulated will have on the breaching party. In *AMEV-UDC*, the High Court did not explain what it meant in (2) above by the expression 'the nature of the relationship between the contracting parties'. It may have been intended to reflect some inequality of bargaining power between the financier and the hirer. However, that consideration is not referred to in the judgment and it was not until three years later that the High Court in its decision in *Esanda Finance Corporation Ltd v Plessnig* confirmed it was not a relevant consideration.⁹⁴ Further, in *AMEV-UDC* the Court refers in (2) above to 'the unconscionability of the non-breaching party's conduct' whereas 'unconscionable' in the *Dunlop* sense is not a reference to conduct but rather to the conclusion which arises when the amount of the sum stipulated is found to be out of all proportion. To be consistent with *Dunlop* the High Court's use of the expression 'unconscionable' in *AMEV-UDC* must be read as referable to the unreasonableness of the burden or the punitive nature of the burden placed on the breaching party in having to pay a stipulated sum that is out of all proportion.

In *Ringrow* the High Court returned to the *Dunlop* sense in which the expression 'unconscionable' is properly to be understood. It is a reference to a narrow concept which is descriptive of the effect of payment of the

⁸⁹ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 190.

⁹⁰ *Cooden Engineering Co Ltd v Stanford* [1953] 1 QB 86. The decision is authority for the proposition that if an agreement is terminated due to a hirer's breach of contract, then the penalty doctrine applies.

⁹¹ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193.

⁹² *Ibid* 193–4.

⁹³ *Ibid* 193.

⁹⁴ See, eg, *Esanda Finance Corporation Ltd v Plessnig* (1989) 166 CLR 131; *Jeancharm Ltd v Barnet Football Club Ltd* [2003] EWCA Civ 58 (16 January 2003) [26].

amount of the stipulated sum when compared to the greatest loss likely to flow from the breach of contract. In *Ringrow*⁹⁵ the High Court refocused the inquiry on the stipulated sum and maintained that disproportion per se was not enough to permit judicial intervention:

Exceptions from that freedom of contract require good reason to attract judicial intervention to set aside the bargain upon which parties of full capacity have agreed. That is why the law on penalties is, and is expressed to be, an exception from the general rule. It is why it is expressed in exceptional language. It explains why the propounded penalty must be judged 'extravagant and unconscionable in amount'. It is not enough that it should be lacking in proportion. It must be 'out of all proportion'.

The Court emphasised that for the stipulated sum to be characterised as a penalty the disproportion must be so extravagant as to be in the nature of punishment. It is only when the stipulated sum is 'out of all proportion' or 'egregious'⁹⁶ that it will be an unenforceable penalty. In that respect *Ringrow* realigned the common law for Australian conditions. The applicable principles were restated for the penalty doctrine in its 'standard application'⁹⁷ which made the two approaches referred to by Meagher JA in *PC Developments* otiose. *Ringrow*⁹⁸ confirms that Lord Dunedin's formulation represents 'the principles governing the identification, proof and consequences of penalties in contractual stipulations'.

Having introduced Lord Dunedin's four propositions and explored how they have been applied this Part moves to consider whether those propositions should properly be characterised as legal rules ie: the *Dunlop* rules, or the penalty rules, which is how they have been referred to from time to time in major texts.⁹⁹

2.2.4 Rules, Principles and Standards: Legal Certainty

Lord Mance has observed that 'the law should be certain, so that it can be easily enforced and so that people can know where they stand. We expect that of Parliament when it frames statute law, and of judges when they expound the common law. We expect it in our relations with authority, and in our relations with each other.'¹⁰⁰

Legal certainty, which John Eldridge¹⁰¹ defines as '[concerning] the confidence with which the content and scope of substantive legal principles can be stated' is only achievable if the law is clear, predictable and able to develop in a principled manner which requires that similar cases be treated consistently. Legal certainty is enhanced when courts resolve disputes according to established legal principles and, in that sense, act in a legitimate manner. In that respect the achievement of legal certainty is closely linked with reasoned decision

⁹⁵ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 669 [32].

⁹⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1280 [266], cited by Kiefel J in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 553 [53].

⁹⁷ This is the expression used by the High Court in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 662 [10].

⁹⁸ *Ibid* 663 [12].

⁹⁹ See for example, Michael Furmston, *Cheshire, Fifoot and Furmston's Law of Contract* (Oxford University Press, 17th ed, 2017) 782; J W Carter, *Contract Law in Australia* (7th ed, LexisNexis, 2018) 864 [37.12]; Justice James Edelman, *McGregor on Damages* (Sweet and Maxwell, 20th ed, 2018) 503 [16.008]; Hugh Beale, 'Damages' in Hugh Beale (ed), *Chitty on Contracts* (Sweet and Maxwell, 32nd ed, 2015) vol 1, 1797, 1915 [26.182].

¹⁰⁰ Lord Mance, 'Should the Law Be Certain?' (Speech delivered at the Oxford Shrieval Lecture, University Church of St Mary the Virgin, Oxford, 11 October 2011); see also Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 142–5 [4.69]–[4.74].

¹⁰¹ John Eldridge, 'Contract Codification and Certainty' (2018) 35 *Journal of Contract Law* 146, 148.

making rather than decisions made in an arbitrary manner.¹⁰²

Lord Dunedin's four propositions have been referred to variously as the 'Dunlop Rules', the 'Penalty Rules' or the 'Dunedin Rules' and were only intended to provide guidance in determining whether a stipulation is liquidated damages or a penalty. In *Cavendish*¹⁰³ Lords Neuberger and Sumption said 'Lord Dunedin proposed his four tests not as rules but only as considerations which might prove helpful or even conclusive "if applicable to the case under consideration"' and in *Paciocco*, a similar point was made by Gageler J where he observed that the *Dunlop* propositions were 'not rules of law ... they were distillations of principle'.¹⁰⁴

The extent to which the law is certain is related to the manner in which it is structured as between principles and rules. Ian MacNeil defines 'principles' as broad statements applicable to a range of acts and in common law systems, they tend to develop incrementally through a series of decisions rather than being established in a single decision. Rules are more specific and relate to particular acts.¹⁰⁵ Tightly specified legal rules increase legal certainty¹⁰⁶ as they provide rigour and rigidity which makes compliance achievable without the intervention of a discretion. Ofer Raban¹⁰⁷ has said 'it is generally believed that legal rules provide the virtues of certainty and predictability, while legal standards afford flexibility, accommodate equitable solutions and allow for more informed development of the law.'

On the one hand, a legal rule would provide that, 'driving in excess of one hundred kilometres per hour on the highway is prohibited'. 'This is a 'bright line rule'¹⁰⁸ with a 'hard empirical trigger and a hard determinative response'.¹⁰⁹ The car-driving members of the public who use the highway know the maximum permissible speed is and can decide whether to comply with it. Lord Dunedin's four propositions are not expressed in language which satisfies the definition of a legal rule and accordingly, reference to Lord Dunedin's propositions as 'rules' is a misnomer.

On the other hand a legal standard might provide that 'driving at an excessive speed on the highway is prohibited'. This is a 'flexible standard'¹¹⁰ which has a 'soft evaluative trigger and a soft modulated response'.¹¹¹ Whether the standard has been breached will be open to question as it will be a matter of judgment as to what constitutes 'excessive speed'.

¹⁰² Ian MacNeil, 'Uncertainty in Commercial Law' (2009) 13 *Edinburgh Law Review* 68, 71.

¹⁰³ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199 [22], quoting *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87.

¹⁰⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 574 [143]; see also Kiefel J at 542–3 [16].

¹⁰⁵ MacNeil, above n 102, 72.

¹⁰⁶ John Braithwaite, 'Rules and Principles: A Theory of Legal Certainty' (2002) 27 *Australian Journal of Legal Philosophy* 47, 51.

¹⁰⁷ Ofer Raban, 'The Fallacy of Legal Certainty: Why Vague Legal Standards May Be Better for Capitalism and Liberalism' (2010) 19 *Boston University Public Interest Law Journal* 175.

¹⁰⁸ Pierre Schlag, 'Rules and Standards' (1985) 33 *UCLA Law Review* 379; Louis Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42 *Duke Law Journal* 557.

¹⁰⁹ Schlag, above n 108, 382.

¹¹⁰ *Ibid* 379.

¹¹¹ *Ibid* 383.

The choice between rules and standards effects costs and Louis Kaplow has observed¹¹² rules are typically more costly to create compared to standards. However, standards are more costly to enforce at a number of levels because:

- ❖ individuals have to interpret the standard when making decisions about how to act;
- ❖ enforcement authorities have to decide how the standard is to be applied;
- ❖ lawyers have to predict how the court will interpret the standard; and
- ❖ a court must apply the standard to past conduct;

This is complicated because each step requires later determinations of the meaning of the content of the law represented by the standard.

Kaplow¹¹³ states that the content of the law and in particular the common law changes over time after taking into account available information conditions¹¹⁴ and perceived rules. He states that in common law systems standards are easier to keep up to date as they are given content in a definitive way when they are applied to particular conduct. This is observed in *Cavendish* and *Paciocco* where the courts in England and Australia have reinterpreted and applied the *Dunlop* propositions in circumstances where there has been a breach of contract to now endorse a test for penalty based on a consideration of the legitimate interests of the non-breaching party in performance of the contract. In arriving at this conclusion those courts went about the task of carefully re-examining the speeches in *Dunlop* and did not overrule that decision.

Christopher J Rossiter¹¹⁵ comments that ‘the *Dunlop* rule is a product of centuries of equity jurisprudence. No new rules or principles were promulgated in that decision’. None of Lord Dunedin’s four propositions are rules in the sense discussed above but, rather, they provide a range of standards or considerations against which the facts of each case can be measured. Those standards were developed in the various antecedent decisions referred to by Lord Dunedin and distilled by him into his four propositions. It is one of the virtues of the common law that it develops incrementally¹¹⁶ and this is exemplified by the decisions in *Cavendish* and *Paciocco* which did not overrule *Dunlop* but rather reinterpreted the speeches of the Lords and in particular Lord Atkinson thereby confirming the continued relevance of *Dunlop* to the operation of the modern penalty doctrine.

2.3 The Penalty Jurisdiction: Some Salient Features

There are a number of salient features of the penalty doctrine that will be considered in the balance of this Part including that the doctrine is a product of public policy and its rationale is grounded in a refusal to enforce stipulations that aim to punish the breaching party. Stipulations in the nature of exemplary damages will not be enforced as punishment is not a part of the civil law and in particular the remedial aspect of civil law. The penalty doctrine operates as an exception to the principle of freedom of contract but *Cavendish* and *Paciocco* have had the practical effect of making it less likely that the doctrine will be successfully applied in

¹¹² Kaplow, above n 108, 562-3.

¹¹³ Ibid 616.

¹¹⁴ See the comment by the High Court to this effect in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 663 [12]. An example of change over time is the development of the law of negligence in Australia and England.

¹¹⁵ Christopher J Rossiter, *Penalties and Forfeiture: Judicial Review of Contractual Penalties and Relief against Forfeiture of Proprietary Interests* (Law Book Co, 1992) 33.

¹¹⁶ *Secretary of State for Environment, Food and Rural Affairs v Meier* [2009] 1 WLR 2780, 2785 [11].

future in circumstances where there has been a breach of contract. This increases contractual certainty for the parties regarding the quantum of damages that will be payable and for the breaching party as to its potential liability, as well as enhancing the respect the law gives to party autonomy. Inequality of bargaining power is commonplace in consumer contracting however the weaker party to a contract of this type is adequately protected by statutory remedies. When a stipulation is found to be a penalty, the non-breaching party still has an available remedy of unliquidated damages.

2.3.1 The Rationale: Stipulations That Aim to Punish Will Be a Penalty

In contradistinction to the enforceable liquidated damages clause is the secondary stipulation which is an unenforceable penalty.¹¹⁷ Damages payable upon breach of contract are intended to compensate the non-breaching party and not punish the breaching party. The purpose of contract law is to satisfy the expectations of the non-breaching party in obtaining performance.¹¹⁸ To be characterised as a penalty¹¹⁹ a stipulation must provide, inter alia, for the payment of a sum of money which is extravagant, exorbitant, unconscionable in amount and 'out of all proportion' to the damage likely to be suffered by the non-breaching party as a result of a breach of the contract.¹²⁰ In *Cavendish*¹²¹ Lord Hodge said 'the rule against penalties is a rule of contract law based on public policy'.¹²² In common law systems a stipulation found to be a penalty will not be enforced.¹²³ In *Campbell Discount Co Ltd v Bridge*¹²⁴ Lord Radcliffe observed that the doctrine of penalties had always been 'a rule of the court's own produced and maintained for the purposes of public policy'. This thesis argues it is for this reason the rationale for the penalty doctrine is that stipulated sums whose aim or purpose is to punish the breaching party will not be enforced because 'the innocent party can have no proper interest in simply punishing the defaulter'.¹²⁵

The expressions 'extravagant, exorbitant, unconscionable' used in *Clydebank* and *Dunlop* are words that describe the oppressive nature of the enforcement of payment of a sum stipulated which is disproportionate in amount. In *Cavendish*, Lord Toulson said these expressions are 'strong words'¹²⁶ and they describe the 'plainly excessive nature of the stipulation in comparison with the interests sought to be protected by the stipulation'.¹²⁷ In *Paciocco*,¹²⁸ Keane J observed that the terms 'extravagant' and 'unconscionable' in proposition 4(a) in *Dunlop* 'function as pointers toward the punitive purpose which imbued the challenged provision with the character of a punishment'. In *Dunlop* when Lord Dunedin used the expressions 'extravagant and unconscionable' they were to be read narrowly as descriptive of the punishment that would

¹¹⁷ See *Legione v Hately* (1983) 152 CLR 406, 445.

¹¹⁸ Harvey McGregor, 'Compensation versus Punishment in Damages Awards' (1965) 28 *Modern Law Review* 629.

¹¹⁹ See, eg, *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 where a clause in an equipment hire contract which provided that, in the event of the hirer failing to pay any instalment punctually, the owner was entitled to terminate the contract, and to repossess the equipment and recover not only the unpaid instalments plus interest, but the whole unpaid balance of hire during the term of the contract, was held to be a penalty.

¹²⁰ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 669 [32].

¹²¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1274 [243].

¹²² See also Lord Diplock in *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1446.

¹²³ A penal clause is not void ab initio, rather, it is unenforceable: see *Australian Capital Financial Management Pty Ltd v Linfield Developments Pty Ltd* (2017) 18 BPR 36 683, 36 750 [372]; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 568 [122].

¹²⁴ *Campbell Discount Co Ltd v Bridge* [1962] AC 600, 622. See also Lords Neuberger and Sumption in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1193–4 [7], 1194–5 [9].

¹²⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204-5, [32].

¹²⁶ *Ibid* 1285–6 [293].

¹²⁷ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 548 [34].

¹²⁸ *Ibid* 611–12 [268].

be suffered by the breaching party from having to pay the disproportionate amount of the sum stipulated. In *Ringrow*¹²⁹ the High Court observed: ‘a mere difference is not enough, let alone a suspicion of difference. The comparison calls for something “extravagant and unconscionable” ... it calls for a “degree of disproportion” sufficient to point to oppressiveness’.

In *Cavendish*¹³⁰ Lord Hodge relied upon a line of 19th century Scottish decisions decided on the basis that prevention of punishment was the proper rationale to be applied in determining whether a stipulation was a penalty. In *Craig v M’Beath*¹³¹ Lord Justice Clerk Inglis cited *Home v Hepburn*¹³² in support of the proposition that ‘parties cannot lawfully enter into an agreement that the one party shall be punished at the suit of the other’. Further, more reference was made to *Forrest v Henderson, Coulborn and Co*¹³³ where Lord President Inglis stated that equity would interfere to prevent a claim being maintained to an exorbitant and unconscionable amount.¹³⁴ In the same case Lord Kinloch¹³⁵ referred to a stipulation being ‘so utterly extravagant and unreasonable’ that the Court could infer that it was a penalty or punishment. These Scottish decisions were cited in the later judgments in *Clydebank* and *Dunlop*.

The rationale for the penalty doctrine proposed in this thesis finds support in the judgments in *Paciocco*, where for example Kiefel J said:¹³⁶

the basal purpose of the larger principle, or policy, of the law is not stated. That policy has not changed over time. It is that a sum of money may not be stipulated for on payment or default if it is stipulated as a threat over the person obliged to perform; it may not be stipulated where the purpose and effect of requiring payment is to punish the defaulting party.

In the same decision, Keane J¹³⁷ observed ‘The real objection, as a matter of public policy, to a penalty clause which operates upon breach of contract is that it is no part of the law of contract to allow one party to punish the other for non-performance.’ That exposition of the rationale for the penalty doctrine is consistent with *Legione v Hateley*¹³⁸ which was endorsed in *Andrews*¹³⁹ and *Cavendish*.¹⁴⁰

In *Paciocco*,¹⁴¹ Gageler J observes that: ‘the relevant indicator of punishment lies in the negative incentive to perform being so far out of proportion with the positive interest in performance that the negative incentive

¹²⁹ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 666 [21], quoting *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193.

¹³⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1277–8 [253]; see also Gageler J in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 570 [131].

¹³¹ *Craig v M’Beath* (1863) 1 M 1020, 1022.

¹³² *Home v Hepburn* (1549) Mor 10033; see also *Robertson v Driver’s Trustees* (1881) 8 R 555, 562.

¹³³ *Forrest v Henderson, Coulborn and Co* (1869) 8 M 187, 193.

¹³⁴ The same expression was used by Lords Deas, Ardmillan and Neaves at 198, 199 and 203.

¹³⁵ (1869) 8 M 187, 201.

¹³⁶ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 547–8 [32] citing *Legione v Hateley* (1983) 152 CLR 406, 445; the other justices provided similar commentary: see Gageler J at 578 [158], 579 [159], see Keane J at 595 [221], 601 [240], 612 [270]; and *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32], 1248 [243].

¹³⁷ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 605–6 [253], citing *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32], 1246 [148], 1278 [254], 1285 [291].

¹³⁸ *Legione v Hateley* (1983) 152 CLR 406, 445.

¹³⁹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [9].

¹⁴⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [31]–[32], 1246 [148].

¹⁴¹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 580–1 [164]–[165], 605–6 [253].

amounts to deterrence by threat of punishment'. In *Campbell Discount Co Ltd v Bridge*,¹⁴² Lord Radcliffe had said the description of a penalty as a threat to be enforced 'in terrorem' added nothing to the requisite analysis. However, in *Paciocco*, Gageler J¹⁴³ rejected this outright and concluded that the description 'in terrorem' actually 'captures the essence of the conception to which the whole of the analysis is directed'.¹⁴⁴ He said that framing the inquiry in terms of whether the stipulation is properly characterised as having no purpose other than to punish compels a more tailored inquiry into the commercial circumstances that led the parties to enter into the contract as they did and including the stipulation.

In *Paciocco*, Gageler J¹⁴⁵ cited with approval from the opinion of Frankfurter J in *Priebe and Sons Inc v United States* where he had said 'the infliction of punishment through courts is a function of society and should not inure for the benefit of individuals'. In *Paciocco*,¹⁴⁶ Nettle J put it this way:

the law of penalties ... It is concerned with whether an obligation to make a payment on breach of a contractual or other principal obligation is of an amount which is grossly disproportionate to the foreseeable consequences of breach. In effect, the gross disproportion is in itself sufficient to render the obligation 'unconscionable' and therefore unenforceable.

The 'obligation' referred to by Nettle J is payment of the stipulated sum and the relevant inquiry is whether that sum is grossly disproportionate. If there is gross disproportion then payment is not warranted as the sum stipulated for is a penalty. In that circumstance the amount of the sum to be paid is therefore extravagant and unconscionable and it is the gross disproportion in the sum payable which amounts to punishment of the breaching party, and a stipulation exhibiting this characteristic is not enforced.

The rationale for the penalty doctrine supported in this thesis, ie: prevention of punishment, has its critics. Roger Halson¹⁴⁷ does not support the rationale and in particular he argues decisions such as *Priebe and Sons Inc v United States*¹⁴⁸ which support the theory that punishment is something that should be the responsibility of the state is 'both emotive and over-general'.¹⁴⁹ He argues that application of the current law will often result in the enforcement of liquidated damages clauses that over-compensate the non-breaching party. These observations were made by Halson mindful of the decisions in *Cavendish* and *Paciocco* but fail to take into account the fulsome analysis which the UK Supreme Court and the High Court undertook of the decisions that preceded *Dunlop* and the decision in *Dunlop* itself. Both *Cavendish* and *Paciocco* in clear language endorse prevention of punishment as the rationale for the doctrine. Another critic is Nicholas Tiverios¹⁵⁰ who questions whether it is convincing to characterise the typical penal clause as providing for a form of 'punishment'. In his opinion this is due to the typical judicial reticence to depart from the agreed remedy provided for in the parties' contract which means the parties are afforded a generous margin to set

¹⁴² *Campbell Discount Co Ltd v Bridge* [1962] AC 600, 622.

¹⁴³ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 580–1 [165].

¹⁴⁴ Keane J expressed a similar opinion at *ibid* 607 [259].

¹⁴⁵ *Ibid* 577–8 [155], citing *Priebe and Sons Inc v United States*, 332 US 407, 417–18 (1947).

¹⁴⁶ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 630–1 [330].

¹⁴⁷ Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 132–5, [4.56]–[4.59].

¹⁴⁸ *Priebe and Sons Inc v United States*, 332 US 407, 418 (1947).

¹⁴⁹ Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 134 [4.58].

¹⁵⁰ Tiverios, above n 8, 468–9; see also Collins, above n 5, 373–9; similar observations to those of Tiverios were made in Sarah Worthington, 'Common Law Values: The Role of Party Autonomy in Private Law' in Andrew Robertson and Michael Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (Hart Publishing, 2016) 301, 318.

their own contractual terms.¹⁵¹ These observations were made before *Paciocco* was decided and must be considered in that light.

The rationale for the penalty doctrine is based on a long line of authority and has the support of the High Court and the UK Supreme Court. It is consistent with the position that, before a stipulation will be found to be a penalty it must be out of all proportion. Courts are very slow to conclude that *inter partes* stipulations, particularly in negotiated commercial contracts between properly advised parties of comparable bargaining power offend this requirement. Having confirmed the rationale for the penalty doctrine this Part will consider whether awards of exemplary damages fall within the purview of the penalty doctrine.

2.3.2 Exemplary Damages and the Penalty Doctrine

In *Broome v Cassell*,¹⁵² Lord Hailsham said he preferred the term ‘exemplary damages’ to ‘punitive damages’ as better expressing the policy of the law. Exemplary damages are generally not available for breach of contract in Australia¹⁵³ and England.¹⁵⁴ Exemplary damages are awarded in tort to punish a breaching party, rather than to compensate a non-breaching party for the loss suffered due to the conduct of the breaching party. In its 1997 Report¹⁵⁵ the Law Commission (UK) concluded there were a number of reasons why exemplary damages are not generally available as a remedy for a breach of contract. Firstly, the award of such damages is not conducive to commercial predictability. Secondly as an award of exemplary damages is a court awarded remedy¹⁵⁶ it is in that regard contrary to remedial terms agreed *inter partes* (eg liquidated damages) where the parties consensually and autonomously allocate rights and duties.¹⁵⁷ Thirdly if exemplary damages were to be awarded for contractual breach then contracting parties would be deterred from breaching their agreements even if it was efficient for them to do so.¹⁵⁸ Another major policy argument against the award of exemplary damages in contract is that it would have the effect of introducing punishment into the civil law which confuses the civil and criminal functions of the law. The practical effect is ‘it would provide judicial usurpation of legislative function that exposes civil litigants to criminal liability without the attendant constitutional and procedural safeguards’.¹⁵⁹

Solene Rowan¹⁶⁰ has observed that ‘penalty clauses are a close cousin of punitive damages. As with

¹⁵¹ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 669 [31]–[32].

¹⁵² *Broome v Cassell* [1972] AC 1027, 1073.

¹⁵³ However, in *Egan v State Transport Authority* (1982) 31 SASR 481, because of extreme factual circumstances, exemplary damages were awarded for breach of a construction contract.

¹⁵⁴ The leading authority is *Addis v Gramophone Co Ltd* [1909] AC 488 where the House of Lords refused to award exemplary damages for the abrupt and oppressive way in which, in breach of contract, an employee had been terminated by an employer. Exemplary damages may be awarded in tort in three situations set out by Lord Devlin in *Rookes v Barnard* [1964] AC 1129.

¹⁵⁵ Law Commission, *Aggravated, Exemplary and Restitutionary Damages*, Report No 247 (1997) 118–19 [1.72].

¹⁵⁶ See *Harris v Digital Pulse Pty Ltd* (2003) 56 NSWLR 298, 312 [57]–[60].

¹⁵⁷ Law Commission, *Aggravated, Exemplary and Restitutionary Damages*, above n 155, 118–19 [1.72]; Katy Barnett and Sirko Harder, *Remedies in Australian Private Law* (Cambridge University Press, 2014) 303.

¹⁵⁸ Law Commission, *Aggravated, Exemplary and Restitutionary Damages*, above n 155, 118–19 [1.72]. Despite the Law Commission’s reference to efficient breach theory it has shown ‘no signs of purchase on the English judiciary’ — see Adam Kramer, *The Law of Contract Damages* (Bloomsbury, 2nd ed, 2017) 18. The theory has also been repudiated in Australia by the High Court in *Zhu v Treasurer (NSW)* (2004) 218 CLR 530, and *Tabcorp Holdings Ltd v Bowen Investments Pty Ltd* (2009) 236 CLR 272. See below at [2.4.2]. Accordingly, it can be disregarded as an argument that favours the unavailability of exemplary damages as a remedy for breach of contract.

¹⁵⁹ Pey-Woan Lee, ‘Contract Damages, Corrective Justice and Punishment’ (2007) 70 *Modern Law Review* 887, 888.

¹⁶⁰ Solene Rowan, *Remedies for Breach of Contract: A Comparative Analysis of the Protection of Performance* (Oxford University Press, 2012) 220.

punitive damages the purpose of penalty clauses is to deter and punish'. In *Paciocco*,¹⁶¹ Keane J referred to exemplary damages and said that 'courts have consistently refused to countenance the enforcement of attempts to impose punishment or to threaten such punishment'. Keane J also cited with approval from the judgment of Lord Hoffmann¹⁶² that 'the purpose of the law of contract is not to punish wrongdoing but to satisfy the expectations of the party entitled to performance'.

The law will not enforce a liquidated damages clause that is truly in the nature of punishment where in reality it constitutes a payment of exemplary damages for breach of the contract. Alternatively and consistent with the rationale for the penalty doctrine advocated in this thesis, the courts will not enforce stipulations providing for payment upon breach of contract providing for exemplary damages in the guise of liquidated damages.

From the foregoing consideration of the rationale for the penalty doctrine and the conclusion that there is no role for exemplary damages in the penalty doctrine this Part will consider whether freedom of contract and inequality of bargaining power are relevant to the operation of the penalty doctrine.

2.3.3 Freedom of Contract and Inequality of Bargaining Power

Contracting parties are free (subject to public policy) to agree the amount of damages payable upon breach of contract. Such a stipulation can provide for the payment of money (ie: the standard application)¹⁶³ the transfer of property or forfeiture of monies or property.¹⁶⁴ It used to be said that it is not for the courts to rewrite the parties' contracts, and as long ago as 1875, Sir George Jessel MR observed:

if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by the courts of justice.¹⁶⁵

This individualistic approach however, has its limits and the penalty doctrine is one such limitation. In *Biotechnology Australia Pty Ltd v Pace*,¹⁶⁶ Kirby P observed it is 'an attribute of a free society ... that it is generally left to parties themselves to make bargains'. However, the principle of freedom of contract¹⁶⁷ is elusive as it lacks definition. John W Carter has observed that freedom of contract involves three assumptions namely freedom whether to contract¹⁶⁸ freedom with whom to contract and freedom to negotiate the terms of a contract.¹⁶⁹ Carter's assumptions are subject to a number of qualifications. Firstly it is assumed that parties predominantly enter into contracts for business purposes however it is not unusual

¹⁶¹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 606 [254], citing *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1278 [254], 1285–6 [291]–[293].

¹⁶² *Co-Operative Insurance Society Ltd v Argyll Stores (Holdings) Ltd* [1998] AC 1, 15.

¹⁶³ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 662 [10].

¹⁶⁴ *Ibid* 669 [31].

¹⁶⁵ *Printing and Numerical Registering Co v Sampson* (1875) LR 19 Eq 462, 465. Similar sentiments were expressed by Lord Roskill in *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399, 403; and more recently by Lord Neuberger in *Arnold v Britton* [2015] AC 1619, 1628–9 [20].

¹⁶⁶ *Biotechnology Australia Pty Ltd v Pace* (1988) 15 NSWLR 130, 133.

¹⁶⁷ Stephen A Smith, *Contract Theory* (Oxford University Press, 2004) 59 provides that '[f]reedom of contract refers to the idea, fundamental in the orthodox understanding of contract law, that the content of a contractual obligation is a matter for the parties, not the law'.

¹⁶⁸ Stephen A Smith (*ibid*) provides that '[f]reedom to contract refers to what is arguably the most basic requirement for establishing a contractual obligation: that the person obliged undertook to do something.'

¹⁶⁹ Carter, *Contract Law in Australia*, above n 99, 8 [1.08].

for the commercial seller to be in a better contractual position than its counterpart, the consumer purchaser. Secondly inequality of bargaining power is the touchstone of consumer or standard form contracts¹⁷⁰ which has led to statutory intervention seeking to protect the weaker contracting party.¹⁷¹ Thirdly contracts are frequently informal with little genuine negotiation of the terms and obligations are often created by implied terms¹⁷² from the common law¹⁷³ or by statute.¹⁷⁴

The courts have said many times, the power to strike down a penalty clause 'is a blatant interference with freedom of contract'.¹⁷⁵ Lords Neuberger and Sumption observed as much in *Cavendish*¹⁷⁶ and added that 'the penalty rule ... undermines the certainty which parties are entitled to expect of the law'. Their Lordships referred to what Lord Diplock had said in *Robophone*¹⁷⁷ that 'the court should not be astute to descry¹⁷⁸ a penalty clause'. Further, they referred to the speech of Lord Woolf in *Philips*¹⁷⁹ where he observed 'the court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld', not least because 'any other approach will lead to undesirable uncertainty especially in commercial contracts'. Where there is evidence that the sum stipulated results from commercial negotiations the courts have displayed an interest and willingness to enforce the intentions of the parties by upholding the stipulation¹⁸⁰ and the law has developed to a stage where only 'egregious' stipulations will not be enforced¹⁸¹ and in situations where the breaching party contends that a stipulated sum is a penalty it will face a 'high hurdle'.¹⁸²

The law recognises there are exceptions to the principle of freedom of contract and in *Paciocco*, Keane J observed that freedom of contract is not 'a universal legal value'¹⁸³ which means the principle must yield, for example, to statutes providing relief against 'unconscionable conduct'¹⁸⁴ 'unjust transactions'¹⁸⁵ and 'unfair'¹⁸⁶ contract terms. Accordingly, contracting parties are not free to contract as they wish¹⁸⁷ and in fact

¹⁷⁰ *Schroeder Music Publishing Co Ltd v Macaulay* [1974] 1 WLR 1308, 1316.

¹⁷¹ See, eg, *Competition and Consumer Act 2010* (Cth) sch 2 ('*Australian Consumer Law*'); *Goods Act 1958* (Vic); *Building and Construction Industry Security of Payment Act 2002* (Vic).

¹⁷² Carter, *Contract Law in Australia*, above n 99, 8 [1.08].

¹⁷³ For example, in a construction contract, that work will be done in a good and tradesmanlike manner: *Pearce v Tucker* (1862) 3 F & F 136; 176 ER 61.

¹⁷⁴ For example, that goods will be reasonably fit for purpose and of merchantable quality; see *Goods Act 1958* (Vic) s 19.

¹⁷⁵ Dickson J in *Elsley v J G Collins Insurance Agencies Ltd* [1978] 2 SCR 916, 937, approved by the Privy Council in *Philips Hong Kong Ltd v A-G (Hong Kong)* (1993) 61 BLR 41, 58; and also by the UK Supreme Court in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1205 [33], 1275–6 [248].

¹⁷⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1216–17 [73].

¹⁷⁷ *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1447.

¹⁷⁸ To cry out, declare, make known.

¹⁷⁹ *Philips Hong Kong Ltd v A-G (Hong Kong)* (1993) 61 BLR 41, 59.

¹⁸⁰ *Ibid* 58; *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428; *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005) [15], [70], [114], [118]; *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] BLR 271, 279–80 [48]; *Azimut-Benetti SpA v Healey* (2011) 1 Lloyd's Rep 473; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172. *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1280 [266].

¹⁸¹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 553 [53].

¹⁸² *Ibid* 594–5 [220], citing *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 215–16 [5].

¹⁸³ *Australian Securities and Investments Commission Act 2001* (Cth) s 12CB; *Fair Trading Act 1999* (Vic) s 8.

¹⁸⁴ *National Consumer Credit Protection Act 2009* (Cth) sch 1 ('*National Credit Code*'); *National Credit Code* s 76.

¹⁸⁵ *Fair Trading Act 1999* (Vic) pt 2B; *Australian Securities and Investments Commission Act 2001* (Cth) ss 12BF, 12BG; and the *Competition and Consumer Act 2010* (Cth) sch 2 Australian Consumer Law provides in s 25(1) examples of unfair terms of a consumer contract or small business contract and in s 25(1)(c) specifying 'a term that penalises, or has the effect of penalising, one party (but not another party) for a breach or termination of the contract.' Statutory provisions of this nature may have a possible effect for liquidated damages provisions.

¹⁸⁶ Barnett and Harder, above n 157, 304.

their freedom to contract is relevantly a freedom set within the limits dictated by Parliament which provides certain remedial protections to consumers in an effort to prevent abuse.

The elusive freedom of contract principle is open to question in contracts which have been entered into where there has been inequality of bargaining power. This is predominantly so in consumer contracting where standard form contracts are the norm. When considering whether consumer contracts should be treated differently a number of issues arise. Firstly inequality of bargaining power of itself is not a ground for contractual invalidity. Invalidity is dependent on the stronger party doing more. It must be found to have taken unfair advantage of the weaker party eg: duress, unconscionable conduct, undue influence. Secondly exact equality of bargaining power between contracting parties is rarely achieved in consumer contracts as there is always going to be a stronger party. Thirdly inequality of bargaining power more often means inequality of bargaining skill. Fourthly cases arise where the real issue is inequality of access to relevant information.¹⁸⁸ Fifthly there is a significant body of statutory protection now provided to consumers for example the *Australian Consumer Law*.¹⁸⁹

The historical position is reflected in decisions like *The Imperial Tobacco Company (of Great Britain and Ireland) Ltd v Parslay*¹⁹⁰ where the Court of Appeal was dismissive of the relevance of inequality of bargaining power in the determination of whether a stipulation is a penalty however this may well have been a sentiment of the times in 1936. In that case the trial judge had found a stipulation was a penalty due to disproportion in the bargaining power of the parties and in allowing the appeal, Lord Wright¹⁹¹ said he could not see any reason:

for introducing into a question of this sort any consideration of the relative wealth or poverty of the two parties. A millionaire may enter into a contract in which he is to pay liquidated damages, or a poor man may enter into a similar contract with a millionaire, but in each case the question is exactly the same, namely, whether the sum stipulated as damages for the breach was exorbitant or extravagant ...

In Australia, the relevance of the relative bargaining strength of the parties for the purposes of the penalty doctrine was considered and dismissed by the High Court in *Esanda Finance Corporation Ltd v Plessnig*¹⁹² where the majority in the South Australian Full Court decision under appeal had taken into account the inequality of bargaining power between the parties where the respondent had entered into a standard form hire purchase agreement with a financier and the Full Court found the impugned stipulation was a penalty. On appeal to the High Court Wilson and Toohey JJ considered the Full Court 'places too much emphasis'¹⁹³ on the superior bargaining position of the finance company which resulted in a wrong conclusion that the 'mere possibility of unfairness lurking in the formula' contained in the impugned stipulation was sufficient to characterise it as a penalty. The appeal was allowed and the finding of penalty set aside.

The position had softened by the 1990s when Lord Woolf observed in the Privy Council decision in *Phillips*

¹⁸⁸ See generally Furmston, above n 99, 25–6.

¹⁸⁹ See generally Carter, *Contract Law in Australia*, above n 99, 515–41 [24.01]–[24.31].

¹⁹⁰ *The Imperial Tobacco Company (of Great Britain and Ireland) Ltd v Parslay* [1936] 2 All ER 515.

¹⁹¹ Ibid 523.

¹⁹² *Esanda Finance Corporation Ltd v Plessnig* (1989) 166 CLR 131.

¹⁹³ Ibid 141–2.

Hong Kong Ltd v Attorney-General (Hong Kong):¹⁹⁴

Except possibly in the case of situations where one of the parties to the contract is able to dominate the other as to the choice of the terms of the contract, it will normally be insufficient to establish that a provision is objectionably penal to identify situations where the applications of the provision would result in a larger sum being recovered by the injured party than his actual loss.

However in *Andrews* and *Paciocco* the High Court showed no sign of considering whether it was relevant that ANZ's customers were consumers who had signed the bank's standard form contracts. In *Cavendish*¹⁹⁵ the UK Supreme Court considered it relevant that both parties had negotiated their contract and received advice from commercial lawyers. Inequality of bargaining power was not regarded as relevant to the litigants in that appeal. On the present state of the law neither principle discussed above has any role to play in deciding whether a stipulation is enforceable liquidated damages or a penalty.

2.3.4 Relief from Penalty: Unliquidated Damages

In common law systems, where a court finds a stipulation is a penalty the non-breaching party is not devoid of a remedy and the non-breaching party can claim unliquidated damages for the losses which it can prove were actually caused by the breach of contract.¹⁹⁶ Any claim for unliquidated damages is subject to all of the common law rules relating to the assessment of damages for breach of contract¹⁹⁷ such as causation, remoteness and mitigation.

Whether the impugned stipulation sets an upper limit or ceiling beyond which unliquidated damages may not be recovered remains an open question amongst some text book writers.¹⁹⁸ However this chapter argues that the stipulated sum is an upper limit or ceiling. The principle was best expressed in 1807 by Lord Ellenborough when he said: 'Beyond the penalty you shall not go; within it, you are to give the party any compensation which he can prove himself entitled to'.¹⁹⁹ In delivering the decision of the Privy Council in *Commissioner of Public Works v Hills*²⁰⁰ Lord Dunedin described a penalty as something which 'covers the damage if proved, but does not assess it', and held that the party in question was entitled 'to prove such damages not exceeding the sums in the penalties', 'as they can make out'.²⁰¹ A similar sentiment was expressed by the Canadian Supreme Court in *Elsley v J G Collins Insurance Agencies Ltd*²⁰² in the following terms: 'The party imposing the penalty should not be able to obtain the benefit of whatever intimidating force

¹⁹⁴ *Phillips Hong Kong Ltd v A-G (Hong Kong)* (1993) 61 BLR 41, 58.

¹⁹⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1205–6 [35].

¹⁹⁶ *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana; The Scaptrade* [1983] 2 AC 694, 702; *W&J Investments Ltd v Bunting* [1984] 1 NSWLR 331, 335–6.

¹⁹⁷ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 191, 212.

¹⁹⁸ On the one hand, J W Carter et al, 'Contractual Penalties: Resurrecting the Equitable Jurisdiction' (2013) 30 *Journal of Contract Law* 99, 116 express the opinion that 'the balance of authority favours the view that the amount stipulated in a penalty is not a cap on the promisee's damages entitlement' (citations omitted). On the other hand, Roger Halson, 'Remedies for Breach of Contract' in Michael Furmston (ed), *The Law of Contract* (LexisNexis, 6th ed, 2017) 1671, 1820 [8.128] expresses the contrary opinion that the stipulated sum constitutes a ceiling on recovery because 'in this way the law avoids committing itself to the absurdity, whenever the payee's actual loss exceeds the sum stipulated, of placing the person who deliberately stipulates for a penalty in a better position than someone who inserts a genuine pre-estimate of loss.'

¹⁹⁹ *Wilbeam v Ashton* (1807) 1 Camp 78, 78; 170 ER 883, 883, cited in Halson, 'Remedies for Breach of Contract', above n 198, 1671 [8.128].

²⁰⁰ *Commissioner of Public Works v Hills* [1906] AC 368, 375.

²⁰¹ *Ibid* 376.

²⁰² *Elsley v J G Collins Insurance Agencies Ltd* [1978] 2 SCR 916, 937.

the penalty clause may have had in inducing performance, and then ignore the clause when it turns out to be to his advantage to do so'. In England in *Royal Brompton Hospital NHS Trust v Hammond [No 8]*²⁰³ Lloyd J expressed the opinion that even if the liquidated damages provision in the relevant construction contract in question became inoperative 'the employer cannot recover more than the amount that would have been recoverable had the clause operated'.

These decisions all support the proposition that the amount of the stipulated sum represents a cap or ceiling on the amount recoverable as unliquidated damages. The cap or ceiling argument is supported as it is consistent with the benefits that accrue to those who utilise liquidated damages clauses namely that 'such clauses are used both to provide ease of calculation of the damages payable and to give the breaching party the benefit of a limit of liability.'²⁰⁴

2.3.5 Conclusion

The penalty doctrine is grounded in 'unconscionability' in the narrow sense in which that expression is used in *Dunlop* where the court is concerned to prohibit enforcement of stipulations the aim or purpose of which is punishment of the breaching party. Contractual provisions stipulating for punishment will not be enforced particularly where the stipulated sum is egregious, gross, extravagant or exorbitant in an amount that is out of all proportion. This protects the bargains of commercial parties and pays respect to party autonomy, the principle of freedom of contract and provides contractual certainty regarding the amount of recoverable damages and the potential liability of the breaching party. Part I has examined Lord Dunedin's four propositions and questioned their assumed status as '*Dunlop* Rules' to be mechanically followed. Two separate approaches to application of the *Dunlop* propositions ie: the mechanical and the equitable approaches have been identified and found to be inconsistent with the correct application of Lord Dunedin's four propositions. In *Ringrow*, the High Court returned to the proper application of *Dunlop*, and determined that before the stipulation can be a penalty it must be out of all proportion as mere disproportion is not enough. The rationale for the penalty doctrine advanced in this Part had its origins in Scots decisions which predate *Clydebank* and *Dunlop* and the rationale for the doctrine is supported by *Dunlop*, *Andrews*, *Cavendish* and *Paciocco*. Theorists who disagree with the rationale proposed in this chapter have failed to have proper regard to the reasoning in *Cavendish* and *Paciocco* which support the rationale. The relationship between the penalty doctrine and the principle of freedom of contract as well as inequality of bargaining power were examined. As regards the former the penalty doctrine is an exception but not one which will be enlivened very often given the present state of the law in Australia and England represented by *Cavendish* and *Paciocco*. As regards the latter, it has been engaged in a few decisions but the better view is that it is of no present relevance to the penalty doctrine. Part II will consider a variety of arguments from the law and economics literature and argues they provide significant support for the use of liquidated damages clauses in commercial contracts primarily so as these arguments promote economic efficiency.

²⁰³ *Royal Brompton Hospital NHS Trust v Hammond [No 8]* (2002) 88 Con LR 1, 45–6 [67].

²⁰⁴ Bailey, above n 60, vol II, 1217-8 [13.185]; Manly, 'The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages', above n 4.

PART II

2.4 Introduction

This Part explores the utility of liquidated damages clauses from a law and economics perspective.²⁰⁵ Economic analysis of the law commenced as a separate field of intellectual endeavour in the early 1960s, primarily at the Chicago School of Law and Economics²⁰⁶ and has expanded to include coverage of, inter alia, property, contracts, torts and criminal law.²⁰⁷ Law and economics theorists conclude that liquidated damages clauses are mutually beneficial as they provide contracting parties with the freedom to agree on the measure of compensation to be paid upon breach of contract. This leads to contractual certainty which is economically efficient and it is also consistent with acceptable levels of risk sharing which permits the incorporation of idiosyncratic claims for loss into the calculation of the amount of the stipulated sum.²⁰⁸

Contracting parties are free (subject to public policy considerations) to agree the sum payable in the event of a breach of contract.²⁰⁹ For example, in a construction contract a contractor may agree to pay \$1000 per day as liquidated damages for each day that a building remains unfinished after the contractual date for completion has passed. There are many reasons why parties might stipulate in their contracts the remedy for breach of the primary obligation²¹⁰ and they include considerations such as that the sum stipulated will function as an admitted pre-assessment of loss²¹¹ facilitating the non-breaching party's recovery of elements of loss that are difficult to assess;²¹² and that it can promote the settlement of potential disputes. Further

²⁰⁵ See, eg, Manly, 'The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages', above n 4; Robert L Birmingham, 'Breach of Contract, Damage Measures and Economic Efficiency' (1970) 24 *Rutgers Law Review* 273; Charles J Goetz and Robert E Scott, 'Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach' (1977) 77 *Columbia Law Review* 554; Philip R Kaplan, 'A Critique of the Penalty Limitation on Liquidated Damages' (1977) 50 *Southern Californian Law Review* 1055; Kenneth W Clarkson, Roger LeRoy Miller and Timothy J Muris, 'Liquidated Damages v Penalties: Sense or Nonsense' [1978] *Wisconsin Law Review* 351; Richard A Posner, 'Some Uses and Abuses of Economics in Law' (1978-9) 46 *University of Chicago Law Review* 281; Paul Rubin, 'Unenforceable Contracts: Penalty Clauses and Specific Performance' (1981) 10 *Journal of Legal Studies* 237; Eric L Talley, 'Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule' (1994) 46 *Stanford Law Review* 1195; Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 *American Journal of Comparative Law* 427; Robert A Hillman, 'The Limits of Behavioural Decision Theory in Legal Analysis: The Case of Liquidated Damages' (2000) 85 *Cornell Law Review* 717; Gerrit De Geest and Filip Wuyts, 'Penalty Clauses and Liquidated Damages' in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopaedia of Law and Economics* (Edward Elgar, 2000) vol 3, 141; Larry A Di Matteo, 'A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages' (2001) 38 *American Business Law Journal* 633; Aristides N Hatzis, 'Having the Cake and Eating It Too: Efficient Penalty Clauses in Common and Civil Contract Law' (2002) 22 *International Review of Law and Economics* 22; Larry A Di Matteo, 'Penalties as Rational Response to Bargaining Irrationality' [2006] *Michigan State Law Review* 883.

²⁰⁶ Ron Harris, 'The Uses of History in Law and Economics' (2003) 4 *Theoretical Inquiries in Law* 659, 664.

²⁰⁷ Cooter and Ulen, above n 17, 1; Richard A Posner, *Economic Analysis of Law* (Wolters Kluwer, 9th ed, 2014) 29–31; Anthony Ogus, *Costs and Cautionary Tales: Economic Insights for the Law* (Hart, 2006) 1–34.

²⁰⁸ Jeremy Thorpe, 'Economists Divided — Difference Perceptions of Contracts Penalty Doctrine' (1994) 6 *Bond Law Review* 189, 196.

²⁰⁹ See generally Law Reform Commission of Victoria, *Liquidated Damages and Penalties*, Discussion Paper No 10 (1988) 1–2; Manly, 'The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages', above n 4.

²¹⁰ Louise Gullifer, 'Agreed Remedies' in Andrew Burrows and Edwin Peel (eds), *Commercial Remedies: Current Issues and Problems* (Oxford University Press, 2003) 191; Manly, 'The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages', above n 4.

²¹¹ *Boucaut Bay Co Ltd (in liq) v Commonwealth* (1927) 40 CLR 98, 106; *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana*; *The Scaptrade* [1983] 2 AC 694; *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1447.

²¹² *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1448; Mindy Chen-Wishart, 'Controlling the Power to Agree Damages' in Peter Birks (ed), *Wrongs and Remedies in the Twenty-First Century* (Clarendon Press, 1996) 271, 276; Charles J Goetz and Robert E Scott, 'Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach', above n 205; Roger Halson, 'Pre-

each party can plan for the financial consequences of potential breach.²¹³ Liquidated damages clauses operate as an incentive to performance in circumstances where performance is more valuable to the breaching party than damages²¹⁴ as they can enable a non-breaching party to protect itself if the other party becomes a bad credit risk.²¹⁵ Finally as liquidated damages in law are characterised as a debt the rules of civil procedure permit the non-breaching party to adopt a quick legal process for recovery ie: summary judgment.²¹⁶

2.4.1 The Utility of Liquidated Damages Clauses: The Law and Economics Perspective

Economic efficiency requires that resources be allocated and risks assigned so that all possible gains from beneficial exchanges are exhausted.²¹⁷ Richard A Posner an economic theorist has observed ‘the common law exhibits a deep unity that is economic in character’²¹⁸ and further ‘much of the common law can be interpreted as aimed at maximising the wealth of society’.²¹⁹ A central driver to the economic analysis of the law is ‘efficiency’ which aims to promote wealth and the efficiency in question is transactional efficiency which focuses on costs which include the costs of contract drafting, negotiation, performance, and breach. Transactional efficiency is achieved when the transaction costs (ie: the time, effort and resources involved to consummate the contract) are proportionate to the end value of the subject matter of the contract.

It is generally efficient to permit parties to draft their own contracts including agreed remedy clauses and in the normal course the courts should (subject to public policy considerations) enforce the agreed terms of those contracts. Posner argues that the refusal of the common law to enforce penalty clauses in contracts ‘apparently promotes inefficiency’ and ‘remains a major unexplained puzzle in the economic theory of the common law’.²²⁰ The puzzling thing about the dichotomy between enforceable liquidated damages and unenforceable penalty clauses is the tension between the intention of the parties and the position taken by common law courts. The inefficiency referred to by Posner is the courts’ refusal to enforce the agreed terms of a contract. A rationale for the courts’ intervention is that it may be able to make the transaction more efficient by improving the bargain.

Liquidated damages clauses are used to minimise transaction costs and to create certainty for both parties. That certainty is of the amount one will pay and the other will receive upon breach of the contract and the use of liquidated damages clauses permits contracting parties to allocate and price risks. Risk management is an important consideration in contract negotiation and formation. The ability to agree the amount of liquidated damages recognises that parties have different tolerances to risk and may wish to negotiate the

²¹³ Estimated Damages’ in Donald Harris, David Campbell and Roger Halson (eds), *Remedies in Contract and Tort* (Cambridge University Press, 2nd ed, 2005) 133, 138, 141; Kaplan, above n 205, 1058.

²¹⁴ Kaplan, above n 205, 1058. For example, whether it has the right to sell land that was the subject matter of the contract: *Union Eagle Ltd v Golden Achievement Ltd* [1997] AC 514.

²¹⁵ E McKendrick and M Graham, ‘The Sky’s the Limit: Contractual Damages for Non-Pecuniary Loss’ [2002] *Lloyd’s Maritime and Commercial Law Quarterly* 161.

²¹⁶ *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752.

²¹⁷ Collins, above n 5, 368.

²¹⁸ David Campbell, ‘Introduction: The Function and Structure of Remedies for Failure to Perform a Contractual Obligation’ in Donald Harris, David Campbell and Roger Halson (eds), *Remedies in Contract and Tort* (Cambridge University Press, 2nd ed, 2005) 3, 12.

²¹⁹ Posner, *Economic Analysis of Law*, above n 207, 297.

²²⁰ *Ibid* 32.

²²⁰ Posner, ‘Some Uses and Abuses of Economics in Law’, above n 205, 290.

stipulated sum so the less risk-averse party at least partially protects or insures the more risk-averse party against a fixed amount of loss arising from a breach of the contract. Furthermore these types of clauses can be drafted to incorporate difficult components of prospective loss.²²¹

Liquidated damages clauses are also utilised because of the potential dissatisfaction by litigants with judicial approaches to the assessment of damages. These types of clauses can become important in circumstances where judicial damages assessments which are conducted ex post are more costly than the private assessments undertaken by the parties ex ante and additionally judicial assessments ex post can be inaccurate or even wrong (and subject to an appeal) when compared to the parties' ex ante assessment. Courts often experience difficulties with the calculation of damages recoverable for breach of contract.²²² Where it is difficult to calculate the extent of the non-breaching party's loss with any precision the court will do its best to arrive at an appropriate award of damages even if this involves elements of speculation or guesswork.²²³ Sometimes this will involve some estimation falling short of certainty where the court will seek 'as much precision as the subject matter reasonably permits'²²⁴ and sometimes it may be 'largely a matter of impression ... on the material available'.²²⁵ However if the non-breaching party is unable to prove it has suffered more than nominal loss as a consequence of a breach of contract then it will only be entitled to recover nominal damages.²²⁶

The risk of appealable legal error in the calculation of damages upon a finding of breach of contract are reduced by the use of liquidated damages clauses and clauses of this nature thereby provide the contracting parties with the benefit of additional contractual certainty. Economist Andrew Ham argues²²⁷ the greater the difficulty in proving loss the more likely it is that a liquidated damages clause will be enforced. This argument presupposes a genuine attempt had been made to accurately pre-estimate the future losses that would arise from a breach of contract and so avoid the difficulties of proving damages for the breach of contract once it arises. The higher the probability of enforcement of the liquidated damages clause, the greater will be the incentive on the breaching party to settle the non-breaching party's claim out of court and there is thereby a saving in post-breach transaction costs but this saving may be outweighed by pre-breach transaction costs eg: such as the extra costs incurred by the parties of negotiating the liquidated damages clause.

2.4.2 Efficient Breach Theory

Some economists argue the reason why clauses stipulating for a penalty are not enforced is because they impede efficiency by preventing 'efficient breaches' of the contract.²²⁸ Thus Joseph M Perillo²²⁹ has

²²¹ De Geest and Wuyts, above n 205, vol 3, 142; see *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1447–8; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193.

²²² Seddon, above n 60, 12–15.

²²³ Bailey, above n 60, vol II, 1170–1 [13.100]; *Chaplin v Hicks* [1911] 2 KB 786.

²²⁴ *Placer (Granny Smith) Pty Ltd v Thiess Contractors Pty Ltd* (2003) 196 ALR 257, 266 [37]–[38].

²²⁵ *Griffiths & Beerens Pty Ltd v Duggan* (2008) 66 ACSR 472, 536–7 [200].

²²⁶ Bailey, above n 60, vol II, 1170–1 [13.100]; *Tabet v Gatt* [2010] 84 ALJR 292.

²²⁷ Andrew Ham, 'The Rule against Penalties in Contract: An Economic Perspective' (1990) 17 *Melbourne University Law Review* 649, 659.

²²⁸ The Holmesian theory of efficient breach arose from the proposition about the nature of contractual promises advanced in Oliver Wendell Holmes, 'The Path of the Law' (1897) 10 *Harvard Law Review* 457, 462 where he stated '[t]he only universal consequence of a legally binding promise is that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfilment has gone by, and therefore free to break his contract if he chooses.' Birmingham, above n 205,

explained the efficient breach theory as:

the theory of efficient breach holds that if a party breaches, and is still better off after paying damages to compensate the victim of the breach, the result is Pareto superior,²³⁰ which means that considered as a unit, the parties are better off because of the breach and the breach makes no party worse off ...

This theory can be illustrated by the example²³¹ below which presumes there is an economic case for efficient breach. The example is based on the Holmesian theory that society should encourage and permit the breaching party to not perform the contract whenever the breach would leave it better off after fully compensating the non-breaching party. Assume D promises to sell a book to C for \$30 but before performance Y says to D that he will purchase the book from D for \$45. Efficiency may require D to breach his contract with C and sell the book to Y. Efficiency requires this if Y places a higher value on the book than C. So, if the value C places on the book is \$39, efficiency requires D to breach the contract he has with C, and sell the book to Y for \$45 and give C \$9 damages. A clause stipulating for a penalty may preclude these types of efficient breaches. If there were a penalty clause of say \$18 in C and D's contract, an efficient breach is prevented because D is going to be worse off if he breaches.

As the example seeks to identify, in theory there is a powerful incentive to breach a contract when it is in the breaching party's interests to pay compensation and deliberately withdraw performance where it expects to make a net profit from the opportunities created by a proposed breach.²³² The theory has been supported by Posner²³³ who has argued that a breach of contract which results in a transfer of goods or services from their promised low value use to a high value use is beneficial to society as a whole because it enhances 'efficient' economic behaviour.²³⁴

On the other hand, the efficient breach theory has been criticised by Craig Warkol on the basis it has had little demonstrable impact on real world legal arguments and judicial decisions.²³⁵ He points out the assumptions that underlay the theory are unrealistic, unprovable and run counter to the everyday world, to

284; Posner, *Economic Analysis of Law*, above n 207, 131; *Lake River Corporation v Carborundum Company*, 769 F 2d 1284 (Posner J) (7th Cir, 1985).

²²⁹ Joseph M Perillo, 'Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference' (2000) 68 *Fordham Law Review* 1085, 1091.

²³⁰ 'A Pareto efficient situation is one in which the welfare of one individual cannot be improved without reducing the welfare of others ... Pareto efficiency is thus a situation where all parties benefit, or none is harmed, by a reallocation of resources, goods, or assets, or a change in the law': see Vento Veljanovski, *Economic Principles of Law* (Cambridge University Press, 2007) 32.

²³¹ Prince Saprai, 'The Penalties Rule and the Promise Theory of Contract' (2013) 26 *Canadian Journal of Law and Jurisprudence* 443, 444–5, citing Andrew Burrows, *Remedies for Torts and Breach of Contract* (Oxford University Press, 3rd ed, 2009) 450.

²³² Campbell, above n 217, 11; Perillo, above n 229.

²³³ Posner, *Economic Analysis of Law*, above n 207, 131.

²³⁴ Note that in *Lake River Corporation v Carborundum Company*, 769 F 2d 1284 (7th Cir 1985) Judge Posner had to decide whether a stipulation in a packaging contract, where one party undertook to ship a minimum quantity of goods to another for packaging and if in default to pay for the difference between the quantity of goods shipped and the quantity guaranteed, was a penalty. In his academic capacity Judge Posner had argued for greater enforcement of such stipulations. However, he applied Illinois law and accepted the defendant's argument that enforcing the stipulation would produce an award in excess of actual damages, and found the stipulation to be a penalty and unenforceable.

²³⁵ Craig S Warkol, 'Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach' (1998) 20 *Cardozo Law Review* 321, 352–3. Katy Barnett, *Accounting for Profit for Breach of Contract: Theory and Practice* (Hart Publishing, 2012) 109–15; Barnett and Harder, above n 157, 321; Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 118–22 [4.38]–[4.41].

life experience and to the natural intuition of fair minded people.²³⁶ The theory has been lively food for thought and debate for law and economics scholars²³⁷ but its implementation and application are hardly ever accepted in the courts.²³⁸

Australian law does not accept the Holmesian theory that the breaching party has a right to elect either to perform the contract or pay damages. At common law the non-breaching party has the legal right to performance of the contract.²³⁹ Further the Holmesian assumption that anyone who enters a contract is at complete liberty to break it provided damages adequate to compensate the non-breaching party are paid has been criticised by the High Court²⁴⁰ as a submission which attempts to 'arrogantly impose a form of economic rationalism' onto the non-breaching party. Furthermore the assumption upon which the Holmesian theory is based fails to take into account equitable remedies namely specific performance and injunction which ensure or encourage performance of contracts rather than payment of damages for breach. As the theory has been repudiated by the judges in the High Court of Australia²⁴¹ it will not be further examined in this Part.²⁴²

2.4.3 Some Law and Economics Arguments Relative to Liquidated Damages

Law and economics scholars have recognised there are a variety of arguments supporting the use of liquidated damages clauses which can be beneficial to contracting parties.²⁴³ One of the major benefits arising from the use of liquidated damages clauses is the saving of court time as the judge is freed from the task of assessing evidence of damages.²⁴⁴ This was recently recognised by Lord Hodge in *Cavendish*²⁴⁵ where he observed 'there is beyond doubt real benefit to the parties being able to agree to the consequences of a breach of contract ... Parties save on transaction costs where they can avoid expensive litigation on the consequences of breach of contract'.

Liquidated damages clauses protect the allocation of contractual risk for both parties.²⁴⁶ On the one hand they are an exhaustive remedy providing certainty to the non-breaching party of recovery of the stipulated sum as a debt, and on the other hand, however they provide the breaching party with a cap on its liability.

²³⁶ Warkol, above n 235, 334–5, 337–9, 340; Perillo, above n 229.

²³⁷ Ibid 334, 340.

²³⁸ The theory has been labelled by Andrew Kull as 'hypothetical' and an 'academic artefact' that is 'as familiar in the classroom as it is difficult to find in real life': Andrew Kull, 'Disgorgement for Breach, the 'Restitution Interest' and the Restatement of Contracts' (2001) 79 *Texas Law Review* 2021.

²³⁹ *Coulls v Bagot's Executor and Trustee Co Ltd* (1967) 119 CLR 460, 504.

²⁴⁰ *Tabcorp Holdings Ltd v Bowen Investments Pty Ltd* (2009) 236 CLR 272, 285–96.

²⁴¹ *Zhu v Treasurer (NSW)* (2004) 218 CLR 530, 574–5 [128], where the High Court sets out the correspondence between Sir Frederick Pollock and Holmes J about the issue; *Tabcorp Holdings Ltd v Bowen Investments Pty Ltd* (2009) 236 CLR 272, 286–7 [13].

²⁴² See also Samuel King and James Nguyen, 'Equity's Obligation to Perform: Efficient Breach and the Inadequacy of Common Law Damages' (2014) 88 *Australian Law Journal* 874, in which the authors are critical of the efficient breach theory. They argue the common law provides contracting parties with recourse to compel the breaching party to perform eg: specific performance, injunction and account of profits. See also Jonathan Korman, 'The Measure of Damages for Breach of a Construction Contract where There Is No Economic Loss: An Examination and Evaluation of the Law in England and Australia' (2018) 34 *Building and Construction Law* 159, 174–6.

²⁴³ See generally De Geest and Wuyts, above n 205; Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 116–28 [4.34]–[4.48].

²⁴⁴ Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 *International and Comparative Law Quarterly* 600, 610; Pascal Hachem, *Agreed Sums Payable upon Breach of an Obligation* (Eleven International Publishing, 2011) 49.

²⁴⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1279 [259].

²⁴⁶ *Philips Hong Kong Ltd v A-G (Hong Kong)* (1993) 61 BLR 41, 55.

Loss and damage does not have to be proved and mitigation post-breach of the contract is not a relevant consideration.²⁴⁷ The certainty of outcome provided by an enforceable liquidated damages clause is reassuring to contracting parties and is of great importance to the proper and efficient operation of commerce. Risk allocation is a central motivating factor in every commercial transaction and a carefully drafted liquidated damages clause offers contracting parties that protection.²⁴⁸ By way of example²⁴⁹ suppose that a large number of the employees of company A need to attend an important business meeting. B is a transport company. A contracts with B to provide transport services. In their agreement, A may wish to transfer some of the risk of B's potential non-performance by stipulating for payment of a higher liquidated damages sum. If so, B could offset some of the risk it assumes by requiring A to pay a higher fee for the transport service. This arrangement allocates risk and makes sound commercial sense because B is encouraged to take greater care in its performance of the agreement, but stands to receive a higher fee as a result.

Economist Paul Rubin contends that any voluntary contract between two parties will generally be efficient as rational parties do not enter into agreements which do not benefit them.²⁵⁰ A liquidated damages clause is beneficial because the stipulated sum is payable irrespective of loss²⁵¹ which means that the use of such a clause is less likely to result in litigation, following the event of breach and thereby minimises transaction costs.²⁵²

Liquidated damages clauses create what economists refer to as a 'double responsibility at the margin'²⁵³ which means the breaching party has agreed to be responsible for payment of the stipulated sum to extinguish its liability for breach of the contract and the non-breaching party has agreed upon payment of the stipulated sum to accept responsibility for the value of and the consequences of the actual harm arising from the breach.²⁵⁴ By agreeing to a liquidated damages clause the potential breaching party receives an incentive to make provision for payment of an optimal amount of agreed damages which operates as a precaution against the relevant risk (eg: in the case of a construction contract it could be delay to completion). The non-breaching party obtains a perfect incentive to provide for all of its costs (ie: including remote costs and not just reliance costs), as it receives a fixed compensation in the event of a breach of

²⁴⁷ Justice Edelman, above n 99, 509 [16.022]; John Cooke and David Oughton, *The Common Law of Obligations* (Butterworth, 1989) 228; John Stannard, *Delay in the Performance of Contractual Obligations* (Oxford University Press, 2007) 276–7 [9.134]; *Abrahams v Performing Right Society Ltd* [1995] ICR 1028 where Hutchinson J held at 1040–1 that arguments about the duty to mitigate and mitigation were irrelevant to liquidated damages. This case was cited with approval in *MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2015] EWHC 283 (Comm) (12 February 2015) [69]–[71], affd [2016] EWCA Civ 789 (27 July 2016) [47]–[50].

²⁴⁸ Michael Hollingdale, 'Designing and Enforcing Liquidated Damages Clauses to Maximise Recovery' (2005) *Building and Construction Law* 412; Patrick Mead, 'Current Trends in Risk Allocation in Construction Projects and Their Implications for Industry Stakeholders' (2006) 22 *Building and Construction Law* 407; *Widnes Foundry (1925) Ltd v Cellulose Acetate Silk Co Ltd* [1931] 2 KB 393, 404, 406–7.

²⁴⁹ Adapted from the 'Case of the Anxious Alumnus' in Goetz and Scott, above n 205; see also Oliver Barron, 'The Penalty Doctrine: Reformulating New Zealand's Regime Against Penalty Clauses' (Student/Alumni Paper No 30/2018, Victoria University of Wellington Legal Research Papers, 2017) 25.

²⁵⁰ Rubin, above n 205, 241.

²⁵¹ Rossiter, above n 115, 139; *BFI Group of Companies Ltd v DCB Integration Systems Ltd* [1987] CILL 348 (12 June 1987); *Boucalt Bay Co Ltd (in liq) v Commonwealth* (1927) 40 CLR 98, 107.

²⁵² Rubin, above n 205, 243–4. See also John Carter and Elizabeth Peden, 'A Good Faith Perspective on Liquidated Damages' (2007) 23 *Journal of Contract Law* 157.

²⁵³ De Geest and Wuyts, above n 205, vol 3, 145. Robert Cooter, 'Unity in Torts, Contract and Property: The Model of Precaution' (1985) 73 *California Law Review* 1, 3–5 explains in fn 7 that 'the margin refers to the change in harm brought about by a small change in precaution by either party'.

²⁵⁴ Cooter, above n 253.

contract, regardless of the amount of loss it has actually incurred. This is not the case with expectation or reliance damages awarded by a court as the measure of damages for breach of contract at common law as recovery is limited by the rules of reasonable foreseeability and remoteness in *Hadley v Baxendale*²⁵⁵ and considerations of mitigation of loss.

2.4.3.1 Liquidated Damages Clauses and Transaction Costs

Liquidated damages clauses affect transaction costs which are examined at the ex ante and ex post stages. Economists Gerrit De Geest and Filip Wuyts²⁵⁶ argue that the use of liquidated damages clauses increase ex ante transaction costs²⁵⁷ which are incurred primarily by the non-breaching party to pre-estimate the damages that may arise from a future breach of contract. Any ex ante calculation is undertaken prospectively and takes account of all foreshadowed circumstances of potential breach. This is what makes the calculation difficult and explains why the courts countenance a generous difference between the stipulated sum and the greatest loss that could arise from the breach. The mitigation principle must also be taken into account in the ex ante calculation when deciding ex post whether the sum stipulated is a genuine pre-estimate.²⁵⁸

The ex ante analysis of transaction costs can be more expensive than one conducted ex post as the amount of costs incurred after the event should be able to be contained to the one event of breach and it is usually the position that significantly more information about the actual loss is available after the event. This means it should be possible for both parties to carry out a more accurate analysis of the financial consequences of breach ex post compared to the state of knowledge that exists at the ex ante stage. However, the fact that a more accurate analysis of damages is possible ex post does not mean the information will necessarily be less expensive to gather. The opposite may apply and the cost of analysis may be significant. The availability of information and the costs of its compilation will play a significant role in whether this argument can be sustained and information no matter when it is obtained requires the investment of resources to gather it in and then analyse it. However ex post involvement of lawyers has an effect on costs if arguments are pursued about the relevance and admissibility of the data or the use to which it may be put for the purposes of calculating damages for breach of contract at common law as an example.

The construction industry is a heavy user of standard form contracts²⁵⁹ which all provide for liquidated damages. The use of a standard form contract without amendment impacts on the amount of the ex ante transaction costs that are incurred and operates to keep them relatively low. The cost of negotiating and drafting the contract (which may be significant) are thus avoided. Recent empirical research²⁶⁰ conducted into the adoption of standard form contracts by the Australian construction industry confirms the use of liquidated damages clauses can increase pre-breach transaction costs. In 2013 the Melbourne University Law School's Construction Law Program, with the support of the Society of Construction Law Australia,

²⁵⁵ *Hadley v Baxendale* (1854) 9 Ex 341; 156 ER 145.

²⁵⁶ De Geest and Wuyts, above n 205, vol 3, 144.

²⁵⁷ These costs are those incurred by the parties in negotiating the terms of the liquidated damages clause and the amount of the liquidated damages sum itself or the formula to be used to calculate the liquidated damages amount.

²⁵⁸ Beale, above n 99, 1797, 1922 [26.187].

²⁵⁹ For example, in Australia, they are published by Standards Australia, the Master Builders Association, and the Royal Australian Institute of Architects.

²⁶⁰ See Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 99 [4.11] which states that empirical data is 'simply scarce'; but see also Sharkey et al, above n 2.

undertook a research project which investigated and assessed the current use and effectiveness of a range of the standard forms of construction contract in use in Australia. The research particularly inquired into the ability of the standard forms to reflect an appropriately balanced risk allocation and facilitation of efficient project administration. The research involved a web-based survey and interviews with construction industry stakeholders and the empirical data was published in a research report in June 2014,²⁶¹ concluding that in 84 per cent of the projects which used a standard form contract, that contract had been amended and those amendments were typically 'voluminous'. On 71 per cent of occasions, the clauses dealing with delay damages and including liquidated damages were amended. The findings from this research confirm empirically that the costs of negotiating and amending the provisions of standard form contracts used in Australia in the construction industry will add to the all-up ex ante transaction costs.

2.4.3.2 Saving of the Parties' and Court's Time

The argument most often presented by law and economics commentators²⁶² and jurists²⁶³ in support of utilising liquidated damages clauses is that they avoid the difficulty, uncertainty, delay and expense of proving actual loss,²⁶⁴ as they are self-enforcing. Thereby these clauses promote economic efficiency and protect risk allocation.²⁶⁵ In *AMEV-UDC Finance Ltd v Austin*,²⁶⁶ the High Court held that a liquidated damages clause 'makes for greater certainty by allowing the parties to determine more precisely their rights and liabilities consequent upon breach or termination.' Furthermore the enforcement of such provisions encourages "greater use of such provisions, [would] result in fewer breaches, fewer law suits, and fewer or easier trials, and in many cases [would] provide as just a result as a court trial ..."²⁶⁷

In the event the liquidated damages clause is enforced by the non-breaching party then the ex post calculation of actual loss ie: expectation damages is not necessary.²⁶⁸ Charles J Goetz and Robert E Scott²⁶⁹ observes that utilising liquidated damages clauses thus reduces transaction costs which occurs where the amount of the ex ante transaction costs ie: legal, accounting and executive time of negotiating the liquidated

²⁶¹ Sharkey et al, above n 2. For international trade contracts see the 'Report of the Secretary-General: Liquidated Damages and Penalty Clauses' (1979) 10 *Yearbook of the United Nations Commission on International Trade Law* 40.

²⁶² The difficulties in making a pre-estimate of loss are illustrated by an empirical study of liquidated damages in the holiday travel industry: Alan Milner, 'Liquidated Damages: an Empirical Study in the Travel Industry' (1979) 42 *Modern Law Review* 508. See also Ontario Law Reform Commission, *Report on Amendment of the Law of Contract* (1987) 139; Ham, above n 227; Roger Halson, 'Pre-Estimated Damages' in Donald Harris, David Campbell, Roger Halson (eds), *Remedies in Contract and Tort* (Cambridge University Press, 2nd ed, 2005) 133, 140; Burrows, above n 231, 449; Carter, *Contract Law in Australia* above n 99, 859–60 [37.07]; Brian Eggleston, *Liquidated Damages and Extensions of Time in Construction Contracts* (Wiley-Blackwell, 3rd ed, 2009) 41–2; Bailey, above n 60, vol II, 1186–7 [13.130].

²⁶³ See, eg, *Kemble v Farren* (1829) 6 Bing 141, 148; 130 ER 1234, 1237; *Diestal v Stevenson* [1906] 2 KB 345, 350; *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1447; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1279 [259]; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193.

²⁶⁴ *Wise v United States*, 249 US 361, 365–7 (1918), followed in *Bethlehem Steel Corp v Chicago*, 350 F 2d 649 (1965). See also *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 11; *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1445; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 616 [284].

²⁶⁵ Law Reform Commission of Victoria, *Liquidated Damages and Penalties*, above n 209, 1–2; see also California Law Revision Commission, *Recommendation and Study Relating to Liquidated Damages*, Publication No 104 (1973) 1208; Law Commission, *Penalty Clauses and Forfeiture of Monies Paid*, Working Paper No 61 (1975) 30; Ontario Law Reform Commission, above n 262, 139.

²⁶⁶ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193 (emphasis added); see also Lord Hodge in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1280 [259], citing *Wallis v Smith* [1882] 21 Ch D 243, 266.

²⁶⁷ Californian Law Reform Commission, *Recommendation and Study Relating to Liquidated Damages*, Publication No. 104 (1973) 1208-9.

²⁶⁸ Halson, 'Pre-Estimated Damages', above n 262, 140.

²⁶⁹ Goetz and Scott, above n 205.

damages clause incurred by the non-breaching party are less than the amount of the expected ex post transaction costs of litigation that may follow consequently upon breach of the contract. An enforceable liquidated damages clause has the practical effect of saving the non-breaching party from calculating its actual loss and damage ex post and saves the court from the time and expense of conducting a trial on that issue and assessing the amount of the non-breaching party's legally recoverable common law damages.

2.4.3.3 Recovery of Damages for Otherwise Unrecoverable Loss

At the time of contracting the non-breaching party may fear that damages assessed under the ordinary common law principles will lead to inadequate compensation due to an inability to recover for a head of loss the common law would consider to be too remote or unusual.²⁷⁰ The common law contractual measure of damages for loss of bargain looks to performance of the contract and seeks to protect the expectation interest of the non-breaching party and to place it as the victim of the breach of contract, so far as an award of damages can into the position it would have been in if the contract had been performed.²⁷¹ Losses that are too remote may not be recoverable in a claim for damages for breach of contract at common law as they are often difficult to calculate or not reasonably foreseeable as a result of the breach. A liquidated damages clause is mutually beneficial in such circumstances as it is the best way of dealing with the recovery of such losses.²⁷²

2.4.3.4 Liquidated Damages Clauses Avoid Adverse Selection Problems and 'Signal' That the Potential Breaching Party Is Reliable

Economists De Geest and Wuyts²⁷³ have identified that liquidated damages clauses operate to avoid 'adverse selection problems',²⁷⁴ or 'hidden information problems.'²⁷⁵ Adverse selection is a problem of knowledge, probabilities and risk which arises in two common scenarios. Firstly, insurance companies experience this type of problem due to the cost incurred by insurers in accurately distinguishing between high risk and low risk clients.²⁷⁶ Secondly, construction contractors will often experience uncertainty concerning the level of competence of a previously unknown tenderer. As these two scenarios demonstrate the adverse selection problem arises when the parties to a transaction have access to different information. For example where a potential breaching party does not know the magnitude of the losses, the non-breaching party may suffer in the event of a breach of the contract. The non-breaching party in all probability assumes ex ante that the potential breaching party represents an average risk in terms of breaching the

²⁷⁰ Halson, 'Pre-Estimated Damages', above n 262, 140. In *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1447 Diplock LJ refers to this type of loss as 'enhanced loss'.

²⁷¹ *Robinson v Harman* (1848) 1 Ex 850, 855; 154 ER 363, 365.

²⁷² *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1446–8 where Diplock LJ refers to such loss as 'enhanced loss'. A different approach was suggested by the Law Commission, in the Law Commission, *Penalty Clauses and Forfeiture of Monies Paid*, above n 265, 33 [44]. See also Louise Gullifer, 'Agreed Remedies' in Andrew Burrows and Edwin Peel (eds), *Commercial Remedies: Current Issues and Problems* (Oxford University Press, 2003) 191; Chen-Wishart, above n 212, 276; Goetz and Scott, above n 205; Halson, 'Pre-Estimated Damages', above n 262, 138, 146.

²⁷³ De Geest and Wuyts, above n 205, vol 3, 145; Cooter and Ulen, above n 17, 40, 48.

²⁷⁴ See Pengcheng Xiang and Xiangnam Song, 'Preventing Adverse Selection Risk of Construction Project Based on Signaling' (2014) 8 *Open Construction and Building Technology Journal* 439, defines 'adverse selection' as 'the dynamic game model of researching asymmetric information, which means the party that holds more information, uses other's ignorance of information to conceal relevant information for their own benefits, objectively leading to unreasonable distribution of market': at 439.

²⁷⁵ Keith Crocker and Arthur Snow, 'The Social Value of Hidden Information in Adverse Selection Economies' (1992) 48 *Journal of Public Economics* 317.

²⁷⁶ Cooter and Ulen, above n 17, 40, 48; Posner, *Economic Analysis of Law*, above n 207, 116–18.

contract and being able to pay damages as a consequence.²⁷⁷ By way of another example in the tender phase of a construction project the contractor may not know the technical strength of the tenderer or its level of management or service quality. Additionally the tenderer may be unclear about the contractor's intentions for the building its financial capacity and business reputation. In this situation adverse selection is prone to occur because of asymmetry between the information held by the two parties.²⁷⁸

The requirement of foreseeability provided in the common law test for the recovery of damages for breach of contract²⁷⁹ mitigates 'adverse selection problems' as it encourages the non-breaching party whose damages may be higher than usual or too remote to communicate this fact to the potential breaching party during contract negotiations on the basis it constitutes relevant information for risk assessment and calculation of the amount of the stipulated sum.²⁸⁰ In economic theory the offer by a potential breaching party to accept a liquidated damages clause may operate as a 'signal'²⁸¹ aimed at convincing the non-breaching party of the reliability of the other party. This may otherwise be difficult to prove if the parties do not have a trading history²⁸² and the risk of having to pay liquidated damages should operate as a disincentive to breaching the contract. The assurance of reliability is often more important where the potential breaching party is unknown to the non-breaching party, eg: it may be a newcomer to the market who as yet has no reputation for reliability. In the construction industry context instead of offering a lower tender price than its competitors the contractor may attempt to win the tender by putting itself at greater risk by agreeing to a higher sum as liquidated damages. This may be viewed by the principal as an assurance of reliability and operate as a substitute for having an established reputation thereby increasing the prospects of the contractor winning the tender. It has been suggested that such a clause is likely to be preferred by a new entrant into the market as 'being less costly than offering a lower price'.²⁸³ Therefore it is correct to say that liquidated damages clauses represent an assurance that the party will keep to its promise: "it makes him a credible person to do business with, and thus promotes commerce".²⁸⁴

2.4.3.5 Liquidated Damages Clauses Can Act as a Form of Insurance and Limitation of Liability

Economists Goetz and Scott²⁸⁵ theorise that the non-breaching party who obtains the consent of the potential breaching party to include in its contract a liquidated damages clause has thereby purchased a form of lump sum insurance²⁸⁶ which will provide protection against the consequences of non-performance by the potential breaching party. A liquidated damages clause will operate to place a cap or ceiling on the financial

²⁷⁷ De Geest and Wuyts, above n 205, vol 3, 145.

²⁷⁸ Xiang and Song, above n 274.

²⁷⁹ *Hadley v Baxendale* (1854) 9 Ex 341, 354–5; 156 ER 145, 151.

²⁸⁰ De Geest and Filip Wuyts, above n 205, vol 3, 145.

²⁸¹ Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 109–11 [4.22]–[4.25].

²⁸² Posner, *Economic Analysis of Law*, above n 207, 141; Halson, 'Pre-Estimated Damages', above n 262, 139–42; Cooter and Ulen, above n 17, 322.

²⁸³ Timothy J Muris, 'Opportunistic Behaviour and the Law of Contracts' (1981) 65 *Minnesota Law Review* 521, 582–3. This possible function has been promoted in America, see Erica Baffi, 'Efficient Penalty Clauses with Debiasing: Lessons from Cognitive Psychology' (2013) 47 *Valparaiso University Law Review* 993, 995; and in Canada see Paul-Erik Veel, 'Penalty Clauses in Canadian Contract Law' (2008) 66 *University of Toronto Faculty of Law Review* 229, 251.

²⁸⁴ *XCO International Inc v Pacific Scientific Company* 369 F 3d 998, 1001 (2004).

²⁸⁵ Goetz and Scott, above n 205; Cooter and Ulen, above n 17, 41.

²⁸⁶ This would be represented by the amount of the total liquidated damages sum payable upon breach of the contract.

risk the potential breaching party is willing to accept.²⁸⁷ If the stipulated sum is in fact insufficient to fully compensate the non-breaching party for its losses that party is encouraged to seek further protection and to insure against the consequences of non-performance.²⁸⁸

Parties to a contract may agree that in the event of breach the breaching party will pay a liquidated sum which is demonstrably less than the likely loss, ie: under-liquidated damages.²⁸⁹ In that circumstance the stipulation will act as a limitation of liability and Hugh Beale comments that clauses which under-liquidate damages 'are often the basis of the insurance arrangements to be made by the parties.'²⁹⁰ The practical effect of an under-estimate is that the breaching party benefits as it accepts liability for loss only up to the amount of the stipulated sum while the non-breaching party accepts the risk of any excess loss over this figure. There is a distinction between a liquidated damages clause and a limitation of liability clause. Pursuant to the former clause the breaching party will be obliged to pay the full amount of the stipulated sum even though the non-breaching party's actual loss is less or none at all²⁹¹ whereas pursuant to the latter clause the breaching party will only be obliged to pay the non-breaching party the amount of its loss that can be proved up to the fixed limit.²⁹²

In conclusion Part II has argued there are a variety of law and economics arguments supportive of the utility of liquidated damages clauses. The most often cited justifications relate to economic efficiency in terms of removing problems associated with the calculation of actual recoverable loss. Those problems include difficulty, delay, uncertainty and expense. Furthermore justifications are based on agreed risk allocation between contracting parties and certainty together with the prospect that unusual losses may be incorporated into the stipulation.

PART III

2.5 Conclusion

This Chapter has analysed *Dunlop* which was the 'leading authority'²⁹³ or 'locus classicus'²⁹⁴ on the penalty doctrine which settled the law for just over a century. In his speech Lord Dunedin set out four propositions to be applied to assist in determining whether a stipulation is liquidated damages or an unenforceable penalty. Lord Dunedin's formulation of the penalty doctrine involves an inquiry whether as at the date of the contract the stipulated sum is a genuine pre-estimate of the greatest loss that could arise as a consequence of a

²⁸⁷ Roger Halson, 'Pre-Estimated Damages', above n 262, 141–2; Posner, 'Some Uses and Abuses of Economics in Law', above n 205, 290; *Multiplex Constructions Pty Ltd v Abgarus Pty Ltd* (1992) 33 NSWLR 504, 519; *Cellulose Acetate Silk Co, Ltd v Widnes Foundry (1925), Ltd* [1933] AC 20.

²⁸⁸ Goetz and Scott, above n 205; Halson, 'Pre-Estimated Damages', above n 262, 141–2.

²⁸⁹ William F Fritz, 'Under Liquidated Damages as Limitation of Liability' (1954) 33 *Texas Law Review* 196; Halson, 'Remedies for Breach of Contract', above n 198, 1671 [8.129]; Halson, *Liquidated Damages and Penalty Clauses*, above n 1, 78–83 [3.10]–[3.17].

²⁹⁰ Beale, above n 99, 1931 [26.201] (emphasis added).

²⁹¹ *BFI Group of Companies Ltd v DCB Integration Systems Ltd* [1987] CILL 348 (12 June 1987); *Boucaut Bay Co Ltd (in liq) v Commonwealth* (1927) 40 CLR 98, 106–7.

²⁹² Burrows, above n 231, 448; G H Treitel, *Remedies for Breach of Contract: A Comparative Account* (Clarendon Press, 1988) 208–44.

²⁹³ *Lansat Shipping Co Ltd v Glencore Grain BV (The Paragon)* [2009] 1 Lloyd's Rep 658, 662 [17].

²⁹⁴ *Edgeworth Capital (Luxembourg) SARL v Ramblas Investments BV* [2015] EWHC 150 (Comm) (30 January 2015) [61].

breach of the contract. It would not be a genuine pre-estimate if the sum stipulated was extravagant and unconscionable in amount. Lord Dunedin's four propositions were often applied by the courts in a mathematical or formulaic fashion which led to a rigid dichotomy between genuine pre-estimate and a penalty. An alternative equitable approach also developed and the proponents of that approach were primarily Wilson and Mason JJ in their decision in *AMEV-UDC Finance Ltd*.²⁹⁵ This approach concentrated on the nature of the relationship between the contracting parties and whether that may make enforcement of the stipulation unconscionable. As such this was an approach which led to a movement away from the narrow sense in which the expression 'unconscionable' had been used in *Dunlop*.

In *Ringrow*, the High Court restated the relevant rule for penalties as being the formulation provided for in *Dunlop*, but that the stipulation must be 'out of all proportion' before it could be set aside as a penalty. The relevant test was recalibrated to concentrate on the degree of disproportion between the stipulation and the greatest loss as mere disproportion was not enough. Application of the *Dunlop* formulation as 'bright line' rules complicated the process for judges. Lord Dunedin's four propositions were not drafted by him on the basis that they were strictly enforceable rules. In fact, they were a convenient summary of the then existing state of the law which included three decisions of relatively recent origin.²⁹⁶ As was argued in Part I there is a distinction between rules and standards with greater flexibility being provided by the latter and Lord Dunedin's four propositions are a series of standards which will assist and guide when a stipulation is challenged on the grounds it is a penalty.

Re-examination of the speeches in *Clydebank* and *Dunlop* carried out, in particular, by the UK Supreme Court in *Cavendish* and later by the High Court in *Paciocco*, revealed that the reasons for judgment in these earlier decisions had been founded on considerations of not enforcing stipulations that were aimed at punishing the breaching party. The expressions 'extravagant, exorbitant and unconscionable' originated in early 19th century Scots decisions and had been repeated in *Clydebank* and *Dunlop*. Those expressions are of narrow compass and descriptive of the level of disproportion in the amount of the stipulated sum. Punishment is not a concern for the civil law and the judgments in *Cavendish* and *Paciocco* refer to the avoidance of punishment as the rationale that underpins the penalty doctrine. This rationale is consistent with the general unavailability of an award of exemplary damages for breach of contract save in the most extreme cases.²⁹⁷

This Chapter has supported a rationale for the penalty doctrine based on the reinterpretation of *Dunlop* carried out in *Cavendish* and *Paciocco*. The courts' reconsideration of *Dunlop* has led to the formulation of fresh tests to determine whether an impugned stipulation is a penalty in equity or at common law. The penalty doctrine is an exception to the principle of freedom of contract as the law of contract which as a matter of public policy refuses to enforce stipulations permitting one party to punish the other and the penalty doctrine operates as a bulwark against this type of oppressive behaviour. However, a stipulation will be enforced unless it can be proved that it is egregious or grossly disproportionate in the sense of providing for

²⁹⁵ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 190–3.

²⁹⁶ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6; *Commissioner of Public Works v Hills* [1906] AC 368; *Webster v Bosanquet* [1912] AC 394.

²⁹⁷ For example, see *Egan v State Transport Authority* (1982) 31 SASR 481.

payment of a sum that is out of all proportion. As this is not likely to occur often as the penalty doctrine is rarely successfully invoked, and this protects freedom of contract and provides increased certainty to contracting parties with regard to party autonomy. However as will become evident in chapters 4 and 5 the penalty doctrine is not a dead letter and continues to be applied.

Inequality of bargaining power is not a relevant factor in the determination of whether a stipulated sum is a penalty in equity or at common law. However for example it is a relevant factor²⁹⁸ for the court to consider for statutory unconscionable conduct prohibited by *Australian Consumer Law* s 21. This factor did not feature as relevant in the leading decisions of *Andrews*, *Cavendish* or *Paciocco*. Liquidated damages clauses are economically efficient and their benefits and utility have been acknowledged in Part II. By and large the law and economics literature is supportive of the use of liquidated damages clauses as they are efficient and promote wealth. They operate in a manner that can provide certainty to the contracting parties and allocate risks. Upon breach loss does not have to be proved the liquidated sum is a debt and therefore, mitigation is not a relevant consideration. These types of clauses are well recognised as protectors of risk allocation and provide contractual certainty because they are self-enforcing. It is acknowledged by economists they may have an effect on transaction costs as they provide a signalling function that may confirm contractual reliability as well as protecting the non-breaching party's ability to recover unusual losses which may not be recoverable as damages for breach of contract.

The common law does not deprive the non-breaching party of a remedy if a stipulation is found to be an unenforceable penalty. It is entitled to recover its unliquidated damages for breach of contract. Despite a lack of unanimity amongst text book writers this chapter argues the better view based on the authorities is that the amount of the impugned stipulation reflects the ceiling or cap on recovery of the amount of unliquidated damages.

In the three Chapters to follow where *Andrews*, *Cavendish* and *Paciocco* are analysed, the changing face of the common law in Australia and England becomes apparent, and these decisions demonstrate the incremental development of the common law. The ways in which each decision has shaped the common law is consistent with the principle enunciated by Brennan J in *Gala v Preston*²⁹⁹ 'in a society where values change and where the relationships affected by the law become increasingly complex, judicial development of the law is a duty of the courts'. *Andrews*, which is considered in Chapter 3, caused a divergence with the common law position in England by recognising a jurisdiction to provide equitable relief from a penalty stipulation in the absence of a breach of contract. This decision was described by Lords Neuberger and Sumption in *Cavendish*³⁰⁰ as 'a radical departure from the previous understanding of the law'. Thus, there developed a divergence in the law of Australia and England, because in the former jurisdiction a breach of contract was not necessary before the penalty doctrine in equity could be enlivened, whereas in the latter jurisdiction the notion of a penalty doctrine in equity was soundly rejected.

²⁹⁸ See *Australian Consumer Law* s 22(1)(a).

²⁹⁹ *Gala v Preston* (1991) 172 CLR 243, 262.

³⁰⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1207–8 [41].

Chapter 3

The Penalty Doctrine in Australia: *Andrews* Re-Enlivens the Equitable Jurisdiction

3.1 Introduction

This Chapter is the first of three which analyses the operation of the penalty doctrine in Australia and England by referencing to the recent important decisions of *Andrews*,¹ *Cavendish*² and *Paciocco*.³ These decisions have each contributed to a reshaping of the doctrine. It is a well-established principle of law that the ‘purpose of the law of contract is not to punish wrongdoing but is to satisfy the expectations of the party entitled to performance’.⁴ *Cavendish*⁵ and *Paciocco*⁶ confirm the rationale for the penalty doctrine at common law is that if, upon breach of the contract, the quantum of the sum stipulated amounts to punishment of the non-breaching party, then that stipulation will not be enforced because it is a penalty. *Andrews* has extended the operation of the penalty doctrine, and concludes that, in equity (absent any breach of contract), if compensation can be made to the promisee⁷ for the prejudice or damage done to its interests by failure of the primary stipulation then the sum stipulated will be partially enforced or scaled down but only to the extent of that compensation. In *Cavendish*,⁸ the UK Supreme Court rejected the *Andrews*-extension of the penalty doctrine in equity.

This Chapter is divided into three parts. Part I briefly reviews the operation of the penalty doctrine in Australia pre-*Andrews* where the *Dunlop* formulation applied and was only engaged where a breach of contract was established and this will be referred to as the breach limitation. Part II provides a summary of the *Andrews* litigation and sets out ‘the settled aspects’ of the penalty doctrine and confirms a dormant jurisdiction in equity to relieve against stipulations not activated by a breach of contract but by failure of a primary obligation. The chapter argues that *Andrews* confirmed the existence of a general penalty doctrine that supports separate common law and equitable jurisdictions which operate side by side. After a brief analysis of legal history *Andrews* concluded that the equitable jurisdiction to relieve against penalties had not ‘withered on the vine’⁹ after the courts of common law began to follow Chancery in granting relief against the enforcement of penal stipulations. The High Court distinguished secondary or collateral stipulations eg., liquidated damages clauses, which engage the penalty doctrine, from alternative stipulations, such as

¹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; see Richard Manly, ‘Breach No Longer Necessary: The High Court’s Reconsideration of the Penalty Doctrine’ (2013) 41 *Australian Business Law Review* 314.

² *Cavendish Square Holding BV v Makdessi* [2016] AC 1172.

³ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

⁴ *Ruxley Electronics and Construction Ltd v Forsyth* [1996] AC 344, 365; *Co-Operative Insurance Society Ltd v Argyll Stores (Holdings) Ltd* [1998] AC 1, 15; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32].

⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32].

⁶ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 548 [32], 569–70 [127], 580–1 [164]–[166], 605–6 [253], 607 [259], 613 [273].

⁷ Note, in this Chapter, the ‘non-breaching party’ is referred to as the promisee and the ‘breaching party’ is referred to as the promisor. This is because in equity the penalty doctrine can be engaged without the need for a breach of contract.

⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1207–9 [41]–[42].

⁹ This is the expression used by Mason and Wilson JJ in *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 191.

options¹⁰ which do not engage the doctrine. This distinction was supported by reference to two obscure decisions, one from the Court of Chancery in Ireland and the other from the New South Wales Court of Appeal. The High Court's reliance on the New South Wales decision is questioned on the basis that it was wrongly decided and is therefore of dubious relevance.

Part III examines some perceived difficulties with the *Andrews*-extended operation of the penalty doctrine, and explains how the recent Victorian Court of Appeal decision in *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd*¹¹ has applied *Andrews*. The grant of equitable relief against penalties is 'comparatively rare'¹² but where applicable, operates so that the impugned stipulation is partially enforced or 'scaled down'. For monetary stipulations, this is straightforward, but where the subject matter of the stipulation is property, then difficulties are likely to arise. Two examples are provided where the penalty doctrine has been applied to a stipulation requiring the payment of money and one requiring the transfer of property. These examples establish that sound outcomes can be achieved. The Chapter concludes that although *Andrews* is an important decision which extends the operation of the penalty doctrine, it is of limited application, so its practical effects on commercial transactions, to date, have not been significant.

PART I

3.2 The Common Law in Australia pre-*Andrews*

The *Dunlop* formulation was first applied by the High Court in *Heron v Port Huon Fruitgrowers Co-Operative Association Ltd*.¹³ Australia and other common law jurisdictions¹⁴ applied the *Dunlop* formulation, somewhat like a 'quasi-statutory code'¹⁵ to determine whether a sum stipulated is enforceable liquidated damages or an unenforceable penalty. In *Ringrow*,¹⁶ the High Court confirmed *Dunlop* represented 'the principles governing

¹⁰ Contractual relations may be so configured that one party is given an option to select a particular method of performance contingent upon paying a sum of money to his contractual partner. See Roger Halson, *Liquidated Damages and Penalty Clauses* (Oxford University Press, 2018) 167 [5.43]; *Nutting v Baldwin* [1995] 2 All ER 321, 326–7; *Fratelli Moretti SpA v Nidera Handelscompagnie BV* [1981] 2 Lloyd's Rep 47, 53.

¹¹ *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd* (2014) 45 VR 79 ('*Cedar Meats*').

¹² *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 195, cited with approval by Gageler J in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 569 [124]–[125].

¹³ *Heron v Port Huon Fruitgrowers Co-Operative Association Ltd* (1922) 30 CLR 315, 323. Note the earlier decision in *Lamson Store Service Co Ltd v Russell Wilkins and Sons Pty Ltd* (1906) 4 CLR 672, 681, 689 where the High Court applied *Commissioner of Public Works v Hills* [1906] AC 368 (which was approved in *Dunlop*) and applied a test of penalty that considered whether the stipulated sum was a genuine estimate of the non-breaching party's interest in due performance by the breaching party. The same test was applied by the High Court in *Hamilton v Lethbridge* (1912) 14 CLR 236, 264. See *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 572–3 [139]–[140]; Anthony Gray, 'The Law of Penalties and the Question of Breach' (2017) 45 Australian Business Law Review 8, 13.

¹⁴ *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] BLR 271; *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656; *Gunning v Thorne Riddell* [1990] BCJ No 36 (10 January 1990); *Domain Forest Products Ltd v GMAC Commercial Credit Corp* [2007] 65 BCLR (4th) 1; *Philips Hong Kong Ltd v A-G (Hong Kong)* (1993) 61 BLR 41; *Re Mandarin Container* [2004] 3 HKLRD 554 (9 November 2004); *Camatos Holdings Ltd v Neil Civil Engineering* (1992) Ltd [1983] 3 NZLR 596; *Fernhill Properties Northern Ireland Ltd v Mulgrew* [2010] NICh 20; *Lombank Ltd v Kennedy* [1961] NI 192; *O'Donnell v Truck and Machinery Sales Ltd* [1998] 4 IR 191; *CLAAS Medical Centre Pte Ltd v Ng Boon Ching* [2010] 2 SLR 386; *Edwards Jason Glenn v Australia & New Zealand Banking Group Ltd* [2012] SGHC 61 (21 March 2011); *Eurocopy Rentals Ltd v Tayside Health Board* 1996 SLT 224.

¹⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199 [22], 1270 [225]; see the discussion in Chapter 2 at Part 1, [2.2.3.1].

¹⁶ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 663 [12].

the identification, proof and consequences of penalties in contractual stipulations'. Notably, in England and Australia, the breach limitation has always been a necessary pre-condition for operation of the penalty doctrine.¹⁷ Until *Andrews*, Australia and England¹⁸ were in lockstep regarding application of the doctrine.¹⁹

In *Dunlop*, Lord Dunedin drew upon 'centuries of equity jurisprudence'²⁰ and confirmed the breach limitation was a necessary requirement for engagement of the penalty doctrine at common law. The breach limitation was later confirmed, for English conditions, by Lord Roskill in the House of Lords decision in *Export Credits Guarantee Department v Universal Oil Products Co*,²¹ and again by the UK Supreme Court in *Cavendish*.²² Prior to *Andrews*, the breach limitation was also confirmed for Australian conditions by the High Court in *AMEV-UDC*,²³ and in other decisions.²⁴

PART II

Part II explains why the High Court re-enlivened a dormant equitable jurisdiction to relieve against penalty stipulations in the absence of a breach of contract but for failure of a primary obligation.

3.3 A Brief History of the *Andrews* Litigation

Andrews was a group proceeding which commenced in the Federal Court of Australia. The applicants were customers of ANZ who complained about seventeen fees²⁵ they had been variously charged on a variety of accounts. The relief sought by the customers included statutory remedies for unconscionable conduct, the avoidance of unfair contract terms and unjust transactions,²⁶ together with a declaration that the fees were unenforceable penalties.

¹⁷ *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399; *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656.

¹⁸ Although, note the developments in *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752, and the Court of Appeal decisions prior to *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, discussed in Chapter 4 at Part 1.

¹⁹ This is despite a line of English cases that commenced with *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752 which were followed and approved by a number of Court of Appeal decisions: *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 (21 November 2003); *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005); *Euro London Appointments Ltd v Claessens International Ltd* [2006] 2 Lloyd's Rep 436; *CMC Group Plc v Zhang* [2006] EWCA Civ 408 (14 March 2006); *Lansat Shipping Co Ltd v Glencore Grain BV* [2009] EWCA Civ 855 (31 July 2009); *Cavendish Square Holding BV v Makdessi* [2013] EWCA Civ 1539 (26 November 2013) which advocated a greater emphasis on the 'commercial justification' of the stipulated sum.

²⁰ This is the expression used in Christopher J Rossiter, *Penalties and Forfeiture: Judicial Review of Contractual Penalties and Relief against Forfeiture of Proprietary Interests* (Law Book, 1992) 33.

²¹ *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399; J D Heydon, M J Leeming and P G Turner, *Meagher, Gummow and Lehane's Equity: Doctrines & Remedies* (LexisNexis, 5th ed, 2015) 553.

²² *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [12], 1240 [129], 1270 [226], 1274 [239], 1285 [292].

²³ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 184, 189–90, 211.

²⁴ *IAC (Leasing) Ltd v Humphrey* (1972) 126 CLR 131, 140–1; *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359; *Esanda Finance Corporation Ltd v Plessnig* (1989) 166 CLR 131; *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656.

²⁵ The fees were charged for overdrafts, overdrawn accounts, dishonour fees, and over limit credit card accounts. Collectively, the fees were referred to as 'the exception fees'.

²⁶ The statutory claims were based on 'unconscionable conduct' in contravention of the *Australian Securities and Investments Commission Act 2001* (Cth), the *Fair Trading Act 1999* (Vic); and on the *Fair Trading Act 1999* (Vic) to avoid 'unfair terms'; and on the provisions of the *Consumer Credit (Victoria) Code* and the *National Consumer Credit Protection Act 2009* (Cth) sch 1 ('*National Credit Code*') regarding 'unjust transactions'.

In 2011, Gordon J conducted a trial of certain separate questions²⁷ that did not include the customers' claims for statutory relief. Her Honour decided²⁸ that thirteen of the fees in question were 'not capable of being characterised as a penalty'²⁹ due to the customers' liability to pay those fees³⁰ irrespective of any breach by them of ANZ's terms and conditions.³¹ Furthermore the occurrence of the event upon which the fees were charged (ie: overdrawing the account or credit limit or attempting to do so) was not an event which the customers had an obligation or responsibility to avoid.³² Her Honour found that the New South Wales Court of Appeal decision in *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd*³³ prevented her from finding that the penalty doctrine was capable of being engaged in respect of a stipulation triggered by an event other than a breach of contract. The remaining four late payment fees were found to be payable because of the customer's breach of contract which meant they were therefore 'capable of being characterised as a penalty'.³⁴

The customers appealed to the Full Court of the Federal Court. The appeal was removed to the High Court pursuant to the *Judiciary Act 1903* (Cth) s 40(2),³⁵ because the issues were important and required an urgent decision from the High Court.³⁶ The matter for determination by the High Court was not whether the fees were penalties, but rather, whether the penalty doctrine could be engaged in circumstances where fees were payable even though there had been no breach of contract.

In *Ringrow*, the High Court had stated that any change to the *Dunlop* formulation depended on 'whether any particular feature of Australian conditions, any change in the nature of penalties or any element in the contemporary marketplace suggest the need for a new formulation.'³⁷ Accordingly, if there was to be any change to the long-held common law position represented by *Dunlop*, a fulsome judgment would be expected to provide the necessary explanation for the change.

*Andrews*³⁸ expanded the operation of the penalty doctrine, as the High Court decided there was no historical basis for constraining application of the doctrine at common law to stipulated sums payable upon a breach of contract. The Court overruled the New South Wales Court of Appeal decision in *Interstar*³⁹ which had been binding on Gordon J. In that decision, the Court of Appeal had confirmed, the breach limitation was a necessary constraint that had to be established before the penalty doctrine could be engaged. The High

²⁷ The list of separate questions is set out in sch A to the judgment in *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53, 140 [354].

²⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53; see Manly, above n 1.

²⁹ *Ibid* 60 [5].

³⁰ See, eg, *ibid* 99–100 [153]–[156] where Gordon J sets out the contractual regime that applied, for example, to the honour fees. This was referred to in the High Court judgment in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 220–1 [24].

³¹ In so finding, her Honour correctly found she was bound by the New South Wales Court of Appeal decision in *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2008) 257 ALR 292 ('*Interstar*').

³² *Andrews v Australia and New Zealand Banking Group Ltd* (2011) 211 FCR 53, 112–13 [205]–[208].

³³ *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2008) 257 ALR 292.

³⁴ *Ibid* 60 [5].

³⁵ *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA Trans 104 (11 May 2012).

³⁶ *Bienstein v Bienstein* (2003) 195 ALR 225, 234 [45].

³⁷ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 663 [12].

³⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 228 [49], 236 [78].

³⁹ *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* (2008) 257 ALR 292. In that case the Court of Appeal had held that the penalty doctrine was solely a creature of the common law.

Court confirmed the *Judicature Acts*⁴⁰ permitted a single court to administer common law and equity together, and if there was any conflict then equity would be preferred. The equitable doctrine to relieve against penalties subsisted, and, where appropriate, equitable remedies could be granted. The purpose of any intervention by a court of equity would be to provide a remedy to ameliorate the harshness of the result that could be achieved at common law. The High Court referred, for example, to the litigation in *Dunlop* itself, where in the one court and in the same proceeding, legal and equitable remedies (ie: damages and an injunction) had been sought by the plaintiff and the defendant had pleaded the penalty doctrine as its defence. The High Court said this ‘illustrates the place of the penalty doctrine in a court where there is a unified administration of law and equity’.⁴¹ In short, the High Court concluded the penalty doctrine was not only a rule of the common law but was also a rule of equity.⁴²

The High Court made an order granting a declaration⁴³ to the effect that the late payment fees were not rendered incapable of characterisation as penalties. The narrow form of the declaration meant the High Court was not required to decide the question of whether those fees were or were not unenforceable penalties.⁴⁴ The Court ruled that question did not arise on the appeal because of the way the ‘awkwardly expressed’⁴⁵ separate questions had been framed.⁴⁶ The proper characterisation of the late payment fees remained a ‘live issue’⁴⁷ for the further trial of the proceeding once remitted to Gordon J. The remitter of the proceeding to the Federal Court and its journey back to the High Court in the name of *Paciocco* is the subject of analysis in Chapter 5.

Andrews has been variously described as a ‘significant event’,⁴⁸ ‘controversial’,⁴⁹ ‘rather a shock to contract lawyers’,⁵⁰ ‘opening a Pandora’s box of issues’,⁵¹ as well as a ‘potentially very significant judgment’,⁵² ‘fundamentally changing the accepted understanding of the law of penalties’,⁵³ and a ‘surprising decision’.⁵⁴ In 2013 shortly after the judgment was delivered, John W Carter et al⁵⁵ criticized the judgment as none of the

⁴⁰ See for example, *Supreme Court Act 1986* (Vic) s 29.

⁴¹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 232 [61], 233 [63], 236 [77].

⁴² *Ibid* 233 [63].

⁴³ *Ibid* 238 [87].

⁴⁴ *Ibid* 220 [23], 236–7 [78]–[79], 238 [83]–[84].

⁴⁵ *Ibid* 219 [20].

⁴⁶ *Ibid* 220 [23].

⁴⁷ *Ibid* 238 [83].

⁴⁸ Kanaga Dharmananda and Leon Firios, ‘Penalties Arising without Breach: The Australian Apogee of Orthodoxy’ [2013] *Lloyd’s Maritime and Commercial Law Quarterly* 145.

⁴⁹ J W Carter et al, ‘Contractual Penalties: Resurrecting the Equitable Jurisdiction’ (2013) 30 *Journal of Contract Law* 99, 101; *Re Pioneer Energy Holdings Pty Ltd* [2013] NSWSC 1134 (19 August 2013) [58].

⁵⁰ Elizabeth Peden, ‘Digging around *Andrews*: Treasure or Fool’s Gold?’ [2014] *Australian Mining and Petroleum Law Association Yearbook* 161.

⁵¹ Michael MacGinley and Franka Cheung, ‘Navigating Treacherous Waters: A Practical Guide for Energy and Resources Contracts after *Andrews*’ [2014] *Australian Mining and Petroleum Law Association Yearbook* 179, 180.

⁵² Ben McFarlane, ‘Penalties and Forfeiture’ in John McPhee (ed), *Snell’s Equity* (Thomson Reuters, 33rd ed, 2015) 357, 360–2 [13.003].

⁵³ Nicholas Tiverios, ‘Doctrinal Approaches to the Law of Penalties: A Post-*Andrews* Intention-Based Defence of Relief against Fixed Contractual Remedies’ in Simone Degeling, James Edelman and James Goudkamp (eds), *Contract in Commercial Law* (Thomson Reuters, 2016) 457, 458.

⁵⁴ John W Carter, Wayne Courtney and Greg J Tolhurst, ‘Assessment of Contractual Penalties: *Dunlop* Deflated’ (2017) 34 *Journal of Contract Law* 4.

⁵⁵ Carter et al, above n 49, 128 provides a robust denunciation of the decision, criticising it for failing to articulate the policy that underlies the decision; providing a concept of penalty that is convoluted and lacking in contemporary support in the law; and making the scope of the law of penalties unclear and its application uncertain. Paul S Davies and Peter G Turner, ‘Relief against Penalties without a Breach of Contract’ (2013) 72 *Cambridge Law Journal* 20 say that the *Andrews* decision is the exemplar of a case representing legal change and continuity.

matters identified in *Ringrow* (and mentioned above) were taken into account by the High Court. They concluded this exhibited a lack of policy justification which ‘undermines the judgment’.

Enlivening the court’s equitable jurisdiction to grant relief against penalties extends the reach of the penalty doctrine in Australia. This is because when the court exercises its equitable jurisdiction, application of the penalty doctrine is not limited to those situations where money is payable in the event of a breach of contract, but can also be engaged where there has been a failure of a primary obligation. Commentators suggested that this development may give rise to an increase in challenges to contractual stipulations and contribute to commercial uncertainty.⁵⁶ In a further article published in 2017, Carter et al observed this had already commenced,⁵⁷ and referred to five decisions published⁵⁸ in the five years that had elapsed since *Andrews* was decided.⁵⁸ However, in only one of these decisions, *Cedar Meats*, did the court apply *Andrews* and determine the stipulation was a penalty in equity.⁵⁹ This decision is analysed in Part III below. The modest number of decisions post-*Andrews* hardly supports the suggestion by commentators, and Carter et al in particular, that *Andrews* has sparked an increase in litigation.

3.4 The High Court Decision

In *Andrews*, the High Court set out what it regarded as ‘the settled aspects of the penalty doctrine’⁶⁰ and provided two tests, one for the common law position where there had been a breach of contract, and another for the position in equity where there had not been of breach of contract, but rather a failure of the primary stipulation.

3.4.1 Settled Aspects of the Penalty Doctrine

3.4.1.1 Common Law Test

Initially, the Court referred approvingly to the definition of ‘penalty’ provided in the judgment of Mason and Deane JJ in *Legione v Hateley*⁶¹ where they set out the rule in the following terms: ‘a penalty is in the nature of a punishment for non-observance of a contractual stipulation, and consists, upon breach, of the imposition of an additional or different liability’.

There are three aspects to this definition of penalty which represents the accepted position at common law. Firstly, the definition identifies punishment which is of the ‘essence’⁶² of the penalty doctrine. Punishment is reflected in the disproportionate nature of ‘the sum stipulated for’ which Lord Dunedin describes in

⁵⁶ See, eg, Manly, above n 1. The risk, that every price payable under a contract could be the subject of judicial control, was foreshadowed in 1975 by the English Law Commission when it reported on penalty clauses in Law Commission, *Penalty Clauses and Forfeiture of Monies Paid*, Working Paper No 61 (1975) 16.

⁵⁷ Carter, Courtney and Tolhurst, above n 54, 6. The cases cited are *Kellas-Sharpe v PSAL Ltd* [2013] 2 Qd R 233; *Testel Australia Pty Ltd v KRG Electrics Pty Ltd* [2013] SASC 91 (17 June 2013); *Cedar Meats* (2014) 45 VR 79; *Re Pioneer Energy Holdings Pty Ltd* [2013] NSWSC 1134 (19 August 2013); *GWC Property Group Pty Ltd v Higginson* [2014] QSC 264 (29 October 2014).

⁵⁸ The High Court decision was published on 6 September 2012 and the article was published in 2017.

⁵⁹ 45 VR 79, 97–102. The stipulation in this case was a take-or-pay clause. For an explanation see below [3.5.1]. As the trial judge had not carried out the task of partial enforcement the Court of Appeal remitted this matter back to him. At this point the case was settled.

⁶⁰ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216–17 [9]–[12] (emphasis added).
⁶¹ *Legione v Hateley* (1983) 152 CLR 406, 445.

⁶² *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86 at proposition 2; John G H Stumbles, ‘Paciocco in the High Court: Penalties and Late Payment Fees’ (2017) 91 *Australian Law Journal* 969, 973.

proposition 4(a)⁶³ as ‘extravagant and unconscionable’. The definition of penalty in *Legione* is consistent with *Dunlop*⁶⁴ and in particular, proposition 2,⁶⁵ which states ‘the essence of a penalty is a payment of money stipulated as in terrorem of the offending party’.⁶⁶ Secondly, the reference to ‘non-observance of a contractual stipulation’ and ‘breach’ confirms the breach limitation requirement,⁶⁷ which is also consistent with *Dunlop* and in particular, propositions 3, 4(a), 4(b) and 4(d).⁶⁸ The third aspect of the definition is the imposition of an additional or different liability following the breach of contract,⁶⁹ which is consistent with *Dunlop* and in particular propositions 2, 4(a) and 4(b).⁷⁰

3.4.1.2 Test in Equity

Having confirmed the common law test for the penalty doctrine, the High Court then set out its formulation of the test to apply in equity:⁷¹

In general terms a stipulation prima facie imposes a penalty on a party (‘the first party’) if, as a matter of substance, it is collateral (or accessory) to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party. In that sense, the collateral or accessory stipulation is described as being in the nature of a security for and in terrorem of the satisfaction of the primary stipulation. If compensation can be made to the second party for the prejudice suffered by failure of the primary stipulation, the collateral stipulation and the penalty are enforced only to the extent of that compensation. The first party is relieved to that degree from liability to satisfy the collateral stipulation.⁷²

The penalty doctrine is not engaged if the prejudice or damage to the interests of the second party by the failure of the primary stipulation is unsusceptible of evaluation and assessment in money terms. It is the availability of compensation which operates the ‘equity’ upon which the court intervenes; without it, the parties are left to their legal rights and obligations.⁷³

The primary stipulation may be the occurrence or non-occurrence of an event which need not be the payment of money.⁷⁴

⁶³ See chapter 2 at [2.2.1].

⁶⁴ The definition provided in *Legione* is criticised in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204 [31] as being too wide, but the Supreme Court said that insofar as it refers to ‘punishment’ it gets closer to the concept of penalty than any other.

⁶⁵ See chapter 2 at [2.2.1].

⁶⁶ In *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 580–1 [165], Gageler J considered ‘the description [ie: ‘in terrorem’] captures the essence of the conception to which the whole of the analysis is directed’.

⁶⁷ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87 at propositions 3, 4(a) and (b) and (c).

⁶⁸ See chapter 2 at [2.2.1].

⁶⁹ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86–7 at propositions 2, 4(a) and (b).

⁷⁰ See chapter 2 at [2.2.1].

⁷¹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [10].

⁷² *Ibid*, citing *Waterside Workers’ Federation of Australia v Stewart* (1919) 27 CLR 119, 128–9; *Acron Pacific Ltd v Offshore Oil NL* (1985) 157 CLR 514, 520.

⁷³ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 217 [11], citing *Peachy v Duke of Somerset* (1720) 1 Str 447; 93 ER 626.

⁷⁴ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 217 [12], citing Joseph Story, *Commentaries on Equity Jurisprudence as Administered in England and America* (Little, Brown, 13th ed, 1886) vol 2, 644–5 [1314]; *Jobson v Johnson* [1989] 1 WLR 1026, 1034–5, 1039 where Dillon and Nicholls LJ explained that there is no distinction in principle between a stipulation payable upon default for the transfer of property and a payment of money; such a distinction would elevate form over substance. See also *Forestry Commission of New South Wales v Stefanetto* (1976) 133 CLR 507, 519–21 where the penalty doctrine was held to include ‘use of property’ and not merely transfer of property.

The *Andrews* test is complex. The ‘settled aspects’ of the penalty doctrine apply to stipulations⁷⁵ which require the promisor to pay a sum of money, and to stipulations that provide for the transfer of property, as well as those that provide for the forfeiture of money or assets to the promisee. It can also apply where the failure of the primary stipulation is not a breach of contract, and where the secondary stipulation is to take effect on the doing of some other act or the happening of an event, even outside the control of the parties.⁷⁶

The High Court articulated a broader statement of the penalty doctrine⁷⁷ and sought to explain the application of the doctrine in equity in terms of a ‘failure of the primary stipulation’ which gives rise to a collateral stipulation that imposed an ‘additional detriment.’ This detriment was in the nature of a security or threat for the failure to satisfy the primary stipulation. This aspect of the *Andrews* test is in very broad language which potentially catches a wide variety of stipulations, including stipulations which commonly occur in commercial contracts.⁷⁸ Examples of the types of stipulations that might be caught were provided by Lords Neuberger and Sumption in *Cavendish*⁷⁹ and include provisions for termination on insolvency,⁸⁰ contractual payments due on the exercise of an option to terminate, break fees chargeable on the early repayment of a loan or the closing out of future contracts in the financial or commodity markets, provisions for variable payments dependent on the standard or speed of performance, and ‘take-or-pay provisions’ in long term oil and gas purchase contracts.

It is necessary to distinguish between primary and secondary stipulations or obligations (sometimes referred to as collateral or accessory) to understand how the penalty doctrine in equity can operate. Lord Diplock introduced, and developed, the concepts of primary and secondary obligations into English law.⁸¹ The contract is the source of primary legal obligations where the parties agree what is to be done and by whom. These obligations are concerned with performance, consideration and price. An example of a primary obligation is a clause in a construction contract stipulating that a building is to be constructed in accordance with agreed plans.⁸² A breach of contract is a failure to perform a primary obligation, which will give rise to a substituted or secondary obligation on the part of the promisor to provide compensation. The usual remedy for a breach of contract is payment of monetary compensation for the loss sustained by that breach. It is to be noted that, as a matter of public policy, the penalty doctrine regulates only the remedies provided in secondary obligations for breach of a party’s primary obligations, and not the primary obligations themselves.⁸³

⁷⁵ Ibid 237 [81], citing John Norton Pomeroy, *A Treatise on Equity Jurisprudence* (Bancroft-Whitney, 5th ed, 1941) vol II, 211-4 §437.

⁷⁶ Heydon, Leeming and Turner, above n 21, 551.

⁷⁷ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216–17 [10].

⁷⁸ See Justice of Appeal Hugh Fraser, ‘2017 W A Lee Lecture: The Australian Law of Contractual Penalties’ (2018) 18(2) *QUT Law Review* 111, 123.

⁷⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1208 [42].

⁸⁰ For Australia, see, eg, *Australian Capital Financial Management Pty Ltd v Linfield Developments Pty Ltd* (2017) 18 BPR 36 683, 36 748–50 [361]–[371].

⁸¹ See Brice Dickson, ‘The Contribution of Lord Diplock to the General Law of Contract’ (1989) 9 *Oxford Journal of Legal Studies* 441; and the discussion by Andrew D Archer, ‘Contractual Termination Rights and the Concurrent Exercise of Non-Exercise of Common Law Termination Rights — Caught between the Scylla and Charybdis?’ (2017) 33 *Construction Law Journal* 313, 319.

⁸² *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827, 848.

⁸³ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [13].

The use of the expression 'stipulation' in the *Andrews* test is an all-encompassing reference to the terms of a contract and covers contract terms in general rather than only those that contain promises. It is to be noted that the court in *Andrews* did not use the expression 'breach of contract', but used 'failure of the primary stipulation'. This will permit the penalty doctrine to engage with stipulations that are not triggered by a breach of contract.⁸⁴ The *Andrews* test extends to 'alternative stipulations'⁸⁵ where a party agrees to perform one of two alternatives, but has not failed to do something that it promised (ie: breached the contract) simply by failing to perform one of those alternatives. *Andrews* suggests that some alternative stipulations will include a primary stipulation and another which is 'accessory' or 'collateral' to the primary stipulation. Clauses of this nature which offer true equal alternatives do not engage the penalty doctrine. For example,⁸⁶ a promise to deliver either a green car or a blue car would normally be understood as putting forward true equal alternatives rather than a primary stipulation and an accessory stipulation.

The High Court provided no guidelines to assist in determining if a stipulation is primary, collateral or alternative. In the usual course, the primary stipulation is the promise, and the collateral stipulation is the fee payable upon breach. *Andrews* provides that the collateral stipulation functions as 'security' for the primary stipulation,⁸⁷ which suggests that the primary stipulation is what the promisee wants from the bargain while the collateral stipulation ensures that the purpose is achieved. In *Andrews* the purpose of the primary stipulation is the requirement by the customer to keep its account in credit and the collateral stipulation is the imposition of the late payment fee by ANZ. This analysis is consistent with the theoretical position that the primary obligation represents the purpose of the contract, and is the promise which the parties agreed to perform, ie: obligations discharged by performance, and the secondary or collateral obligation is included in the contract to ensure the purpose or promise is carried out and only arises upon non-performance of any primary obligation by one of the parties to the contract.⁸⁸

The *Andrews* test is satisfied if upon failure of the primary stipulation, the collateral stipulation confers an 'additional detriment' on the promisor which is to the benefit of the promisee. This raises the question of what is the 'additional detriment' additional to and the answer is that it will be additional to the detriment that would flow from the failure of the primary stipulation. This will be measured by a comparison of the value of the detriment following failure of the primary stipulation with the value of the detriment imposed by the collateral stipulation. The requirement for 'additional detriment' prevents the penalty doctrine from being engaged where the contract contains exclusion clauses or limitation of liability clauses which are agreed remedy clauses providing that the promisor's liability is less than that which would normally follow from failure of the primary stipulation. In *Robophone Facilities Ltd v Blank*⁸⁹ Lord Diplock referred in particular, to exemption clauses as 'penalty clauses in reverse'.

⁸⁴ Sam Cathro and Simon Connell, 'New Variations on the Rule against Penalties: Options for New Zealand' (2017) 27 *New Zealand Universities Law Review* 1087, 1095–6.

⁸⁵ Spencer W Symons (ed), *A Treatise on Equity Jurisprudence by John Norton Pomeroy* (Bancroft-Whitney Co, 5th ed, 1941) vol II, 211–14 §437, cited in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 237 [81].

⁸⁶ Cathro and Connell, above n 84, 1096.

⁸⁷ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216–17 [10].

⁸⁸ See Arthur Corbin, 'Discharge of Contracts' (1913) 22 *Yale Law Journal* 513, 514.

⁸⁹ *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1446.

3.4.1.3 Stage 2: *Andrews* Provides Two Limitations to the Test in Equity

The High Court articulated two limitations that were to apply to the operation of the test in equity. Without these limitations there is the prospect that, in effect, all contractual obligations could have been made the subject of judicial review. The limitations are:

- **First Limitation**

Firstly, if the loss or damage suffered by the promisee is 'insusceptible of evaluation and assessment in money terms' then the penalty doctrine cannot be engaged and equitable relief cannot be granted.⁹⁰ By way of illustration, the High Court referred to the decision of *Waterside Workers' Federation of Australia v Stewart*.⁹¹ In this case, a bond was provided by a trade union where one stipulation required it to pay £500 to the employer, and an alternative stipulation required it to pay £50 if and so often as its members in combination should go on strike. Isaacs and Rich JJ found that whilst strikes by workers would almost inevitably cause loss to the employer, the difficulty was that 'no-one can tell how much loss is sustained by not doing business.'⁹² The Court⁹³ referred to *Peachy v Duke of Somerset*⁹⁴ and noted it provided the 'central principle' on which equitable relief against penalties was granted ie: 'the original intent of the case, where the penalty is designed only to secure money, and the Court gives him all that he expected or desired'.

The High Court⁹⁵ found that 'the £50 was therefore a fixed sum — the minimum and the maximum limit of liability of recompense for the concerted cessation of work. That being the clear and certain intent of the parties — the £50 not being recoverable in any other way — equity would not, on any principle heretofore recognized, relieve'. Despite the finding that damage was 'almost impossible to calculate',⁹⁶ the High Court determined it was the parties' intention that £50 was a 'conventional amount' to be paid as compensation to someone injured by the breach of the condition in the bond. The £50 was enforceable liquidated damages, and not an unenforceable penalty.

Identifying the parameters of the first limitation above is not an easy task because it appears to exclude from review the type of situation referred to by Lord Dunedin in proposition 4(d)⁹⁷ and of which, he had remarked, 'that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties'. The first limitation is also vague and raises two issues regarding the promisee's loss and damage that engender uncertainty. On the one hand, in *Andrews* the High Court may have been referring to those situations where it is merely difficult to calculate loss or damage suffered by the promisee which arise due to problems in the assessment following the failure of the primary stipulation. On the other hand, the High Court may have been referring only to those limited situations where the damages cannot be quantified at all.⁹⁸

⁹⁰ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 217 [11], citing *Waterside Workers' Federation of Australia v Stewart* (1919) 27 CLR 119; *Peachy v Duke of Somerset* (1720) 1 Str 447; 93 ER 626.

⁹¹ *Waterside Workers' Federation of Australia v Stewart* (1919) 27 CLR 119, 128.

⁹² *Ibid* 132.

⁹³ *Ibid* 131.

⁹⁴ *Peachy v Duke of Somerset* (1720) 1 Str 447, 453; 93 ER 626, 630.

⁹⁵ *Waterside Workers' Federation of Australia v Stewart* (1919) 27 CLR 119, 132.

⁹⁶ *Ibid* 128.

⁹⁷ See chapter 2 at [2.2.1].

⁹⁸ S A Christensen and W D Duncan, *The Construction and Performance of Commercial Contracts* (Federation Press, 2nd ed, 2018) 139–40.

Should the promisee not be able to 'evaluate or assess' the prejudice or damages suffered by it, then the penalty doctrine in equity will not be engaged and contractual rights can be enforced.⁹⁹ In *Paciocco*,¹⁰⁰ Gordon J determined that where damage was not capable of calculation at all, rather than where the assessment would be very complex and expensive, or difficult or unable to be assessed with certainty, then the stipulation would not be a penalty in equity and would be enforced accordingly to its terms.

- **Second Limitation**

The second limitation is that if the sum stipulated is payable, so that one of the parties can obtain an additional right or further accommodation (ie: an alternative stipulation) then that stipulation cannot be characterised as a penalty.¹⁰¹ Application of this limitation requires the court to identify whether some reciprocal benefit is given in exchange for payment of the sum stipulated.¹⁰² If such a benefit can be identified, then the impugned stipulation is considered to be a primary obligation and on that basis, the penalty doctrine is not engaged.

When drafting liquidated damages clauses post-*Andrews*, prudent drafters must make it clear that the parties agree and acknowledge the loss and damage resulting from non-fulfillment of a primary obligation could not be compensated for in money terms. This maximises the prospect of the stipulation gaining the protection of the first *Andrews* limitation above. Additionally, prudent drafters must provide for the parties to agree and acknowledge that payment of the stipulated sum relates only to the provision of additional or further accommodation, which will maximise the prospect of the stipulation attracting the second *Andrews* limitation above.

In *Andrews*, the High Court set out the 'settled aspects' of the penalty doctrine in equity. The statement is convoluted¹⁰³ in its formulation and appears complex in its application. The High Court stated that in equity a stipulation found to be a penalty is not void, but that it should be enforced to the extent necessary to obtain 'compensation' for loss actually sustained. The court has thereby sanctioned partial enforcement of the stipulation but only on the basis the damage to the promisee's interests is susceptible of evaluation and assessment in money terms. If the loss is not capable of assessment in monetary terms, this may indicate that the stipulation is not a penalty and equity should not intervene. Thus, the result is analogous to finding that the clause is unenforceable at common law and permitting a claim for recovery of unliquidated damages. The jurisdiction in equity permits relief, in the nature of compensation by the 'partial enforcement' or 'scaling down' of the sum stipulated,¹⁰⁴ so that it is enforced only to the extent of the compensation required to satisfy 'the prejudice or damage' to the interests of the promisee. The jurisdiction to grant

⁹⁹ Joseph Story, *Commentaries on Equity Jurisprudence as Administered in England and America*, ed W H Lyon (Little, Brown, 14th ed, 1918) vol III, 335, 342–3 §1726.

¹⁰⁰ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 265 [46]–[47].

¹⁰¹ *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSW 717 ('MGM').

¹⁰² *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 236–7 [79].

¹⁰³ Carter et al, above n 49, 103.

¹⁰⁴ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [10]; see also *GWC Property Group Pty Ltd v Higginson* [2014] QSC 264 (29 October 2014) [37]. Dalton J said the passage at *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [10] contains a description rather than a definition and should not be used as though it is a formula to be rigidly applied.

equitable relief against penalty stipulations therefore permits 'remedial flexibility'¹⁰⁵ and this aspect of the doctrine is examined later in Part III of this chapter.

3.4.2 General Penalty Doctrine or Unitary Penalty Doctrine?

There are competing theories whether *Andrews* confirmed the existence of a general penalty doctrine that recognised two jurisdictions to relieve against penalties; one in equity and another at common law¹⁰⁶ or a unitary penalty doctrine.¹⁰⁷ This thesis supports the general penalty doctrine theory.

Sirko Harder¹⁰⁸ argues the general penalty doctrine theory is applicable. He relies on the decision of Gordon J in *Paciocco v Australia & New Zealand Banking Group Ltd*¹⁰⁹ in which her Honour set out a six-stage test based on *Andrews* to determine whether a stipulation is a penalty, and in which reference is made to the penalty doctrine operating at common law and in equity. In *Paciocco*, the Full Federal Court referred approvingly to the Gordon J test as 'a structure of analysis'.¹¹⁰ When separately considering the doctrine at law and in equity, the principles and the relief are not unconnected. However, the circumstances necessary to enliven the common law doctrine are different to those necessary to enliven the jurisdiction in equity (ie: breach of contract at law, and a collateral or accessory stipulation in equity). The common link is that a stipulation to pay a sum of money will not constitute a penalty at law or in equity unless it is extravagant or unconscionable.¹¹¹

Nicholas Tiverios¹¹² argues that *Andrews* supports a unitary penalty doctrine theory. He thus advances four arguments to support his theory. Firstly, he contends that the High Court in *Andrews*¹¹³ staunchly rejected the proposition that the penalty doctrine in Australia is a conceptually distinct rule of the common law and not equity. He contends that the approach of the High Court signifies a unitary penalty doctrine albeit with equitable origins.¹¹⁴ Secondly, the post-*Andrews* decisions appear to be adopting a clear trend toward

¹⁰⁵ See Jessica Palmer, 'Implications of the New Rule against Penalties' (2016) 47 *Victoria University of Wellington Law Review* 305, 310. An example of where that 'remedial flexibility' was exercised is the decision in *Jobson v Johnson* [1989] 1 WLR 1026.

¹⁰⁶ In *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [10] the High Court set out a test for determining whether a contractual stipulation is a penalty in equity. The Court provided that the equitable rule against penalties was in addition to the common law rule against penalties set out in *Legione v Hateley* (1983) 152 CLR 406, 445. The Court envisaged the co-existence of two rules. Sirko Harder, 'The Scope of the Rule against Contractual Penalties: A New Divergence' in Andrew Robinson and Michael Tilbury (eds), *Divergences in Private Law* (Bloomsbury, 2016) 135, 142 refers to the decisions in *PT Thiess Contractors Indonesia v PT Arutmin Indonesia* [2015] QSC 123 (11 June 2015) [150]; and *IPN Medical Centres Pty Ltd v Van Houten* [2015] QSC 204 (23 July 2015) [196] that assume the coexistence of two rules.

¹⁰⁷ Carter et al, above n 49, 108 refers to a 'single doctrine based on equitable principles'. See also Tiverios, 'Doctrinal Approaches to the Law of Penalties', above n 53, 462; McFarlane, above n 52, 366–7 [13.007].

¹⁰⁸ Harder, 'The Scope of the Rule against Contractual Penalties', above n 106, 142; Heydon, Leeming and Turner, above n 21, 551.

¹⁰⁹ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 258 [15]. Gordon J's analysis was adopted in *Australian Capital Financial Management Pty Ltd v Linfield Developments Pty Ltd* (2017) 18 BPR 36 683, 36 647–8 [359].

¹¹⁰ *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 218 [20].

¹¹¹ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 257 [14], 263–5 [39]–[45].

¹¹² Nicholas Tiverios, 'A Restatement of Relief against Contractual Penalties: A Framework for Applying the Australian and English Approaches' (Pt 2) (2017) 11 *Journal of Equity* 185, 214–16; see also John Eldridge, 'The New Law of Penalties: Mapping the Terrain' (2018) *The Journal of Business Law* 637.

¹¹³ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 233 [63], 236 [77]–[78].

¹¹⁴ *Mineralogy Pty Ltd v Sino Iron Pty Ltd [No 6]* (2015) 329 ALR 1, 73 [470].

applying a unitary approach.¹¹⁵ Thirdly, if *Andrews* is read as entrenching two distinct rules against penalties, then contracts will need to be read and enforced in a complex and bifurcated manner. Fourthly, if there are two rules then there is considerable overlap. As for the first argument, the correct position is that in *Andrews* the High Court referred to ‘the settled aspects of the penalty doctrine’,¹¹⁶ by acknowledging the common law definition of penalty in *Legione*,¹¹⁷ and thereafter providing an exposition of the penalty doctrine in equity.¹¹⁸ This provided an unequivocal formulation of the two jurisdictions to relieve against penalty clauses. Nowhere does the High Court refer to a unitary penalty doctrine. The second argument provides an exaggerated view of the post-*Andrews* decisions. The most recent appellate authority is *Australian Capital Financial Management Pty Ltd v Linfield Developments Pty Ltd*¹¹⁹ decided in 2017 by the New South Wales Court of Appeal in which Ward JA expressly confirmed the existence of two separate jurisdictions to relieve against penalties. In so concluding her Honour relied on the reasoning of Gageler J in *Paciocco*.¹²⁰ On balance it cannot be authoritatively asserted that the decided cases post-*Andrews* support a unitary penalty doctrine. The third and fourth arguments lack force because they are not consistent with what the High Court said in *Andrews* and *Paciocco*. Until such time as the existence of a dual jurisdiction for the penalty doctrine that has been settled by the High Court in *Andrews* is set aside, the profession and commercial community must adhere to the law irrespective of its complexity or inconvenience.

As a fallback position, Tiverios concludes it will be of little or no effect if he is incorrect in his support of a unitary penalty doctrine. He correctly says that the issue is one that awaits clarification by the court, and in the meantime, ‘prudent practitioners may wish to plead the existence of a penalty both at common law and in equity to ensure that the outcome of any litigation does not turn on any real or perceived distinction between these rules’.¹²¹ The importance of this procedural issue is developed later in Chapter 5 as part of the analysis of the High Court decision in *Paciocco*.¹²²

This chapter argues that the approach advocated by Harder is to be preferred because it is consistent with *Andrews*, and the six-step ‘structure of analysis’ of that decision as proposed and applied by Gordon J in *Paciocco*.¹²³ Her Honour’s analysis recognises the existence of separate common law and equitable doctrines, which was not challenged in the *Paciocco* appeal to the Full Federal Court or in the High Court. The general penalty doctrine was also adopted in decisions post-*Andrews*.¹²⁴ In *Paciocco*, after referring to Gordon J’s finding that the late payment fees were ‘penalties at law’,¹²⁵ French CJ described the effects of the decision in *Andrews* in terms that are consistent only with the continued co-existence of a common law rule and some confining role for equity in relation to penalties in contracts in the following terms, ‘equitable

¹¹⁵ *Sydney Constructions & Developments Pty Ltd v Reynolds Private Wealth Pty Ltd* (2016) 115 ACSR 513, 520–1 [45]–[52]; *Wu v Ling* [2016] NSWCA 322 (24 November 2016) [1], [21], [117]–[123].

¹¹⁶ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [8].

¹¹⁷ *Ibid* 216 [9]; *Legione v Hateley* (1983) 152 CLR 406, 445.

¹¹⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216–17 [10].

¹¹⁹ *Australian Capital Financial Management Pty Ltd v Linfield Developments Pty Ltd* (2017) 18 BPR 36 683, 36 647–8 [359]; see also *Arab Bank Australia Pty Ltd v Sayde Developments Pty Ltd* (2016) 93 NSWLR 231, 243 [73].

¹²⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 569 [125]–[126].

¹²¹ Tiverios, ‘Doctrinal Approaches to the Law of Penalties’, above n 53, 463.

¹²² In particular see Chapter 5 at Part III, [5.2.8.4].

¹²³ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 258 [15].

¹²⁴ Harder, ‘The Scope of the Rule against Contractual Penalties’, above n 106, 142 refers to *PT Thiess Contractors Indonesia v PT Arutmin Indonesia* [2015] QSC 123 (11 June 2015) [150]; *IPN Medical Centres Pty Ltd v Van Houten* [2015] QSC 204 (23 July 2015) [196].

¹²⁵ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 536 [2].

relief against penalties had not been subsumed into the common law and ... the rule against penalties was not limited to cases arising out of a breach of contract'.¹²⁶ However, nothing turns on the distinction advocated by Harder or Tiverios as the relief granted by a court exercising equitable jurisdiction 'usually happens to be equivalent to the amount of damages recoverable at common law'.¹²⁷ In each instance the non-breaching party can recover its proved loss¹²⁸ if the stipulation is found to be a penalty at common law or in equity.

3.4.3 An Understanding of the Penalty Doctrine Requires More Than a Brief Backward Glance¹²⁹

Andrews is based on a brief analysis of the historical evolution of the English law of contract prior to 1873.¹³⁰ In so doing, the High Court acknowledged 'an understanding of the penalty doctrine requires more than a brief backward glance'.¹³¹

David Ibbetson¹³² explains that in the late medieval to early modern periods,¹³³ the penal bond was the principal device for framing contracts as it was delivered as a deed and could be sued upon in debt. The bond created the debt rather than the underlying promise. Furthermore, the bond could be simple or conditional. For example, the promisor was to pay £X on Y date, but if the stipulation or promise was performed, then the bond was void. The common law courts upheld such bonds on the basis they were a means of avoiding the usury laws. However, from the 16th century Chancery intervened against harsh outcomes where payment of a large sum of money was stipulated on default of payment of a smaller sum. Chancery¹³⁴ considered security for performance was the proper rationale for the penal bond, and the remedy it granted was to restrain enforcement of the bond on terms that the breaching party pay damages, interest and costs¹³⁵ ie: the actual loss sustained by the non-breaching party. Toward the end of the 17th century the common law courts began to stay proceedings on the penal bond to secure the debt unless the non-breaching party was prepared to accept tender of the money sum together with interest and costs.¹³⁶ Statutory protections¹³⁷ were eventually put in place and by the end of the 18th century, the common law courts treated the statutory procedures as mandatory, requiring damages to be pleaded and proved and

¹²⁶ Ibid 537 [47]. See also the comments by Gageler J at 558 [74], 566–7 [115], 568 [122], 571 [134], 575–6 [150], and Keane J at 604–6 [249]–[254].

¹²⁷ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193, citing *Elsley v J G Collins Insurance Agencies Ltd* (1978) 83 DLR (3d) 1, 13. Note that the amount recoverable in equity might be reduced due such factors as delay or acquiescence.

¹²⁸ At common law, see *W&J Investments Ltd v Bunting* [1984] 1 NSWLR 331, 335–6. In equity see *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [10].

¹²⁹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 218 [14]; Chief Justice James Allsop, 'Singapore Academy of Law Distinguished Speaker Lecture 2017 — 'The Doctrine of Penalties in Modern Contract Law'' (2018) 30 *Singapore Academy of Law Journal* 1.

¹³⁰ The *Judicature Act 1873* fused the administration of common law and equity by amalgamating the superior courts into the Supreme Court of Judicature having jurisdiction over matters of law and equity. See *Supreme Court Act 1986* (Vic) s 29.

¹³¹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 218 [14].

¹³² David Ibbetson, *A Historical Introduction to the Law of Obligations* (Oxford University Press, 2002) 29–30; see also *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 543–4 [19]; Rossiter, above n 20.

¹³³ 1300–1650.

¹³⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1192 [4], citing *Sloman v Walter* (1783) 1 Bro CC 417, 419; 28 ER 1213.

¹³⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1192–3 [5], citing *Peachy v Duke of Somerset* (1720) 1 Str 447, 453; 93 ER 626, 630

¹³⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1193 [6]; *Austin v United Dominions Corp Ltd* [1984] 2 NSWLR 612, 626.

¹³⁷ *Administration of Justice Act 1696*, 8 & 9 Will 3, c II ('*The Statute of William 1696–97*'); *Administration of Justice Act 1705*, 4 & 5 Anne, c 16, s 8 ('*The Statute of Anne 1705*').

staying all further proceedings on the bond.¹³⁸

The High Court concluded that there was an equitable jurisdiction to relieve against penalty stipulations. In arriving at this conclusion the court determined the penalty doctrine did not disappear from equity 'by absorption into the common law action of assumpsit'.¹³⁹ Furthermore, the 'developments in the practice of the common law courts in assumpsit actions before the introduction of the judicature system did not somehow supplant the equity jurisdiction'.¹⁴⁰ The court found there was 'no reason in principle why the scope of the equitable doctrine should be restricted to those cases today where, hypothetically, an assumpsit action would have lain at law in the nineteenth century'.¹⁴¹ The court further found that 'under the Judicature legislation it is equity not the law that is to prevail',¹⁴² as well as that there 'is no basis for the proposition that the penalty doctrine is a rule of law not of equity'.¹⁴³ These findings are consistent with the conclusion that the equitable jurisdiction to relive against penalties co-exists with the common law penalty rule. The final extract from the *Andrews* judgment referred to above appears to deny the existence of any common law rule, however the better construction of what the court said is that it denies only that the common law was left in sole command of the field. It is to be recalled that the court had earlier endorsed the test in *Legione*¹⁴⁴ which represents the common law position.

In *Andrews*, the High Court concerned itself with the expression 'condition'¹⁴⁵ and noted 'the obligation under a bond may be said to be 'conditioned' upon the occurrence of a particular event'.¹⁴⁶ The expression 'conditioned' was not being used by the High Court, in the sense of a reference to breaches of contract.¹⁴⁷ The High Court¹⁴⁸ sought to explain the distinction by citing from a text by Samuel Williston, in which he had confirmed the purpose of the early form of conditional bond was to secure performance of the relevant condition. This was achieved not by trying to secure the result by extracting a promise from the breaching party to perform the condition but rather by an acknowledgement of indebtedness (ie: a promise to pay the stipulated sum of money if the condition was not performed).¹⁴⁹ The High Court said the practical method, in that period, of stipulating for the performance of a collateral act was to make payment of a money sum conditional on non-performance of the desired act. That sum might be recovered in full even if it exceeded the value of the stipulated act or forbearance. The High Court noted¹⁵⁰ 'the condition may be an occurrence or event which need not be some act or omission of the breaching party, analogous to a contractual promise

¹³⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1193 [6].

¹³⁹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 228 [51].

¹⁴⁰ *Ibid* 232 [61].

¹⁴¹ *Ibid* 232 [62].

¹⁴² *Ibid* 233 [63].

¹⁴³ *Ibid*.

¹⁴⁴ See *ibid* 216 [9].

¹⁴⁵ *Ibid* 223 [33], 223–4 [35].

¹⁴⁶ *Ibid* 223–4 [35].

¹⁴⁷ *Ibid*, citing Samuel J Stoljar, 'The Contractual Concept of Condition' (1953) 69 *Law Quarterly Review* 485, 486–8.

¹⁴⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 224 [36], citing Samuel Williston, *A Treatise on the Law of Contracts* (Baker, Voorhis, revised ed, 1957) vol 3, §792. The relevant passage could not be found at the volume and section cited. It was found at Walter H E Jaeger, *A Treatise on the Law of Contracts by Samuel Williston* (Baker, Voorhis, 3rd ed, 1961) vol 5, 655 §774.

¹⁴⁹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 224 [36], citing Samuel Williston, *A Treatise on the Law of Contracts* (Baker, Voorhis, revised ed, 1957) vol 3, §792. The relevant passage could not be found at the volume and section cited. It was found at Walter H E Jaeger, *A Treatise on the Law of Contracts by Samuel Williston* (Baker, Voorhis, 3rd ed, 1961) vol 5, 655 §774.

¹⁵⁰ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 225 [39].

by the obligor’.

*Andrews*¹⁵¹ explained that if payment on the bond was dependent on a condition, and that condition was not necessarily promissory in character, then the event triggering payment did not require a breach by the other party. Based on the foregoing ‘brief backward glance’¹⁵² the High Court concluded there was a live equitable jurisdiction that engaged the penalty doctrine and it had not ‘withered on the vine’ as had been suggested in *AMEV-UDC*.¹⁵³

3.4.4 The Operative Distinction between a Secondary Stipulation and an Alternative Stipulation

A question which arises from *Andrews* is whether to decide there is a secondary or collateral stipulation that imposes an additional detriment on the promisor which acts coercively to make that party perform rather than requiring proof that that party was under a contractual obligation to ensure there was no failure of the primary stipulation. The High Court¹⁵⁴ explained there was an ‘operative distinction’¹⁵⁵ between a secondary stipulation (ie: collateral or accessory)¹⁵⁶ provided as satisfaction for failure of a primary stipulation and what John Pomeroy has referred to as an ‘alternative stipulation’.¹⁵⁷ The distinction is important as the former engages the penalty doctrine and the latter does not.

An example of a secondary stipulation is a clause providing for payment of a sum of money by way of liquidated damages for late completion of a construction contract. In this instance, the money is the security for performance of the primary obligation which is to complete the construction on time. The penalty doctrine can be engaged if the sum stipulated as payable upon breach is out of all proportion. On the other hand, an alternative stipulation differs as it is an obligation to pay a sum of money for the enjoyment of an ‘additional’ right or service which the High Court refers to as a ‘further accommodation’.¹⁵⁸ As such, an example of an alternative stipulation is the grant of a performance option¹⁵⁹ where the penalty doctrine is not engaged by such a stipulation.¹⁶⁰ The High Court sought to demonstrate the distinction by reference to two decisions; one from the Court of Chancery in Ireland and the other from the New South Wales Court of Appeal, each of which concerned the operation of alternative stipulations and will now be analysed.

3.4.4.1 *French v Macale*

The first example relied upon by the High Court was the 1842 decision of Sir Edward Sugden,¹⁶¹ Lord

¹⁵¹ Ibid.

¹⁵² See *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 218 [14].

¹⁵³ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 191.

¹⁵⁴ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 237 [81].

¹⁵⁵ Ibid 237 [80].

¹⁵⁶ This is the language used in *ibid* 216 [10].

¹⁵⁷ This is the language adopted in Spencer W Symons (ed), *A Treatise on Equity Jurisprudence by John Norton Pomeroy* (Bancroft-Whitney Co, 5th ed, 1941) vol II, 211–14 §437 to which the court referred in *ibid* 237 [81]; see also Edwin Peel, ‘The Rule against Penalties’ (2013) 129 *Law Quarterly Review* 152.

¹⁵⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 236–7 [79]; Heydon, Leeming and Turner, above n 21, 564.

¹⁵⁹ *Reardon Smith Line Ltd v Ministry of Agriculture, Fisheries and Food* [1963] AC 691, 729, the conferral of a ‘right of choice specially granted to the holder of the option and to be used solely for his own benefit’. See also Halson, above n 10, 167–8 [5.43]–[5.44].

¹⁶⁰ *MGM* [1966] 2 NSW 717 where a stipulation was found to be a performance option and did not attract the penalty doctrine.

¹⁶¹ Baron Saint Leonards (1852), Lord Chancellor of Great Britain.

Chancellor for Ireland, in *French v Macale*.¹⁶² The case concerned a motion by a tenant to dissolve an injunction obtained by a landlord regarding the tenant's proposal to burn farming land. By a lease, the tenant had covenanted not to burn any part of the demised premises 'under a penalty of £10 for every acre so burned to be recovered as additional rent'. The Court had to decide, as a matter of construction, whether the parties had intended that the tenant should be entitled to burn the land upon payment of the specified sum, or whether the parties had intended the tenant should not be entitled to burn the land, but should pay compensation if he did. In the latter case, an injunction would issue to restrain the tenant from doing the forbidden thing.¹⁶³ The Court held the tenant was not entitled to burn the land upon payment of the specified sum as liquidated damages for doing the act, and that the Court would restrain the tenant by injunction from doing so.

In *Andrews*, the High Court relied on an extract¹⁶⁴ from the judgment in *French* to distinguish between a secondary obligation that engaged the penalty doctrine and a different stipulation that gives rise consensually to an additional obligation. The relevant extract from *French* provides:

The question for the court to ascertain is whether the party is restricted by covenant from doing the particular act although if he do it a payment is reserved, or whether, according to the true construction of the contract, its meaning is that the party shall have a right to do the act on payment of what is agreed upon as an equivalent. If a man let a meadow land for two guineas an acre, and the contract is that, if the tenant choose to employ it in tillage, he may do so, paying an additional rent of two guineas an acre, no doubt this is a perfectly good and unobjectionable contract; the breaking up the land is not inconsistent with the contract which provides that in case the act is done the landlord is to receive an increased rent.

Rossiter¹⁶⁵ helpfully explains the distinction between the different obligations in terms of promises. In the first instance he considers a promise to do or refrain from doing something or to pay a sum of money where a breach of this promise does not engage the penalty doctrine but gives the promisee a choice of whether to sue in debt or damages. In the second instance he considers the difference a promise which is to do or refrain from doing something and to pay a specified sum of money as compensation for breach. A breach of this form of promise does engage the penalty doctrine and may, in appropriate circumstances, attract the award of an injunction.¹⁶⁶

3.4.4.2 *Metro Goldwyn Mayer Pty Ltd v Greenham*

The second example relied upon by the High Court was the New South Wales Court of Appeal decision in *Metro Goldwyn Mayer Pty Ltd v Greenham*.¹⁶⁷ In this case a film exhibitor Greenham was licensed by a hire agreement with MGM (the distributor) to screen a film only once.¹⁶⁸ Clause 3 of the agreement provided

¹⁶² *French v Macale* (1842) 2 Dr & War 269, 275–6; All ER Rep 6, 9, cited in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 237 [80].

¹⁶³ J L Barton, 'Penalties and Damages' (1976) 92 *Law Quarterly Review* 20, 22.

¹⁶⁴ See *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 237 [80], quoting *French v Macale* (1842) 2 Dr & War 269, 275–6; All ER Rep 6, 9.

¹⁶⁵ Rossiter, above n 20, 75.

¹⁶⁶ For example, this was part of the relief sought in *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79.

¹⁶⁷ *Metro Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSW 717. See also the Case Note by Robert Baxt at (1968) 41 *Australian Law Journal* 508.

¹⁶⁸ The agreement was in a standard form prescribed under the *Cinematograph Films Act 1935* (NSW). Clause 9 was a negative stipulation that provided: 'The Exhibitor shall within the period of hire exhibit the films set out in the

that if Greenham committed any breach of the agreement as regards the purpose, manner, time or place for which the film may be used, MGM may then terminate the agreement. Clause 56(a) of the agreement¹⁶⁹ required payment of a further fee of four times the original fee for each subsequent screening of the film (the 'extra fee clause'). Since there was an express prohibition in clause 9, any unlicensed screening had to be a breach of the agreement.¹⁷⁰ Greenham screened the film on twelve extra occasions and MGM issued legal proceedings.

MGM did not sue for damages for breach of the agreement but instead issued a default summons¹⁷¹ claiming as a debt money payable to it as hire. However, in a statement of agreed facts for the hearing, the parties stated 'the defendant in breach of the terms of the said agreement, exhibited the films supplied by the plaintiff on twelve unauthorised occasions additional to those authorized by the respective agreement'.¹⁷² Holmes JA¹⁷³ proceeded on the basis that 'if the exhibition of the films by the defendant-exhibitor was not a breach of the agreement, the statement of facts, by calling it so, cannot make it so'. MGM sued for sums due because of twelve unauthorised extra screenings of the film and Greenham pleaded the extra fee clause was a penalty. At first instance, the defence of penalty was successful. However, on appeal, the majority (Jacobs and Holmes JJA) found the extra fee stipulation was an enforceable performance option which permitted the purchase of the right to further screenings of the film upon payment of the extra fee, and the stipulation was not a penalty.

Wallace P (dissenting) held clause 9 of the agreement, which expressly prohibited Greenham from exhibiting the film at a time or place not authorised, was enforceable by injunction. He decided the extra fee clause was not a performance option, but was a penalty as it operated as a sanction for breach of the agreement, if the film was screened more than once. The fourfold extra fee was extravagant and not a genuine pre-estimate of loss consequent upon any breach of the agreement.¹⁷⁴ He concludes that clause 56 was 'neither an option to exhibit at an unauthorised time, subject to payment at a multiple rate, nor a pre-estimation of liquidated damages.'¹⁷⁵

Jacobs JA found the extra fee clause provided for a performance option. He considers Greenham had no right to exhibit the film otherwise than on the one authorised occasion. However, if Greenham exceeded this then he had exercised an option to do so pursuant to the extra fee clause. The option was exercisable upon payment of the extra fee and as these screenings were strongly discouraged, a '*very large hiring fee*' was provided. The extra screenings of the film were in the nature of additional performances as the right to the

Schedule in the theatre and shall not exhibit any of the said films, or allow, or suffer, any of the said films to be exhibited or used at any other place or at any time not authorised by or pursuant to this Agreement without the written consent of the Distributor.'

¹⁶⁹ Clause 56(a) provided:

If the Exhibitor without the consent in writing of the Distributor exhibit or permit to be exhibited any film on or at any date or time or at any place not authorised by this Agreement the Exhibitor shall pay as hire for each such exhibition, four times the amount of the hire calculated in accordance with clause 54 as if each day on which the film was so exhibited or permitted to be exhibited were an authorised exhibition date on which the Exhibitor without excuse had failed to exhibit ['the extra fee clause'] ...

¹⁷⁰ *MGM* [1966] 2 NSW 717, 722 where Jacobs JA records that the parties agreed the unauthorised screening was a breach of the agreement.

¹⁷¹ In New South Wales at the time, a default summons was used to recover a debt and a special summons was used to recover damages.

¹⁷² *MGM* [1966] 2 NSW 717, 722, 726.

¹⁷³ *Ibid* 726.

¹⁷⁴ *Ibid* 720–1.

¹⁷⁵ *Ibid* 720.

initial performance endured. He explains it as:¹⁷⁶

there is no right in the exhibitor to use the film otherwise than on an authorised occasion. If he does so, then he must be taken to have exercised an option so to do under the agreement, if the agreement so provides. The agreement provides that he may exercise such an option in one event only, namely, that he pay a hiring fee of four times the usual hiring fee.

Holmes JA also found the extra fee clause was not a penalty. In his opinion, screening of the film on twelve unauthorised occasions was 'not covered by the agreement'.¹⁷⁷ He relies on clause 9 which prohibits screening of the film, at any place or at any time, not authorised by or pursuant to the agreement without the written consent of MGM.¹⁷⁸ He refers¹⁷⁹ to the words in clause 56(a) 'not authorised by this Agreement' and said they must be read, keeping in mind, that the clause contemplated screenings not authorised by the agreement, as covering those screenings that took place with the consent in writing of MGM. His Honour¹⁸⁰ notes there 'is a little bit of difficulty in reconciling these expressions' and concludes¹⁸¹ that as clause 56 does not relate to breaches of the agreement, then the law of penalties could not apply. The distributor had a choice between preventing additional screenings by an injunction or claiming the fourfold extra fee.¹⁸²

The High Court relies on *MGM* to demonstrate the distinction between a secondary stipulation and an alternative stipulation. In *MGM*, the majority had found the stipulation in question (ie: clause 56(a)) to be an alternative stipulation as it was characterised as a performance option.¹⁸³ However, the judges were divided as to the proper characterisation of the stipulation under consideration¹⁸⁴ and advanced two constructions of the stipulation. On one hand, Wallace P construes the extra fee clause as an agreement containing a restraint on any more than one screening of the film, with an agreed pre-screening payment of the extra fee required for additional screenings. This construction attracted the penalty doctrine as the stipulated extra fee was payable consequent upon breach of the agreement. On the other hand, Jacobs and Holmes JJA construes the clause as providing for the first screening at a certain price, with optional subsequent screenings attracting payment of the extra fee.¹⁸⁵ The finding of the majority that the extra fee clause was not a penalty is arguably not correct, as there was no real option and, in fact, there were twelve unauthorised screenings of the film that were in breach of the agreement. The agreement does not confer an option on the exhibitor to provide extra screenings without seeking consent from *MGM*. Therefore, the exhibitor could not have enjoyed a true option in performance. Once there was an unauthorised screening of the film, clause 56(a) applies and it provides for payment of the extra fee on the basis the exhibitor has 'without excuse failed to exhibit' the film on an 'authorised exhibition date'.

¹⁷⁶ Ibid 723; *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 237–8 [82].

¹⁷⁷ *MGM* [1966] 2 NSW 717, 726.

¹⁷⁸ Ibid 726.

¹⁷⁹ Ibid 727.

¹⁸⁰ Ibid.

¹⁸¹ Ibid.

¹⁸² Ibid 726–7. Note that at 726 he provides the example of a lease of land and recites facts that are similar to *French v Macale* (1842) 2 Dr & War 269; All ER Rep 6, but without citing the decision.

¹⁸³ See Carter et al, above n 49, 128, where the authors criticise the Court's reliance on the *MGM* decision and state that reliance on the decision does not 'engender confidence in the new law of penalties'.

¹⁸⁴ The judges in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172 suffered from the same difficulty.

¹⁸⁵ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 237 [80].

Consistently with the above criticism of the majority judgments, Harder¹⁸⁶ demonstrates two problems with the decision in *MGM*. Firstly, Jacobs JA found, upon the proper construction of the agreement, that Greenham enjoyed an option of conducting additional screenings of the film upon payment of the extra fee. This construction characterises the extra fee clause as an alternative stipulation to the primary obligation in clause 9. However, Jacobs JA also observes that the purpose of the significant increase in the fee payable for extra screenings may have been to ‘strongly discourage’¹⁸⁷ any additional screenings. This observation closely equates to a conclusion that the increased fee was security for and in terrorem of the requirement to adhere to the one screening permitted by clause 9. This approach meets the *Andrews* description for a secondary stipulation (ie: the imposition of an additional detriment upon the failure of the primary stipulation). On Harder’s reasoning, Jacobs JA’s analysis was incorrect and the penalty doctrine was engaged. Secondly, Holmes JA found that conducting additional screenings of the film was not a breach of the agreement even though those extra screenings could have been prevented by an injunction. Harder points out ‘this makes no sense’¹⁸⁸ as an injunction would only apply to enjoin the extra screenings of the film if that conduct, constitutes a breach of clause 9 of the agreement. Again, the penalty doctrine would be engaged.

This chapter argues that the *MGM* decision should be treated with caution because arguably it was wrongly decided. Clause 9 is a negative stipulation in the sense that Greenham was prohibited from screening any film at any time or place not authorised by the agreement or without the written consent of MGM. Clause 9 cannot properly be construed as providing for an option. In the event of breach of the agreement, *MGM* would be entitled to an injunction to restrain such a breach. Clause 56(a) provides an absolute veto upon the screening of a film at any time not authorised by clause 9, without the written consent of *MGM*. Clause 56 is not an option to exhibit at an authorised time subject to payment of the extra fee, and that extra fee is not a pre-estimation of loss. Clause 56(a) provides for an ‘extravagant and quite inconsistent multiplier of four’.¹⁸⁹ The power in clause 3 that permits MGM to terminate upon breach of the agreement is not consistent with the grant of an option. Clause 56(a) operates as a deterrent, in that it provides an additional sanction for breach of the negative covenant in clause 9. Another aspect of clause 56(a) which supports the argument that it is an unenforceable penalty is that it provides a fixed measure (ie: extra fee) of universal application upon occasions where there has been unauthorised screening(s) of the film. This fails to take into account the nature, entertainment value of the relevant film, the location and the surrounding circumstances of MGM as well as that different films attract different hiring rates for authorised screenings.¹⁹⁰ These matters are in conflict with Lord Dunedin’s proposition 4(c) in *Dunlop*.¹⁹¹

Despite these criticisms of the reasoning of the Court, *MGM* is a decision of the New South Wales Court of Appeal that was cited with approval in *Andrews* to support the proposition that if a contract provides two primary stipulations as alternatives then the penalty doctrine cannot be engaged because performance of either stipulation will not give rise to a breach of the contract. On this construction, there was no breach of

¹⁸⁶ Harder, ‘The Scope of the Rule against Contractual Penalties’, above n 106, 149–50.

¹⁸⁷ *MGM* [1966] 2 NSW 717.

¹⁸⁸ Harder, ‘The Scope of the Rule against Contractual Penalties’, above n 106, 149–50.

¹⁸⁹ *MGM* [1966] 2 NSW 717, 720.

¹⁹⁰ *Ibid* 721.

¹⁹¹ See chapter 2 at [2.2.1].

the hire agreement and, therefore no question of penalty arose.¹⁹² Additionally, on its proper construction, the extra fee clause in *MGM* fixed an additional price as being payable to compensate MGM for extra screenings of the film not otherwise authorised by the agreement.¹⁹³

PART III

3.5 *Andrews*: Perceived Difficulties

In 2012 when *Andrews* was decided, commentators argued it was a major development in the law, and would have wide-ranging ramifications for commercial transactions including the drafting of commercial contracts.¹⁹⁴ In particular, commercial arrangements in the financial services sector, the equipment finance industry, as well as information technology, mining, construction, engineering and services contracts were all said to be affected. Furthermore, there were stipulations that had specifically been drafted to avoid the operation of the penalty doctrine,¹⁹⁵ for example: take-or-pay clauses; provisions in hire purchase agreements and chattel leases which dealt with payments due upon termination; clauses providing for discounts for punctual payment; and certain interest provisions in finance documents which were said to now be unenforceable penalties.¹⁹⁶

Subject to one exception¹⁹⁷ the extension of the scope of the penalty doctrine in equity in Australia has not had the deleterious impact which was feared by some commentators¹⁹⁸ as the penalty doctrine in equity is rarely engaged and drafters of contracts are able to draft alternative stipulations providing for an additional right or in the form of further accommodation. For example, as 'options exercisable ... for contrived or nominal consideration',¹⁹⁹ or licences, or bonus provisions which fall within the definition of alternative stipulations. If a contract provides that, in a certain event, a sum of money paid under the contract is to be repaid to the original payer, the reimbursement cannot be a penalty.²⁰⁰ Also, the penalty doctrine will not apply to a stipulation providing for an incentive payment eg: an increase in the price if certain targets in the contract are bettered or if the costs are reduced. The penalty doctrine does not encompass situations where a reduced interest rate is charged on condition that payment is punctual, but if it is not, the full rate will apply.²⁰¹ A sum could be payable as the price of the 'right to pay late' rather than upon the breach of an obligation to pay on time.²⁰² Also, banking or finance contracts could be drafted to categorise amounts

¹⁹² Baxt, above n 167.

¹⁹³ Pursuant to clause 56(a) the exhibitor of the film could have obtained the consent in writing of *MGM* to screen the film at times and places not authorised.

¹⁹⁴ For example, Peel, above n 157; Carter et al, above n 49; Manly, above n 1.

¹⁹⁵ See Halson, above n 10, 169–180 [5.47]–[5.79].

¹⁹⁶ For example, see Dharmananda and Firios, above n 48, 148–9; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1208–9 [42]; see generally Manly, above n 1.

¹⁹⁷ *Cedar Meats* (2014) 45 VR 79.

¹⁹⁸ Eldridge, above n 112, 2.

¹⁹⁹ Halson, above n 10, 49 [2.37], 169–78 [5.47]–[5.72]; Christensen and Duncan, above n 98, 165–6; *Fratelli Moretti SpA v Nidera Handelscompagnie BV* [1981] 2 Lloyd's Rep 47, 53.

²⁰⁰ *Alder v Moore* [1961] 2 QB 57, approving *Re Apex Supply Co Ltd* [1942] Ch 108; Hugh Beale, 'Damages' in Hugh Beale (ed), *Chitty on Contracts* (Sweet and Maxwell, 32nd ed, 2015) vol 1, 1797, 1929 [26.197].

²⁰¹ *Astley v Weldon* (1801) 2 Bos and P 346, 353; 126 ER 1318, 1319; *Wallingford v Mutual Society* (1880) 5 App Cas 685, 702.

²⁰² Eliza Mik, 'Subject to Review? Consideration, Liquidated Damages and the Penalty Jurisdiction' (Paper presented at Obligations VII, University of Hong Kong, 18 July 2014) 4 <https://ink.library.smu.edu.sg/sol_research/1737/>.

payable as fees for services rendered, or characterise a transaction as a payment for a right or benefit, rather than as a payment of compensation for breach or failure to adhere to a term.

3.5.1 **Andrews: Application to a Take-or-Pay Clause**

Take-or-pay clauses are common in long-term natural resources contracts under which a purchaser agrees to take delivery from a seller of a certain quantity of product or pay for the minimum quantity anyway at an agreed rate even if the product is not taken.²⁰³ The purpose of such provisions include that they guarantee a seller's revenue stream which then enables it to service debt, and operate to allocate risk of loss between purchaser and seller due to fluctuations in the market price of the commodity.

A take-or-pay clause will not engage the penalty doctrine because the effect of the clause is to create a debt upon the happening of one of two events: goods being ordered and received or goods not being ordered.²⁰⁴ The revenue stream created by a take-or-pay clause is almost always a primary obligation which is a debt and not a secondary obligation to pay damages upon breach of the contract.²⁰⁵ On that basis, these types of stipulations would ordinarily not engage the penalty doctrine.

In England, a claim in debt is not subject to the penalty doctrine.²⁰⁶ In Australia, the position is different because of *Andrews* which was recently applied by the Victorian Court of Appeal to a take-or-pay clause in *Cedar Meats*.²⁰⁷ In this case, the parties had entered into a contract pursuant to which Cedar Meats (the seller) agreed to provide Five Star (the purchaser) with manufacturing, processing and packaging services for an 'agreed daily volume' of lamb products at Cedar Meats' abattoir.²⁰⁸ Clause 7 of the contract provided Cedar Meats would kill, process and pack lamb in accordance with the 'agreed daily volumes'.²⁰⁹ Clause 8(a) of the contract provided that if Five Star supplied less than 75 per cent of the 'agreed daily volumes', it would in any event pay Cedar Meats a fee equal to 75 per cent of the agreed daily volumes and prices for the relevant days. This is a form of 'take-or-pay clause'. Clause 9 of the contract provided that Five Star would pay Cedar Meats a 'per head price'.²¹⁰ Five Star fell far short of the 'agreed daily volumes' from the outset of the contract and eventually production ceased. Cedar Meats received payment on the basis of only the volumes of lamb actually supplied and processed at its abattoir, but did not press for full payment of its fees (some \$15 million)²¹¹ under clause 8(a) of the contract until 2011 when Five Star advised it was going to supply its lamb to a different processor.

²⁰³ Prashanth Sabeshan and Alexandra Birdseye, 'Take-or-Pay Clauses in Supply Contracts: The *Polymers* Decision and Australian Practice' (2008) 27 *Australian Resources and Energy Law Journal* 421; Halson, above n 10, 204–5 [6.39]–[6.41].

²⁰⁴ Halson, above n 10, 204–5 [6.39]–[6.41]; *White and Carter (Councils) Ltd v McGregor* [1962] AC 413, 427 which is authority for the proposition that the penalty doctrine is not relevant where the plaintiff's claim is not for damages for breach of contract, but a claim for the agreed sum (a debt) due from the defendant in return for the plaintiff's performance of his side of the contract.

²⁰⁵ See Ben Holland and Phillip Spencer Ashley, 'Enforceability of Take-or-Pay Provisions in English Law Contracts — Revisited' (2013) 31 *Journal of Energy and Natural Resources Law* 205, 214.

²⁰⁶ *Euro London Appointments Ltd v Claessens International Ltd* [2006] 2 Lloyd's Rep 436, 445; *Abrahams v Performing Right Society Ltd* [1995] ICR 1028, 1040–1; *MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2015] EWHC 283 (Comm) (12 February 2015) [70].

²⁰⁷ (2014) 45 VR 79.

²⁰⁸ The relevant terms of the contract are set out at *ibid* 82 [5].

²⁰⁹ Set out in item 2 of Schedule 2 to the Contract.

²¹⁰ Set out in clause 9 and items 2 and 3 of Schedule 2 to the Contract: \$21.50 per head.

²¹¹ *Cedar Meats Pty Ltd v Five Star Lamb Pty Ltd* [2013] VSC 164 (12 April 2013) [7].

At trial, Sifris J²¹² made findings that the parties had abandoned the contract, including that Cedar Meats had also abandoned its accrued rights under clause 8(a) of the contract to recover in excess of \$15 million for outstanding fees. This latter finding was based on an inference that Cedar Meats had failed to seek to enforce its right to full payment of its fees until some time after the shortfalls and it continued to process small quantities of lamb for Five Star on an ad hoc basis, in the interim on different terms. Five Star argued clause 8(a) of the contract was an agreed damages clause and as it imposed a burden that was extravagant and far exceeded the greatest loss that could conceivably be suffered by Cedar Meats, it constituted an unenforceable penalty. Cedar Meats argued the 'traditional view'²¹³ that the effect of clause 8(a) of the contract was to create a debt, and therefore the penalty doctrine could not be engaged.

Sifris J²¹⁴ noted that 'there was a requirement under clause 8(a) for Five Star to pay \$21.50 per head of lamb, in the circumstances where this greatly exceeded the actual damages likely to be inflicted on Cedar Meats by a failure on the part of Five Star to deliver 75 per cent of the agreed daily volumes'. Further, he said²¹⁵ 'insisting on payment of the full amount per head without making any allowance for the significant cost savings associated with not performing the relevant tasks constitutes, in my opinion, the stipulation for an extravagant amount that far exceeds the greatest loss suffered by Cedar Meats'. The trial judge applied *Andrews* and found the payments alleged to be due to Cedar Meats under clause 8(a) of the contract were 'clearly extravagant' and unenforceable as a penalty. However, Cedar Meats could still recover unliquidated damages for its loss. However that on the available evidence, Sifris J held he was not able to reach any conclusion on that issue.²¹⁶

The Court of Appeal found that, even though the parties had abandoned the contract the judge erred in finding Cedar Meats had abandoned its accrued right to payment of its outstanding fees under clause 8(a) of the contract as it had not expressly or impliedly reserved those rights. The Court confirmed that where a contract has been partly performed, it should be inferred that abandonment operates prospectively (ie: from the date of abandonment), with no effect on accrued rights. The Court assesses the parties' intentions objectively and where a contract has been abandoned, only clear and objective evidence would displace the presumption that the parties intended to retain their accrued rights. The Court found the delay by Cedar Meats in enforcing its accrued rights was relevant but not ultimately decisive in assessing whether those rights had been abandoned. Other factors, including evidence of Cedar Meats' intention to keep its enforcement options open, led to the conclusion that the accrued rights had not been abandoned.

The Court confirmed the finding made by Sifris J that the payments required to be made by Five Star under clause 8(a) of the contract were penal and in so doing, affirmed that the principles in *Andrews* were engaged. The Court said *Andrews* re-established that such a provision (ie: clause 8) may still be regarded as penal if it secures a primary stipulation even though the stipulation does not impart a contractual promise.²¹⁷ Accordingly, the Court reasoned that

²¹² Ibid [15].

²¹³ Ibid [100], citing Hugh Beale, 'Damages', in Hugh Beale (gen ed), *Chitty on Contracts* (Sweet and Maxwell, 31st ed, 2012) vol 1, 1873.

²¹⁴ *Cedar Meats Pty Ltd v Five Star Lamb Pty Ltd* [2013] VSC 164 (12 April 2013) [107].

²¹⁵ Ibid [108].

²¹⁶ Ibid [115].

²¹⁷ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 234 [67], 236 [78].

where it is sought to secure the performance of a condition, the obligee [Cedar Meats] extracts a promise from the obligor [Five Star] to pay a sum of money (or perhaps to convey property) if the condition not be performed, the promise is properly to be viewed as a security for the satisfaction of the condition and so, therefore, if the sum of money (or conveyance) is excessive and unconscionable, may now be treated as penal.²¹⁸

The Court held that the contractual promise, embodied in clause 8 of the contract, should be viewed as a penalty where it is provided as a security for the satisfaction of the condition in clause 7 or a primary obligation, and the sum of money is excessive or unconscionable when compared to the greatest loss that could conceivably be proved by Cedar Meats. The Court²¹⁹ found clause 7 of the contract did not impose an obligation on Five Star to deliver the 'agreed daily volumes'. Rather, it was a promise by Five Star that if the conditions specified in clause 7 of the contract were not performed then it would pay Cedar Meats the amount of money specified in clause 8 with this promise subject to questions of excessiveness and unconscionability. The Court of Appeal did not have to decide whether the sums payable pursuant to clause 8(a) of the contract were extravagant and unconscionable because there was no ground of appeal challenging the validity of that finding by Sifris J.²²⁰ Accordingly the Court remitted the question of the proper assessment of compensation in equity back to Sifris J.

It is to be observed that on the trial judge's finding of extravagance and unconscionability the Court of Appeal held²²¹ it was 'inappropriate for us to decide whether we would have come to the same view as the judge'. However, at the commencement of the judgment on the penalty issue, the Court expressly confirmed the finding by Sifris J that clause 8(a) of the contract was a penalty and that he was 'correct on that point'.²²² The comments made by the Court²²³ about how courts should react 'if a similar question arises in another case' supports the view that 'in cases involving commercial organisations of apparently equal bargaining power, courts should be prepared to allow a substantially larger degree of latitude than would be appropriate in cases of contracts of adhesion'. This chapter argues that this strongly supports the view that the Court of Appeal would have been prepared to characterise clause 8(a) of the contract as a stipulation which could engage the penalty doctrine in equity, and if an appropriate ground of appeal had been advanced by the appellant the impugned stipulation would not have been found to be an unenforceable penalty as the sums stipulated for were not extravagant or unconscionable or out of all proportion. Such a finding would be consistent with the comment by Kiefel J in *Paciocco*²²⁴ that 'a person contending that a sum is a penalty will be facing a high hurdle'.

3.6 Penalties in Equity

3.6.1 Introduction

²¹⁸ Ibid 224 [36], 234 [67].

²¹⁹ *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd* (2014) 45 VR 79, 100 [51].

²²⁰ Ibid 101 [54].

²²¹ Ibid.

²²² Ibid 97 [39].

²²³ Ibid 101 [54].

²²⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 553 [53]; see also Lord Hodge in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1280 [266] where he said that 'the criterion of exorbitance or unconscionableness should prevent the enforcement of only egregious contractual provisions'.

Post-*Andrews*,²²⁵ a contractual stipulation requiring payment in circumstances where there has been no breach of contract but instead failure of a primary stipulation could be characterised as a penalty.²²⁶ As was the case in *MGM*²²⁷ and *Cedar Meats* much depends on the proper construction of the contract. The analysis in each instance requires consideration of the nature and effect of the impugned stipulation. Both of the decisions relied upon by the High Court in *Andrews* illustrates that ‘if the contracting party may do either of two things, but is to pay a higher price for one alternative than for the other’,²²⁸ then the penalty doctrine in equity is not engaged because the stipulation is more properly to be characterised as an alternative stipulation. Thus where the contract provides two primary obligations, either of which could be performed without breaching the other then the penalty doctrine has no application to such an arrangement as neither promise is collateral to the other.

Andrews alters the test that has been understood and accepted at appellate level for nearly a century to determine whether a contractual stipulation is a penalty. In *Andrews*, the High Court confirms that the rationale for the penalty doctrine was the avoidance of punishment, which in equity could be constituted by the imposition of an additional or different contractual liability for failure of a primary obligation.²²⁹ The *Dunlop* formulation continues to have relevance to the operation of the penalty doctrine. It was not criticised in *Andrews*, but rather, it was lauded as a perfect example illustrating the place of the penalty doctrine in a court system where there is a unified administration of law and equity.²³⁰ *Andrews* has stimulated debate and generated commentary and criticism from practitioners and academics²³¹ due to the High Court broadening the potential circumstances in which the penalty doctrine can apply, but with little or no explanation for the course it took. However, in practice, post-*Andrews* examples of the successful enlivening of the equitable jurisdiction to relieve against penalty stipulations have proven to be rare.

3.6.2 Compensation for Prejudice or Damage: Partial Enforcement or Scaling Down

The terms upon which equitable relief against penalties can be granted to a promisor are, in the ‘comparatively rare cases’,²³² those ‘in which the party asserting unenforceability [ie: the promisor] is constrained to seek positive relief (whether primary or ancillary)²³³ which is purely equitable in character’.²³⁴ For example, in a declaration where the impugned stipulation is an unenforceable penalty or an injunction to

²²⁵ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

²²⁶ See, eg, *Cedar Meats* (2014) 45 VR 79, 97–102.

²²⁷ *MGM* [1966] 2 NSW 717.

²²⁸ Symons (ed), above n 157, vol II, 211–14 §437.

²²⁹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [9], citing *Legione v Hately* (1983) 152 CLR 406, 445.

²³⁰ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 235 [71].

²³¹ For example, see, eg, Sirko Harder, ‘The Relevance of Breach to the Applicability of the Rule against Penalties’ (2013) 30 *Journal of Contract Law* 52; Peel, above n 156; Carter et al, above n 49; Manly, above n 1; Harder, ‘The Scope of the Rule Against Contractual Penalties’, above n 106; Sarah Worthington, ‘Common Law Values: The Role of Party Autonomy in Private Law’ in Andrew Robertson and Michael Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (Hart Publishing, 2016) 301; Gray, above n 13.

²³² *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 195, cited with approval by Gageler J in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 569 [124]–[125].

²³³ For example, in the matrimonial causes jurisdiction, primary relief would be the decree of divorce and the ancillary relief would be an order for the payment of maintenance.

²³⁴ Gageler J in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 569 [124]–[125], citing with approval Deane J in *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 195, where he provided the example of the ‘rare case’ by reference to an order for reconveyance. This arises when a mortgagor is entitled to have the mortgage reconveyed to him on payment of what is due. For example, a mortgagee who refused to execute the reconveyance before the day appointed for payment was ordered to pay the costs of an action for redemption brought by the mortgagor consequent on such refusal — see *Rourke v Robinson* [1911] 1 Ch 480.

restrain enforcement of the stipulation, such relief is refused in equity unless the promisor undertakes to do equity by paying the promisee the amount of the ‘actual loss’ sustained in lieu of the sum stipulated.²³⁵ The consequence of a finding that an impugned stipulation is a penalty in equity is partial enforcement or ‘scaling down’²³⁶ to the level of recoverable loss, to an amount which equity regarded as just which is represented by payment of compensation for the prejudice suffered by the promisee for damage to its interests. The amount that is recoverable ‘usually happened to be equivalent to’²³⁷ the result at common law where the remedy is a claim for unliquidated damages for breach of contract.

The precise form of equitable relief available where a stipulation is found to be a penalty is discretionary in nature.²³⁸ Jessica Palmer²³⁹ observes ‘an agreed remedy cannot give disproportionately more than compensation for the loss suffered and the striking down of an agreed remedy cannot deprive the innocent party of compensation altogether’. *Andrews* provides that, in equity, the secondary or collateral stipulation is enforced only to the extent that ‘compensation’ can be paid for the ‘prejudice or damage’²⁴⁰ suffered by the promisee. ‘Compensation’ is calculated as damages for breach of contract.²⁴¹

Potential difficulty may arise in applying the penalty doctrine in equity and providing ‘compensation’ as there will have been no breach of the primary stipulation against which to assess the promisee’s compensable loss. In *Paciocco*, Gordon J²⁴² observes that the secondary stipulation can only be enforced to ‘the extent of that party’s proved loss’, as ‘a court of equity would tailor specific relief to ensure adequate compensation, but no more’.²⁴³ In *Paciocco*, High Court confirms the accuracy of this proposition and determines that ‘loss actually suffered’ was the relevant measure for compensation for engagement of the penalty doctrine in equity.²⁴⁴ In *Paciocco*, Gordon J²⁴⁵ further commented that ‘equity assesses the quantum of loss or compensation based on what is just and equitable, or fair and reasonable, in all the circumstances’. In *Andrews*,²⁴⁶ the High Court said: ‘the requirement that equity intervene to ensure the recovery of no more than compensation accommodated the “fundamental principle” of modern contract law to redress breach by adequate compensation’. ‘Partial enforcement’²⁴⁷ or ‘scaling down’ results in the breaching party being relieved from liability to fully satisfy the amount of the secondary stipulation. By way of limitation, *Andrews*²⁴⁸

²³⁵ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 195; *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 227 [44], citing E Allan Farnsworth, *Farnsworth on Contracts* (Aspen Publishers, 3rd ed, 2004) vol III, 301 §12.18.

²³⁶ This is the expression used in *Jobson v Johnson* [1989] 1 WLR 1026, 1045–6.

²³⁷ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193, citing *Elsley v J G Collins Insurance Agencies Ltd* (1978) 83 DLR (3d) 1, 13. However, note that at 13 the Supreme Court of Canada refers to ‘delay or acquiescence’ as considerations that might serve to reduce the amount.

²³⁸ See Davies and Turner, above n 55, 23.

²³⁹ Palmer, above n 105, 310.

²⁴⁰ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 217 [11].

²⁴¹ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 258 [15.6] (Gordon J), approved in *Cedar Meats* (2014) 45 VR 79, 102 [56].

²⁴² *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, [15.6] cited with approval by Nettle and Beach JJA and McMillan AJA in *Cedar Meats* (2014) 45 VR 79, 102 [56]; *Jobson v Johnson* [1989] 1 WLR 1026, 1046; see also Symons (ed), above n 157, vol II, 205–8 §433.

²⁴³ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 232 [60].

²⁴⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 616 [283], 634 [341].

²⁴⁵ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 265–6 [48].

²⁴⁶ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 227 [44], citing with approval Farnsworth, above n 235, 301 §12.18.

²⁴⁷ Sarah Worthington, ‘The Death of Penalties in Two Legal Cultures’ in Daniel Clarry (ed), *The UK Supreme Court Yearbook* (Appellate Press, 2009–17) vol 7, 129, 150 uses the expression ‘partial voidness’.

²⁴⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 217 [11].

provides that the penalty doctrine is not engaged if the 'prejudice or damage' to the interests of the promisee cannot be 'evaluated or assessed in money terms'. In this circumstance, each party is then left to its legal rights and obligations. This means that if an impugned stipulation is found to be enforceable and not subject to challenge as a penalty, then the promisee will be free to enforce the stipulation in full according to its terms.²⁴⁹

By way of illustration, two examples of situations where the courts have carried out the partial enforcement or 'scaling down' process for different types of stipulations found to be a penalty are discussed below. The first example is *Jobson v Johnson*, which concerns a non-monetary stipulation, and the second is *Paciocco*, which considers a monetary stipulation.

3.6.2.1 *Jobson v Johnson*: Partial Enforcement or Scaling Down of a Non-Monetary Stipulation

In *Andrews*, the High Court failed to explain how partial enforcement or 'scaling down' is to be achieved, in practice, where the stipulation does not require payment of money but instead requires the transfer of property. However, *Jobson* demonstrates that where the relief sought is equitable in nature, the court can in appropriate circumstances fashion a remedy.

In *Jobson*,²⁵⁰ the defendant (purchaser) purchased 45 per cent of the issued shares in a football club. Under the share purchase agreement, he agreed to pay an initial deposit of £40 000, and then instalments up to £300 000. The agreement provided that if he defaulted on the second or subsequent instalments he was to retransfer all of the shares to the plaintiff appellant (seller) for £40 000. After making payments of £140 000, the defendant defaulted and the plaintiff (seller) sought retransfer of all of the shares by an order for specific performance of the agreement. The defendant argued the stipulation requiring retransfer of the shares was an unenforceable penalty and counterclaimed for equitable relief in the nature of relief against forfeiture. The counterclaim was struck out because the defendant had failed to make discovery of documents, and therefore relief against forfeiture was no longer an available remedy. Harman J granted the seller a decree of specific performance. The value of the shares had increased following the default and were worth more than the total outstanding balance of the purchase price, which was £200 000. The Court of Appeal applied Lord Dunedin's proposition 4(c)²⁵¹ and held the stipulation was a penalty because the defendant was subject to the same liability irrespective of the nature or gravity of the breach of contract. Nicholls LJ²⁵² held that relief against the penalty was to be granted as of right and would take the form of 'scaling down' the impugned stipulation so that it could only be enforced to the level of the promisee's 'actual loss'.

In the normal course, the effect of the penalty finding would have been that the stipulation was unenforceable and the plaintiff would be free to pursue a claim for unliquidated damages. However, as was pointed out in *Cavendish*,²⁵³ that might have resulted in the defendant being advantaged by his failure to make disclosure of documents. In the end result, the majority (Dillon and Nicholls LJ, Kerr LJ dissenting)

²⁴⁹ Heydon, Leeming and Turner, above n 21, 552.

²⁵⁰ *Jobson v Johnson* [1989] 1 WLR 1026. Note that in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1221–2 [87], the form of relief granted by the Court of Appeal in that case was criticised as 'wrongly decided'. See also Charles Harpum, 'Equitable Relief: Penalties and Forfeiture' (1989) *Cambridge Law Journal* 370.

²⁵¹ See chapter 2 at [2.2.1].

²⁵² *Jobson v Johnson* [1989] 1 WLR 1026, 1038, 1041.

²⁵³ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1220 [84].

provided the plaintiff with relief, which has been described as ‘nuanced’ and was of a type that would not be available at common law:²⁵⁴

- i) a sale of the shares by court order (and either party could bid for them) with repayment to the plaintiff of the outstanding balance of instalments of the purchase price (£200 000) to come from the proceeds of sale; or
- ii) obtain a valuation of the shares and order their retransfer to the plaintiff if that valuation did not exceed the amount owed to him; or
- iii) dismiss the action for specific performance and leave the plaintiff to sue for the outstanding instalments under the Rules of Court, Order 14.²⁵⁵

Jobson was cited with approval by the High Court in *Andrews*.²⁵⁶ The exact status of *Jobson* in England is not clear as the UK Supreme Court in *Cavendish* describes the decision as ‘unsatisfactory’,²⁵⁷ ‘incorrect’²⁵⁸ and ‘wrongly decided’²⁵⁹ but only ‘so far as it related to the form of relief’.²⁶⁰ Lords Neuberger and Sumption said ‘in terms of achieving a fair commercial result, it is perhaps understandable that the Court of Appeal took the course they did’.²⁶¹

The form of judgment provides the plaintiff with a range of options that permits it to recover its ‘actual loss’. It provides an equitable remedy which ensures there was a just outcome which provides compensation to the plaintiff for the prejudice or damage suffered because of the defendant’s breach of the agreement, but limited to ‘actual loss’.

3.6.2.2 *Paciocco v Australia v New Zealand Banking Group Ltd: Gordon J — Partial Enforcement or Scaling Down of a Monetary Stipulation*

In *Paciocco*,²⁶² Gordon J undertook an exercise in partial enforcement or ‘scaling down’ in holding that ANZ’s late payment fees of \$35 and \$20 respectively failed to reflect the losses actually sustained by the bank due to the customers’ late payments. Her Honour found the fees were more properly estimated to be \$3 and \$0.50 respectively. Applying *Andrews*, her Honour determined the fees were a penalty at common law and in equity and ordered ANZ to compensate the customers by reimbursing that amount of the fees which had been charged to the extent they exceeded the properly estimated amounts of ANZ’s loss.²⁶³ The remedial outcome of the appeal is an example of the Court crafting a form of relief that responded to the particular circumstances.

The Full Federal Court and High Court both found the late payment fees charged by ANZ were not penalties

²⁵⁴ Davies and Turner, above n 55, 23.

²⁵⁵ Order 14 provides for Summary Judgment.

²⁵⁶ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 217–18 [13], 232 [60]; and in *New Zealand in Amaltal Corporation Ltd v Maruha (NZ) Corporation Ltd* [2004] 2 NZLR 614, 631 [61].

²⁵⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1208–9 [42].

²⁵⁸ *Ibid* 1283–4 [283].

²⁵⁹ *Ibid* 1221–2 [87].

²⁶⁰ *Ibid*.

²⁶¹ *Ibid* 1221 [85].

²⁶² *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 290 [173], 302 [241].

²⁶³ *Ibid* 327 [376].

and were thus enforceable. Accordingly, relief by partial enforcement or ‘scaling down’ of the fees did not have to be addressed. Although the remedy of partial enforcement or ‘scaling down’ in the manner it was dealt with in *Jobson* was criticised in *Cavendish*,²⁶⁴ there appears to be nothing in the judgment of the High Court in *Paciocco* which detracts from the decision in *Andrews* that partial enforcement or ‘scaling’ remains the available remedy in equity.

3.7 Conclusion

Application of the penalty doctrine in equity has been viewed by commentators as a major development in the law of Australia. This Chapter argues that, in practice, this has not proven to be the case. *Andrews* has reshaped and expanded the operation of the penalty doctrine in Australia and confirms the doctrine is one embraced by the common law and in equity. To that extent this chapter argues in support of the existence of a general penalty doctrine theory rather than a unitary one. *Andrews* repositions the penalty doctrine in equity to where it had been approximately 200 years ago. The equity jurisdiction was found to have not disappeared by absorption into the common law action of *assumpsit*,²⁶⁵ and had not ‘withered on the vine’,²⁶⁶ as was previously thought to be the position. Following *Andrews*, there was much commentary forecasting grave commercial uncertainty, however this has not come to pass and suggestions of a significant rise in cases before the courts have not proven to be accurate. However, *Cedar Meats* has been a useful application of *Andrews* to a form of stipulation previously thought to be immune from operation of the penalty doctrine, on the basis that clauses which provide for a debt rather than agreed damages cannot engage the penalty doctrine.²⁶⁷ Furthermore, this chapter questions whether the outcome of the appeal in *Cedar Meats* would have been the same if the appellant had raised a ground of appeal that challenged the trial judge’s finding as to penalty.

In *Andrews*, the High Court distinguishes secondary (or collateral or accessory) stipulations which engage the penalty doctrine at common law and alternative stipulations, for example, performance options that do not engage the doctrine. The two decisions relied on by the High Court to demonstrate the ‘operative distinction’ were analysed and it is argued that the decision in *MGM* is arguably incorrect and should be treated with caution. The point made by these two decisions is that if the stipulation is characterised as an alternative stipulation then the penalty doctrine is not engaged. Thus the penalty doctrine does not apply where one party to the contract is given an option to choose a particular method of performance, subject to his making a stipulated payment to the other.²⁶⁸ Post-*Andrews*, the penalty doctrine can apply in equity if a clause is a collateral stipulation to a primary stipulation and imposes an additional detriment.²⁶⁹ However, if contracting parties choose to draft alternative stipulations providing for further accommodation then such stipulations do not offend the penalty doctrine.²⁷⁰ As an example, such a stipulation could allow for a higher payment if further services or rights were provided.²⁷¹

²⁶⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1221 [85], 1221–2 [87], 1283–4 [283].

²⁶⁵ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 228 [51].

²⁶⁶ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 191.

²⁶⁷ *M & J Polymers Ltd v Imerys Minerals Ltd* [2008] EWHC 344 (Comm) (29 February 2008); *E-Nik Ltd v Department for Communities and Local Government* [2012] EWHC 3027 (Comm) (2 November 2012).

²⁶⁸ *Fratelli Moretti SpA v Nidera Handelscompagnie BV* [1981] 2 Lloyd’s Rep 47, 53.

²⁶⁹ See, eg, *Cedar Meats* (2014) 45 VR 79, 97–102.

²⁷⁰ For an example, see Katy Barnett and Sirko Harder, *Remedies in Australian Private Law* (Cambridge University Press, 2014) 304; Halson, above n 10, 169–80 [5.47]–[5.79].

²⁷¹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 236–8 [79]–[82].

This Chapter further argues that the enlivening of an equitable jurisdiction to relieve against penalty clauses is either a rare event or, if engaged, will not lead to monetary outcomes significantly different to the common law position. This is primarily so as in equity a stipulation found to be a penalty is to be partially enforced to the level of recoverable loss. Therefore, it is not, in practice, as unsettling as Carter et al have suggested.²⁷² The remedy of partial enforcement or ‘scaling down’²⁷³ can be viewed as an instance where the court in effect rewrites the impugned stipulation.²⁷⁴ In *AMEV-UDC*,²⁷⁵ Mason and Wilson JJ explained there was a ‘difficulty about this approach’, namely, that it is not for the courts to rewrite contracts. That passage was adopted with approval in *Cavendish*.²⁷⁶ An alternative way of analysing the form of remedy²⁷⁷ in equity is to treat it as an instance of the court refraining from enforcing the impugned stipulation but making it subject to a court-imposed condition that the breaching party compensate the non-breaching party for its actual loss. Put another way, the court refuses to permit full enforcement of the penal stipulation. In providing this form of relief in equity, the Court is required to assess the promisee’s recoverable loss as a step in the exercise of its equitable jurisdiction and relieve the promisor from its total liability under the impugned stipulation. The remedy of partial enforcement or ‘scaling down’²⁷⁸ is therefore descriptive of the grant of equitable relief.²⁷⁹

In the next Chapter, the recent developments in English law provided by the UK Supreme Court decision in *Cavendish* are analysed. This decision introduces the ‘legitimate interest’ based analysis to determine whether a stipulation is a penalty in complex contracts. The *Dunlop* formulation has not been overruled but relegated to ‘straightforward damages clauses’. The UK Supreme Court has rejected a move to embrace *Andrews* and an equitable jurisdiction for the penalty doctrine.

²⁷² Carter, et al, above n 49; see above in Part III at [3.5].

²⁷³ *Jobson v Johnson* [1989] 1 WLR 1026, 1046.

²⁷⁴ *Ibid* 1047, 1049; *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130, 135.

²⁷⁵ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 192–3.

²⁷⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1221 [86], quoting *ibid*.

²⁷⁷ *Stumbles*, above n 62, 984.

²⁷⁸ *Jobson v Johnson* [1989] 1 WLR 1026, 1045–6.

²⁷⁹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 569 [125].

Chapter 4

The Penalty Doctrine in England: *Cavendish* and the Legitimate Interests Test

4.1 Introduction

This Chapter analyses recent changes to the penalty doctrine developed by the UK Supreme Court in the conjoined appeals in *Cavendish Square Holding BV v Makdessi; ParkingEye Ltd v Beavis*.¹ Prior to *Cavendish*² a fresh approach to the penalty doctrine was germinating in a number of Court of Appeal decisions which were influenced by the judgment of Colman J in *Lordsvale Finance Plc v Bank of Zambia*.³ Those earlier decisions focused on a determination of whether the impugned stipulation was commercially justified rather than the more rigid *Dunlop* dichotomy between a genuine pre-estimate of loss and a penalty. *Cavendish* reformulates the penalty doctrine for “more complex cases”⁴ and requires a determination of whether the stipulation in question is a secondary obligation imposing a detriment on the breaching party out of all proportion to any legitimate interests the non-breaching party has in performance of the contract and enforcement of the primary obligation.⁵ A non-breaching party with a legitimate interest in contractual performance is still required to establish the stipulation sought to be enforced is not extravagant or unconscionable when compared to its legitimate interests. The *Dunlop* formulation continues to apply⁶ to “simple damages clauses in standard contracts”⁷ and “standard damages clauses in consumer contracts”.⁸ In these instances Lord Dunedin’s four propositions ‘have proved perfectly adequate’ to deal with stipulated sums payable upon breach of contract. In *Ringrow*⁹ the High Court refers to this as “the law of penalties in its standard application”. This question of characterisation which arises is the simple-complex distinction¹⁰ examined in Part III below.

It is to be appreciated that *Cavendish* did not overrule *Dunlop* and the fresh approach it provides to the penalty doctrine is concerned with a determination of whether the impugned stipulation is one that has the aim or purpose of punishment of the breaching party.¹¹ Lord Dunedin’s definition of a penalty ie: a clause that provided for payment of a sum that was greater than a genuine pre-estimate of loss will no longer apply generally.¹² However the fact the impugned stipulation is not a pre-estimate of loss does not, without more

¹ *Cavendish Square Holding BV v Makdessi* (*‘Cavendish’*); *ParkingEye Ltd v Beavis* (*‘ParkingEye’*) [2016] AC 1172.
² *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 (21 November 2003) (*‘Cine’*); *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005) (*‘Murray’*); *Euro London Appointments Ltd v Claessens International Ltd* [2006] 2 Lloyd’s Rep 436; *Makdessi v Cavendish Square Holding BV* [2013] EWCA Civ 1539 (26 November 2013).
³ *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752 (*‘Lordsvale’*).
⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199, [22].
⁵ *Ibid* 1204–5 [32].
⁶ *Ibid* 1201 [25]. See also Kiefel J in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 255, 549 [35] who appears to agree, and Nettle J who agrees at 608–9 [261].
⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199, [22].
⁸ *Ibid* 1201, [25].
⁹ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 [10].
¹⁰ See below at [4.4.6].
¹¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32].
¹² See *Ibid* 1201, [25], 1205, [35] where Lords Neuberger and Sumption suggesting that *Dunlop* may continue to apply in “straightforward” cases. Lords Mance, Toulson and Hodge implicitly agree at 1245, [145], 1270, [225] and 1285, [292].

mean it is an unenforceable penalty.

This Chapter is divided into four Parts. Part I traces the development of the modern penalty doctrine in England by considering the decisions that sought to depart from the *Dunlop* approach by concentrating on 'commercial justification'. Part II analyses the course of the *Cavendish* and *ParkingEye* litigation and the restatement of the penalty doctrine as one based on considerations of 'legitimate interests'. Part III considers the UK Supreme Court interpretation of the historical development of the penalty doctrine; the reinterpretation and explanation of *Dunlop*, and in particular the reasons of Lord Atkinson, the distinction between conditional primary obligations and secondary obligations which can be elusive, the question of proportionality embodied in the legitimate interests test, the scope of legitimate interests, a consideration of what might amount to 'legitimate interests in performance', how legitimate interests might be measured and how the new test might be applied; the simple-complex distinction referred to above, and including a case study where the new test has been successfully applied. Part IV concludes by considering the implications of *Cavendish* and argues that the legitimate interests test will result in fewer contractual stipulations being found to be unenforceable.¹³ By that measure the law becomes more certain and, hence, more predictable, which is a benefit for contracting parties and those who draft contracts and provide legal advice.

PART I

4.2 The Beginnings of a Fresh Approach

Lord Dunedin's four propositions were applied for nearly a century however their utility had become limited to 'straightforward' instances of agreed damages clauses ie: clauses stipulating for payment of an agreed sum upon breach of contract.¹⁴ In a line of decisions commencing in 1996 the relevance of the *Dunlop* formulation to more complex commercial contracts containing stipulated sums impugned as penalties was questioned and concluded it was outmoded. Attempts were made to restate a test in more modern language¹⁵ and 'as a matter of authority shifted English law towards damages clauses within the commercial context'.¹⁶ The focus of the courts' inquiry moved to a consideration of whether payment of the stipulated sum went beyond what was acceptable as commercially justifiable.

4.2.1 *Lordsvale Finance Plc v Bank of Zambia: Commercial Justification*

A fresh approach to the penalty doctrine was initially developed by Colman J in *Lordsvale*¹⁷ which concerned two loan agreements for \$100 million and \$130 million respectively entered into by the Bank of Zambia, as

¹³ Note that the penalty doctrine as reformulated in *Cavendish* has been successfully invoked to strike down a stipulation in *Gray v Braid Group (Holdings) Ltd* 2017 SC 409, and in *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017).

¹⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1201 [25].

¹⁵ *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 (21 November 2003); *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005).

¹⁶ Kal K C Leung, 'The Penalty Rule: A Modern Interpretation' (2017) 29 *Denning Law Journal* 41, 52.

¹⁷ *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752. Some indications of judicial reticence about the confines of the traditional *Dunlop* formulation arose before *Lordsvale*, for example in *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana*; *The Scaptrade* [1983] 2 AC 694, 702; and *Philips Hong Kong Ltd v The Attorney General of Hong Kong* (1993) 61 BLR 41.

borrower. Both loan agreements stipulated¹⁸ that in the event of default the borrower was to pay interest of 1.5 per cent during the default period and an additional and ‘unexplained extra provision’¹⁹ of 1 per cent. The borrower defaulted in its repayment obligations and argued the additional 1 per cent in interest was a penalty as it was in terrorem and its sole function was to ensure compliance with the repayment provisions of the loan agreements.

Colman J recognised the impugned stipulations were of ‘considerable importance for English banking law’.²⁰ The international nature of the transactions was relevant to an understanding of the context of the decision and his shift in emphasis when applying of the penalty doctrine. Colman J held the additional charge of 1 per cent interest was consistent only with an increase in the consideration payable by the borrower for the loans due to the increased credit risk they represented if there was a default. Therefore the stipulations were not a penalty.²¹ His Honour held²²

there seems to be no reason in principle why a contractual provision, the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided always that the dominant purpose was not to deter the other party from the breach.

This modern characterisation of the penalty doctrine has two strands to its application, firstly there must be ‘commercial justification’ for the disproportion between the stipulated sum and the likely loss; and secondly, the sum stipulated must not have as its dominant purpose punishment or deterrence of the breaching party.

Colman J’s ‘commercial justification’ test aligned the penalty doctrine with international commercial practice. He stated that London was ‘one of the greatest centres of international banking in the world’ and the courts of New York were prepared to enforce such ‘prevalent provisions’.²³ In assessing commercial justification he looked beyond a genuine pre-estimate of loss and reasoned the additional interest rate of 1 per cent payable upon the borrower’s default was proportionate as it took into account that a borrower with a bad credit rating would incur greater borrowing costs than one with a good credit rating. His Honour thereby refocused the inquiry away from consideration of whether the stipulated sum was a genuine pre-estimate of loss.

4.2.2 The Modern Characterisation of the Penalty Doctrine Is Endorsed by the Court of Appeal

In 2004, Colman J’s ‘more accessible paraphrase of the concept of penalty’ was cited with approval by Lord Mance in *Cine Bes Filmcilik ve Yapimcilik v United International Pictures*²⁴ which was an appeal from the respondent’s successful summary judgment application. An issue on appeal was whether certain provisions of a licence agreement regarding exhibition of films were unenforceable penalties insofar as they stipulated for payments to be made on termination of the agreement for breach by the appellant. Lord Mance found

¹⁸ The text of the relevant stipulation in clause 10.03A is set out in *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752, 759.

¹⁹ *Ibid* 761.

²⁰ *Ibid*.

²¹ *Ibid* 767.

²² *Ibid* 763–4.

²³ *Ibid* 767 (ie: default interest rates with an additional uplift factor).

²⁴ *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 (21 November 2003) [13]. The text of the stipulations in clauses 16 and 17 are set out at [6] of the judgment.

Colman J's formulation of the commercial justification test indicated²⁵ "a dichotomy between a genuine pre-estimate of damages and a penalty does not necessarily cover all the possibilities. There are clauses which may operate on breach, but which fall into neither category, and may be commercially perfectly justifiable". In applying Colman J's formulation Lord Mance allowed the appeal on the penalty issue as he found it amounted to a triable issue and was not one about which it could be said there was no real prospect of a successful defence and referred the issue to a trial.

The following year in *Murray v Leisureplay Plc*²⁶ the Court of Appeal unanimously approved the commercial justification test formulated in *Lordsvale* and as applied in *Cine*. In that case the appellant had executed a service agreement for the position of chief executive which stipulated²⁷ that on a wrongful termination he was forthwith entitled to 'one year's gross salary, pension contributions and other benefits'. The appellant's employment was wrongfully terminated. At trial Burnton J²⁸ found the stipulation was a penalty as it failed to take account of the appellant's duty to mitigate his damages. The Court of Appeal disagreed and held the fact the stipulation could result in a greater recovery than the actual loss did not automatically mean that without further justification it was penal. The stipulation would only be a penalty if the sum stipulated was extravagant and unconscionable. The stipulation was found to be enforceable liquidated damages. Arden LJ included commercial justification in her 'practical step by step guide'²⁹ to the questions a court should ask when considering a challenge to a stipulation on the basis of penalty. These steps were:

- i) To what breaches of contract, do the contractual damages provision apply?;
- ii) What amount is payable on breach under that clause in the parties' agreement?;
- iii) What amount would be payable if a claim for damages for breach of contract was brought under common law?;
- iv) What were the parties' reasons for agreeing for the relevant clause?; and
- v) Has the party who seeks to establish that the clause is a penalty shown that the amount payable under the clause was imposed *in terrorem*, or that it does not constitute a genuine pre-estimate of loss for the purposes of the *Dunlop* case, and, if he has shown the latter, is there some other reason which justifies the discrepancy between (i) and (ii) above?³⁰

Her Ladyship said that 'extravagant and unconscionable' had to be given a modern meaning and the real question was whether 'the sums for which the parties have provided to be paid on breach differ substantially from the sums that would be recoverable at common law and whether there is shown to be no justification for that'.³¹

Lord Justice Buxton (Clarke LJ agreeing) considered her Ladyship's step-by-step formulation introduced 'a rigid and inflexible element into what should be a broad and general question'.³² In adopting this broader approach he re-examined *Dunlop* and emphasised it was necessary to consider the impugned stipulation in

²⁵ Ibid [15].

²⁶ *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005) [38], where Lady Justice Arden referred to the "useful and succinct statement of law in the judgment of Mance LJ (in *Cine* at [11]-[15]).

²⁷ The text of the relevant stipulation in clause 17 is set out in *ibid* [2].

²⁸ *Murray v Leisureplay Plc* [2004] EWHC 1927 (QB) (5 August 2004).

²⁹ *Ibid* [54].

³⁰ *Ibid*. There is an error in (v); the discrepancy should be between (ii) and (iii).

³¹ *Ibid* [46].

³² *Ibid* [114].

its commercial context.³³ This approach was ‘to stand back and look at the reality of the agreement’³⁴ and in doing so he took judicial notice of the fact that an entrepreneurial company such as the respondent, promoting a product conceived by one man, would often place a high value upon retaining the services, loyalty and attention of that one man as its chief executive to the extent of including in his ‘package’ generous reassurance against the eventuality of dismissal. That such reassurance exceeded the likely amount of contractual damages payable on dismissal did not render the stipulation penal unless the breaching party could demonstrate that the stipulation met the test of extravagance postulated by Lord Dunedin and Lord Woolf.³⁵

The commercial justification test was also applied by the Court of Appeal in *Euro London Appointments Ltd v Claessens International Ltd*³⁶ and *Makdessi v Cavendish Holdings BV*.³⁷ The *Cavendish* appeal to the UK Supreme Court was the first time in a century that the highest court in England was provided with the opportunity to reconsider the penalty doctrine and further important questions such as, whether the *Dunlop* formulation remains relevant, whether commercial justification was the applicable test, whether the doctrine should be extended to provide relief in equity, and whether the doctrine should be abolished.

PART II

4.3 Introduction

In 2016 the UK Supreme Court delivered judgment in the conjoined appeals of *Cavendish* and *ParkingEye*. The facts of the two appeals make it apparent that they ‘lie at opposite ends of a financial spectrum’.³⁸ The *Cavendish* appeal involves a substantial complex commercial contract and the *ParkingEye* appeal involves a low value consumer contract. In the former case if the court upheld the impugned stipulations Mr Makdessi would forfeit his entitlement to recover the balance of the sale price in excess of US\$44 million and forego the entitlement to sell his remaining shares valued at approximately US\$75 million. In the latter case it would require Mr Beavis to pay a £85 parking fee.

4.3.1 *Cavendish Square Holding BV v Makdessi*

In *Cavendish* the appellant purchased shares in a large media business owned and controlled by Makdessi. Pursuant to a Share Sale Agreement the appellant agreed to pay Makdessi a price of up to a maximum of US\$147.5 million by instalments. The final amount of the instalments depended on the calculation of the relevant audited consolidated operating profit after tax. Clause 11 of the agreement³⁹ and the contract price largely reflected the importance of protecting the goodwill of the business the subject of the sale.⁴⁰ The

³³ Ibid [118].

³⁴ Ibid [116].

³⁵ Ibid. The reference to Lord Dunedin relates to his decision in *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87 (proposition 4(a)) and the reference to Lord Woolf relates to his decision in *Phillips Hong Kong Ltd v The Attorney General of Hong Kong* (1993) 61 BLR 41, 58–9.

³⁶ *Euro London Appointments Ltd v Claessens International Ltd* [2006] 2 Lloyd's Rep 436, 437 [5]. The text of the relevant stipulation in clause 4 is set out in the judgment at [5].

³⁷ *Makdessi v Cavendish Square Holding BV* [2013] EWCA Civ 1539 (26 November 2013).

³⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1232 [116].

³⁹ Ibid 1211 [51] which sets out the text of clause 11 ‘Protection of Goodwill’.

⁴⁰ Ibid 1211 [51], [53].

agreement contained restrictive covenants protecting the goodwill of the business.⁴¹ In the event Makdessi became a 'Defaulting Shareholder' the agreement provided:⁴²

- i) pursuant to clause 5.1,⁴³ he would forfeit his entitlement to receive two of the stage payments (ie: Interim and Final); and
- ii) pursuant to clause 5.6,⁴⁴ he had granted a call option⁴⁵ to the appellant which required him to sell his remaining shares at the 'Defaulting Shareholder Option Price'.⁴⁶

Makdessi breached the non-competition covenants and became a 'Defaulting Shareholder'. The appellant then sought to activate the forfeiture and share sale procedures in clauses 5.1 and 5.6 of the agreement and sought a declaration that Makdessi forfeit his entitlement to receive the two remaining payments of the balance of the purchase price and comply with the call option requiring the sale to it of his remaining shares.⁴⁷ *Makdessi* conceded he was a 'Defaulting Shareholder' but argued clauses 5.1 and 5.6 were penalties as the amount to be forfeited pursuant to clause 5.1 could be as much as US\$44 million which was not a genuine pre-estimate of loss that might be suffered by him due to his breaches of restrictive covenants of different types and different levels of severity. He also argued the effect of the call option in clause 5.6 was penal as it required him to transfer his remaining shares to the appellant at an undervalue and precluded him from exercising a put option⁴⁸ which would have required a sale of shares from him to the appellant at a price not exceeding US\$75 million.

At first instance Burton J⁴⁹ found clauses 5.1 and 5.6 were enforceable as there was a commercial justification for each clause. His Honour found clause 5.1 was designed to adjust the commercial consideration for the transaction in the event of a breach of the agreement⁵⁰ and clause 5.6 was designed 'to decouple the parties on a speedy and conventional basis'⁵¹ from their commercial arrangement in the event of a breach of the agreement. The Court of Appeal⁵² disagreed and determined the two stipulations were penalties as they were not genuine pre-estimates of loss as they were 'extravagant and unreasonable'⁵³ given the extent of the forfeiture of the balance of the purchase price and the required share transfer pursuant to the call option. Furthermore a trifling breach of contract would result in *Makdessi* losing the same amount as would be the case with a more serious breach of the agreement. Thus the function of the two

⁴¹ The text of the restrictive covenants in clauses 11.2 and 11.7 is set out in the judgment at *ibid* 1211 [52]–[53].

⁴² See *ibid* 1212 [55] which sets out the text of the relevant stipulations in clauses 5.1 and 5.6.

⁴³ The text of clause 5.1 is set out in the judgment at *ibid* 1212 [55]. Clause 5.1 is a withholding clause.

⁴⁴ The text of clause 5.6 is set out in the judgment at *ibid* 1212 [55]. Clause 5.6 is a transfer of property clause.

⁴⁵ Under a 'call' option one party grants to another party (who gives consideration for the grant or it is given under seal) the right to acquire an asset from the first person, at a specified or determinable price within a specified or determinable period: see Donald J Farrands, *The Law of Options and Other Pre-Emptive Rights* (Law Book, 2010) 16.

⁴⁶ Effectively a net asset valuation that took no account of goodwill.

⁴⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1213 [63].

⁴⁸ *Ibid* 1211 [50] summarises the effect of the put option in clause 15. See also Farrands, above n 45, 16 which defines the put option in the following terms: 'under a 'put' option one party (the grantor) grants to another party (the grantee) who owns an asset (who gives consideration for the grant or it is given under seal) the right to require the first person to acquire the asset'.

⁴⁹ *Cavendish Square Holding BV v Makdessi* [2012] EWHC 3582 (Comm) (14 December 2012).

⁵⁰ *Ibid* [60].

⁵¹ *Ibid* [51].

⁵² *Makdessi v Cavendish Square Holding BV* [2013] EWCA Civ 1539 (26 November 2013) [117].

⁵³ *Ibid*.

clauses was deterrence as they failed to serve a justifiable commercial purpose.⁵⁴ The appellant appealed to the UK Supreme Court where it argued inter alia, that clauses 5.1 and 5.6 were not penalties, the common law of penalties should be abolished, and if not, the doctrine should not extend to commercial transactions between parties of equal bargaining power acting on legal advice. The UK Supreme Court decided the stipulations were enforceable and dismissed the other arguments.

4.3.2 *ParkingEye Ltd v Beavis*

The conjoined case on appeal concerned an £85 consumer transaction. Beavis parked his car in a car park which formed part of the Riverside Retail Park including a large shopping complex. The British Airways Pension Fund as the owner of the complex, had engaged *ParkingEye* (ie: the operator) to operate a 'traffic space maximisation scheme' for the efficient operation of the car park.⁵⁵ The scheme involved erection of signs⁵⁶ at the entrance to and throughout the car park notifying of a '2 hour max stay' and 'Parking limited to 2 hours' as well as notices stating 'Failure to comply ... will result in a Parking Charge of £85', and 'By parking within the car park, motorists agree to comply with the car park regulations'.⁵⁷ *Beavis* parked his car for fifty-six minutes beyond the permitted two hour period and received an £85 charge which he refused to pay and went on to argue the charge imposed by the operator was an unenforceable penalty and also in breach of the *Unfair Terms in Consumer Contracts Regulations 1999*⁵⁸ which required that the terms of consumer contracts be fair. Judge Moloney QC at first instance⁵⁹ and the Court of Appeal⁶⁰ both decided the £85 charge was enforceable as it was in the legitimate interests of the operator to make such a charge to facilitate a high turnover of parking within the car park. On appeal the UK Supreme Court decided the £85 charge was enforceable and dismissed the claim under the 1999 Regulations.

PART III

4.4 History of the Penalty Doctrine

The analysis of the historical origins of the penalty doctrine by the UK Supreme Court exhibits a different perspective to the treatment of penal bonds to that of the High Court in *Andrews*. In *Cavendish*, Lords Neuberger and Sumption⁶¹ found the equitable jurisdiction to relieve against penalties arose 'wholly in the context of bonds defeasible in the event of the performance of a contractual obligation'. There had to be a breach of a contractual obligation⁶² before the penalty jurisdiction could be engaged. This is the fundamental difference with the analysis provided in *Andrews* which recognised a distinct penalty doctrine in equity that was not reliant upon any breach of contract but was engaged by the failure of a primary obligation. Lords Neuberger and Sumption traced the development of the penalty doctrine and the process by which the

⁵⁴ Ibid [118]–[125].

⁵⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1222–3 [91].

⁵⁶ Ibid.

⁵⁷ Ibid [91].

⁵⁸ Ibid [103] sets out the text of the relevant Regulations.

⁵⁹ *ParkingEye Ltd v Beavis* (Unreported, County Court at Chelmsford, Judge Moloney QC, 19 May 2014).

⁶⁰ *ParkingEye Ltd v Beavis* [2015] EWCA Civ 402 (23 April 2015).

⁶¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1192–3 [4]–[5], 1208–9 [42].

⁶² Ibid 1208–9 [42].

equitable rule was adopted by the common law.⁶³

Toward the end of the 17th century, as a matter of practice, the common law courts began to stay legal proceedings⁶⁴ to enforce penal bonds which secured a debt, unless the plaintiff was willing to accept tender of the amount of the debt plus interest and costs. This rule of practice was regularised and extended by statute.⁶⁵ By the end of the 18th century the common law courts were treating the statutory procedures as mandatory and required damages to be pleaded and proved and stayed all further proceedings on the bond. The effect of the statutes made it unnecessary to proceed separately in Chancery for relief against the penalty and in the common law courts to recover the true loss. The effect of these procedural changes was that the equitable jurisdiction was rarely invoked and any further development of the penalty doctrine became the work of the common law courts.

In the 19th and 20th centuries the penalty doctrine developed further, on the basis that although penalty stipulations were secondary obligations, the parties meant what they said when they agreed to the stipulation. The law would only provide relief to the breaching party where, contrary to public policy, the object of the stipulation was punishment. The use of penal bonds gradually declined and the common law developed almost entirely in the context of agreed damages stipulations which were treated as a contractual substitute for common law damages, but could not be regarded as a mere security for payment of common law damages,⁶⁶ because if the agreed sum was a penalty it was unenforceable. In the 1900s the common law courts introduced the distinction between a provision stipulating for payment of a genuine pre-estimate of loss and a penalty in which the sum was extravagant and unconscionable in amount when compared to the greatest loss that could conceivably be proved to have followed from the breach. This description formed the basis of what became the common law formulation recognised by Lord Dunedin's four propositions in *Dunlop*.

A further distinction noted by Lords Neuberger and Sumption was that although the equitable jurisdiction providing for relief against forfeiture developed alongside the equitable jurisdiction to relieve against penal bonds, each jurisdiction followed a different path. This is exemplified by equity's continued role in regulating forfeiture provisions eg: stepping in when there are other options to achieve the performance of leases or mortgages.⁶⁷ A shift in perspective occurred for penalty stipulations and they were treated as a substitute for common law damages rather than as a security mechanism which had the effect that the equitable jurisdiction to relieve against penalties was no longer invoked⁶⁸ and 'withered on the vine'.⁶⁹ As Mason and Wilson JJ observed in *AMEV-UDC Finance Ltd v Austin*,⁷⁰ except in unusual circumstances, the penalty doctrine offered no prospect of relief which was not ordinarily available in proceedings to recover the stipulated sum or alternatively damages.

⁶³ Ibid 1193–4 [6]–[8]; Alfred William Brian Simpson, 'The Penal Bond with Conditional Defeasance' (1966) 82 *Law Quarterly Review* 392, 418–19.

⁶⁴ For example, *Supreme Court (General Civil Procedure) Rules 2015* (Vic) r 23.01 empowers the Court to stay a proceeding generally if it is scandalous, frivolous or vexatious; or if it is an abuse of the process of the Court.

⁶⁵ *Administration of Justice Act 1696*, 8 & 9 Will 3, c 11; *Administration of Justice Act 1705*, 4 & 5 Anne, c 16.

⁶⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1194 [8].

⁶⁷ Ibid 1195 [10].

⁶⁸ Ibid 1194 [8].

⁶⁹ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 191.

⁷⁰ Ibid.

4.5 *Dunlop* Reinterpreted and Explained

In *Cavendish* Lords Neuberger and Sumption said Lord Dunedin's four propositions 'achieved the status of a quasi-statutory code in the subsequent case law'⁷¹ and were not rules to be applied but rather they were more properly to be treated as 'considerations which might prove helpful or even conclusive'.⁷² Additionally the propositions were not applicable to every case⁷³ but were a useful tool for deciding whether the expressions 'unconscionable' or 'extravagant' 'can properly be applied to "simple damages clauses in standard contracts"⁷⁴ or "standard damages clauses in consumer contracts".⁷⁵ They found the propositions are not easily applied to 'less straightforward cases'.⁷⁶ Lord Dunedin's formulation is not a complete statement of the penalty doctrine as it concentrated on the issue of punishment from the perspective of exorbitant and unconscionable loss. What was omitted is the non-breaching party's possible wider legitimate commercial or non-commercial interests in securing performance of the contractual obligation which is the subject of analysis in the speech of Lord Atkinson, in particular, discussed below.

4.5.1 Lord Atkinson's Reasoning

In *Dunlop*, Lord Atkinson⁷⁷ construed the impugned stipulation⁷⁸ and determined its aim to be protection of the brand, goodwill, reputation and authorised distribution network of *Dunlop*. The aim of this inquiry was to discover 'the nature and extent of the innocent party's [ie: *Dunlop*] interest in the performance of the relevant obligation'.⁷⁹ Lord Atkinson took into account the underlying purpose of *Dunlop's* price maintenance agreement and recognised it provided *Dunlop* with a wider interest in enforcing the liquidated damages clause rather than securing pecuniary compensation. The £5 per item stipulated as payable for 'every tyre, cover, or tube sold or offered in breach of the agreement' was not incommensurate with *Dunlop's* interests even if it was incommensurate with the loss occasioned by the customer's breach in wrongfully selling a single tyre cover. In this respect Lord Atkinson was making the same point Lord Robertson had made in his speech in the earlier decision of *Clydebank*⁸⁰ ie: 'the question remains, had the respondents no interests to protect by that clause, or was that interest palpably incommensurate with the sums agreed on?'.⁸¹

In *Dunlop* the reasoning of the other Lords was consistent with the commercial interests approach adopted by Lord Atkinson.⁸² For instance Lord Parker⁸³ said 'whether the sum agreed to be paid on the breach is really a penalty must depend on the circumstances of each particular case' and he described the damage that would result from the breach as 'consisting in the disturbance or derangement of the system of distribution by means of which [Dunlop's] goods reach the ultimate consumer'.⁸⁴ Lord Dunedin,⁸⁵ Lord

⁷¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199 [22].

⁷² Ibid.

⁷³ Ibid.

⁷⁴ Ibid

⁷⁵ Ibid.

⁷⁶ Ibid.

⁷⁷ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 90–1.

⁷⁸ Ibid 81 sets out the text of the impugned stipulation, clause 5.

⁷⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199–200 [23].

⁸⁰ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 20.

⁸¹ Ibid 7 sets out the text of the impugned stipulation which is not a numbered clause.

⁸² *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 97, 99 (Lord Parker), 101–2 (Lord Parmoor).

⁸³ Ibid 97.

⁸⁴ Ibid 99.

Parker,⁸⁶ Lord Parmoor⁸⁷ and Lord Atkinson⁸⁸ were all ultimately content to base their decision that the stipulated sum of £5 was not a penalty on the ground that exact pre-estimation of loss was impossible. If it were found that the £5 per item was payable as compensation for many different events, some causing serious and some trifling damage (ie: Lord Dunedin's proposition 4(c)) then there is a presumption it would be a penalty. However, that presumption would be rebutted where the damage caused by each and every one of those events however varying in importance is found to be of such an uncertain nature that it cannot be accurately ascertained. Lord Atkinson⁸⁹ found that as the damages were of such a nature it was all the more probable that £5 was not stipulated in terrorem but was a genuine pre-estimate of *Dunlop's* probable and possible interest in due performance of the contract.. The £5 was justifiable only by reference to Dunlop's wider interests described in the speech by Lord Atkinson⁹⁰ and was enforceable as liquidated damages

4.6 The Proper Test for a Penalty: Legitimate Interests

4.6.1 The Scope of Legitimate Interests Test

In *Cavendish* their Lordships provide three formulations of the modern test for a penalty based on the 'legitimate interests' of the non-breaching party. Firstly, Lords Neuberger and Sumption⁹¹ (Lords Carnwath and Clarke agreeing)⁹² formulate the 'true test' in the following terms: 'whether the impugned provision is a secondary obligation which imposes a detriment on the contract breaker out of all proportion to any legitimate interests of the innocent party in the enforcement of the primary obligation'. Secondly, Lord Mance⁹³ (with whom Lord Toulson agreed)⁹⁴ said '[t]here may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden'.⁹⁵ He said⁹⁶ furthermore, that the rule is to consider, in each case

first, whether any (and if so what) legitimate business interest is served and protected by the clause, and second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable. In judging what is extravagant, exorbitant or unconscionable, I consider ... that the extent to which the parties were negotiating at arm's length on the basis of legal advice and have every opportunity to appreciate what they were agreeing must at least be a relevant factor ...

Thirdly, Lord Hodge⁹⁷ approves of the approach adopted in the earlier commercial justification decisions⁹⁸ which 'escapes the straightjacket into which the law risked being placed by an over rigorous emphasis on the

⁸⁵ Ibid 87.

⁸⁶ Ibid 98.

⁸⁷ Ibid 103.

⁸⁸ Ibid 91–2.

⁸⁹ Ibid 96.

⁹⁰ Ibid 91–2.

⁹¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32].

⁹² Ibid 1285 [291].

⁹³ Ibid 1245 [145].

⁹⁴ Ibid 1285 [292].

⁹⁵ Ibid 1247 [152].

⁹⁶ Ibid.

⁹⁷ Ibid 1270 [225].

⁹⁸ The decisions he was referring to were *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752; *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 (21 November 2003); *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005).

dichotomy between a genuine pre-estimate of damages on the one hand and a penalty on the other'. He doubted⁹⁹ whether it was helpful to rely on deterrence and said the correct test for a penalty is¹⁰⁰ 'whether the sum or remedy stipulated, as a consequence of a breach of contract, is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract'.

Application of this modern test requires a consideration of whether the impugned stipulation requires payment of a sum which is extravagant and unconscionable ie: the sum is out of proportion either to the loss likely to be suffered or to some wider commercial or non-commercial legitimate interests which the non-breaching party wish to protect. This test is to be applied at the time when the contract was formed and not when the breach occurred. Accordingly the penalty doctrine must be applied with an awareness that it is possible the non-breaching party is not seeking to only protect itself against the risk of suffering financial loss but against a wider risk of harm or disappointment for which monetary relief is not easily quantifiable.¹⁰¹

This chapter argues there is no material difference between the three formulations of the legitimate interests test as they each contain two essential elements. Firstly, the requirement that the non-breaching party seeking to enforce the stipulation must have a 'legitimate interest' in performance of the contract; and secondly, there must be proportionality between the value of the 'legitimate interests' and the stipulated sum that is not exorbitant, unconscionable or extravagant. In contrast to the *Dunlop* formulation, the *Cavendish* test permits the court to consider a wider range of matters when deciding whether a stipulation is a penalty. As a result of this modern development in England genuine pre-estimate of loss that was central to the *Dunlop* formulation of the penalty doctrine is now absent from the test to be applied in commercial or complex contracts. In future proportionality considerations will require courts to determine whether the impugned stipulation amounts to punishment and in that sense whether it is extravagant and unconscionable when compared to the legitimate interests of the non-breaching party in performance of the contract. The practical effect of the legitimate interests test is that it is harder for the breaching party to successfully argue stipulations payable upon breach of contract are not enforceable. Lord Hodge¹⁰² stated "the criterion of exorbitance or unconscionableness should prevent the enforcement of only egregious contractual provisions." Accordingly it is apposite to suggest as Kiefel J later did in *Paciocco* that the breaching party who contends that a sum is a penalty is facing "a high hurdle".¹⁰³

4.6.2 The Distinction between Conditional Primary Obligations and Secondary Obligations

In *Photo Production Ltd v Securicor Transport Ltd*,¹⁰⁴ Lord Diplock explained the distinction between primary and secondary obligations. A primary obligation requires one party to perform an act and the failure by the other party to discharge a duty expressly or impliedly created by the contract constitutes a breach which gives rise to a secondary obligation to pay damages. This obligation arises by default by operation of law

⁹⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1275–6 [248].

¹⁰⁰ *Ibid* 1278 [255], Lord Toulson agreeing at 1285 [292].

¹⁰¹ See Lord Atkinson in *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 90-93; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199-1200 [23].

¹⁰² *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1280, [266].

¹⁰³ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.553, [53].

¹⁰⁴ *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827, 874.

unless the contract itself deals with the matter¹⁰⁵ which can be achieved by stipulating for payment of liquidated damages. Thus it is the secondary obligation which is capable of engaging the penalty doctrine.

Lords Neuberger and Sumption¹⁰⁶ observed that ‘the application of the penalty doctrine may depend on how the relevant obligation is framed in the instrument’ and sought¹⁰⁷ to distinguish between a conditional primary obligation which does not engage the penalty doctrine and a secondary obligation which does engage the doctrine. Carmine Conte¹⁰⁸ commented that ‘the line between these two concepts is very thin if discernible at all’. If the contract does not expressly or impliedly impose an obligation to perform an act but simply provides that if one party fails to perform or other circumstances exist it will pay or forfeit a specified sum such an obligation is a conditional primary obligation and does not engage the penalty doctrine.¹⁰⁹

The distinction between a conditional primary obligation and secondary obligation may be blurred but some clarity is provided by the following examples:¹¹⁰

i) **Example A: Breach of a primary obligation that does engage the penalty doctrine**

X parks his car in Y’s car park and agrees to:

- depart within two hours; and
- upon failure to depart within the two hour period, in breach of contract, to pay Y an £85 charge.

ii) **Example B: Breach of a conditional primary obligation that does not engage the penalty doctrine**

Z parks his car in Y’s car park and agrees either to:

- depart within two hours and pay Y nothing; or
- remain in the car park beyond the two hour period and pay an £85 charge.

The obligations X and Z intended to assume in each of the examples above appear to be the same however it is only the facts in Example A that engage the penalty doctrine as the failure to depart from the carpark within two hours is a breach of the contract for which a consequence has been stipulated ie: payment of an £85 charge. If the payment of money required by a stipulation is to encourage performance or to punish for breach then the payment may be characterised as a secondary obligation and the penalty doctrine can be engaged. However as Example B illustrates if the payment required by a stipulation is characterised as an alternative promise or conditional primary obligation then the penalty doctrine is not engaged.¹¹¹ William Day¹¹² has commented that there is an irony in that ‘whereas the High Court in *Andrews* revised the

¹⁰⁵ See the discussion of the development of the primary and secondary obligations dichotomy by Lord Diplock in Andrew Archer, ‘Contractual Termination Rights and the Concurrent Exercise or Non-Exercise of Common Law Termination Rights — Caught between the Scylla and Charybdis’ (2017) 33 *Construction Law Journal* 313, 319.

¹⁰⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [14].

¹⁰⁷ *Ibid.*

¹⁰⁸ Carmine Conte, ‘The Penalty Rule Revisited’ (2016) 132 *Law Quarterly Review* 382, 386.

¹⁰⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [14]. In *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 237 [81], citing John Norton Pomeroy, *A Treatise on Equity Jurisprudence* (Bancroft-Whitney, 5th ed, 1941) vol II, 211–14 §437, this type of provision is referred to as an ‘alternative stipulation’.

¹¹⁰ See the examples in *ParkingEye Ltd v Beavis* [2015] EWCA Civ 402 (23 April 2015) [23]; Roger Halson, *Liquidated Damages and Penalty Clauses* (Oxford University Press, 2018) 60–1, [2.52]–[2.56].

¹¹¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [13]–[14].

¹¹² William Day ‘A Pyrrhic Victory for the Doctrine against Penalties: *Makdessi v Cavendish Square Holding BV* [2016] *Journal of Business Law* 115, 124.

language of primary and secondary obligations in order to liberate the penalty doctrine from the requirement of breach of contract the UK Supreme Court in *Cavendish* has done so to further restrict the doctrine's ability to render clauses unenforceable'.

The courts have been called upon to make fine distinctions between primary and secondary obligations and in practice it may be difficult to distinguish between them.¹¹³ *Cavendish* reveals there was a real difficulty in distinguishing between these obligations in the complex commercial arrangement constituting the subject matter of the appeal. This difficulty in characterisation is evidenced in particular by the judgments in that case where Lords Neuberger and Sumption (Lord Carnworth agreeing) found clauses 5.1 and 5.6 to be primary obligations operating as a price adjustment mechanism and hence did not attract the penalty doctrine.¹¹⁴ Lord Hodge¹¹⁵ considered there was a "strong argument" that clause 5.1 was a primary obligation without reaching a definite conclusion and in the alternative he analysed the clause as a secondary obligation. Lord Clarke¹¹⁶ agreed with Lord Hodge. Lord Mance¹¹⁷ and appears to have characterised clause 5.1 as a price adjustment clause. Lord Toulson¹¹⁸ agreed with both Lords Hodge and Mance. In contrast, a clear majority appears to have considered that clause 5.6 was a secondary obligation.¹¹⁹ The two illustrative examples above confirm it will be increasingly more important for those who draft contracts to be aware of the subtle distinctions.

This chapter argues the difference of judicial opinion as to the proper characterisation of the stipulations demonstrates the possible weakness of the legitimate interests test. Given the uncertainty about the question of the proper characterisation of the stipulations, there is scope for argument in complex commercial contract disputes about this matter. The difficulty with a rule based on such a characterisation is that by skilful legal drafting a secondary obligation can be converted into a primary obligation and potentially taken out of reach of the penalty doctrine.¹²⁰ In *Cavendish* Lord Hodge observed 'if all such clauses were treated as primary stipulations, there would be considerable scope for abuse'¹²¹ and Lords Neuberger and Sumption also expressed their concern and said 'we have no doubt that price adjustment clauses are open to abuse'.¹²² Clauses that might stipulate withholding of a payment consequent upon breach can be redrafted to provide for a price adjustment. For example, a clause stipulating that a fixed sum is to be payable for late completion of a construction project could be redrafted as one which provides a discount for early completion. Such measures have the potential to weaken the operation of the penalty doctrine as reformulated in *Cavendish*.¹²³ However, despite these drafting efforts the language of the stipulation is not

¹¹³ See, eg, *Edgeworth Capital (Luxembourg) SARL v Ramblas Investments BV* [2015] EWHC 150 (Comm) (30 January 2015); *Richards v IP Solutions Group Ltd* [2016] EWHC 1835 (QB) (22 July 2016); *Brown's Bay Resort Ltd v Pozzoni* [2016] UKPC 10 (16 April 2016).

¹¹⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1217 [74]; 1218 [177]; 1219 [81]; 1220 [83].

¹¹⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1281 [270].

¹¹⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1285 [291].

¹¹⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1257 [181].

¹¹⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1285 [292].

¹¹⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1257-8 [183]; 1283 [280]; 1285 [291]-[292].

¹²⁰ Sarah Worthington, 'Common Law Values: The Role of Party Autonomy in Private Law' in Andrew Robertson and Michael Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (Hart Publishing 2016) 301, 316; Halson, above n 110, 169-78, [5.47]-[5.72].

¹²¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1283 [280].

¹²² *Ibid* 1218 [77].

¹²³ Day, above n 112, 124; Tom Collins, 'Liquidated Damages Clauses — Where Are We Now?' (2016) 32 *Construction Law Journal* 463, 465.

determinative and the Court is likely to inquire into 'what is the real nature of the transaction'.¹²⁴ The Court's approach is to prefer the substance of contractual obligations over the form in which they are drafted.¹²⁵

4.6.3 Four Constraints to Application of the Legitimate Interests Test

A number of issues arise from the Court's determination to ground the modern reformulation of the penalty doctrine in considerations of 'legitimate interests' in contractual performance. This chapter argues there are four issues which will arise when the legitimate interests test is applied. Firstly, it is necessary to determine the relevant legitimate interests to be protected. Lord Hodge used the expression 'it has regard to the legitimate interests, commercial or otherwise'¹²⁶ thus the possibility exists that the legitimate interests sought to be protected are not limited to commercial interests and potentially extend to something else represented by 'otherwise'.¹²⁷ For example, legitimate interests may extend to protection of reputation or perception in the commercial market place. Lords Neuberger and Sumption¹²⁸ refer to 'any legitimate interest of the innocent party in the enforcement of the primary obligation'. Lord Mance¹²⁹ refers to 'legitimate business interest'. Some actors relevant to determining what the non-breaching party's legitimate interests might be include the circumstances in which the contract was made,¹³⁰ whether the contract was concluded between parties of comparable bargaining power and whether both were legally advised. Secondly, it is necessary for the court to determine whose legitimate interests are relevant to the Court's analysis. For instance, in *Dunlop*, Lord Atkinson recognised that *Dunlop's* interest in entering into the price maintenance agreement with its retailers was to protect its brand, reputation, goodwill and its authorised distribution network.¹³¹ In *Cavendish*, Lords Neuberger and Sumption refer to *Dunlop's* 'wider interest' in avoiding having its pricing structure undercut.¹³² Lord Mance recognises 'the maintenance of a system of trade, which only functions if all trading partners adhere to it'¹³³ were a part of *Dunlop's* legitimate interests. In *ParkingEye* the court refers to interests of the landowner who was not a party to the relevant contract. Thirdly, the legitimate interests must exist at the time when protection is contemplated which is at the date of the contract.¹³⁴ The requirement of proportionality between the stipulated sum (or other detriment) and the legitimate interests it is intended to protect are also judged at that time.¹³⁵ Fourthly, the relevant legitimate interest must be the subject of proof and not merely asserted by the non-breaching party.

4.6.4 What Are Legitimate Interests in Performance of the Contract

The test¹³⁶ refers to 'legitimate interest(s) in performance' which is a concept left largely undefined by the court however, some guidance was provided as to what might constitute a legitimate interest. The court

¹²⁴ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 9.

¹²⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1197 [15], 1224 [94], 1268–9 [221]; Halson, above n 128, 180, [5.79].

¹²⁶ *Ibid* 1276 [249].

¹²⁷ *Ibid*.

¹²⁸ *Ibid* 1204–5 [32].

¹²⁹ *Ibid* 1247 [152].

¹³⁰ *Ibid* 1205–6 [35], 1217–18 [75].

¹³¹ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 91–2.

¹³² *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199–200 [23].

¹³³ *Ibid* 1247 [152].

¹³⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, [221].

¹³⁵ Halson, above n 110, 53, [2.44]; *Hayfin Opal Luxco 3 SARL v Windemere VII CMBS Plc* [2016] EWHC 782 (Ch). [137] (8 April 2016); *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017) [35].

¹³⁶ *Ibid* 1204–5 [32]; 1247 [152]; 1278 [255].

said, firstly, there can be no legitimate interest in punishing the breaching party,¹³⁷ secondly, in many cases the stipulated sum adequately serves the legitimate interest of the non-breaching party,¹³⁸ thirdly, there may be circumstances where the non-breaching party has an interest in the enforcement of the primary stipulation which is not satisfied by recovery of the stipulated sum,¹³⁹ and finally, there is the stipulation where the non-breaching party has an interest extending beyond compensation that bears no relationship to loss and aims to deter breach.¹⁴⁰ The non-breaching party will have a legitimate interest in obtaining performance of its contract rather than the recovery of damages in the following circumstances.¹⁴¹ Firstly, where it would face serious difficulties in proving its loss, if any, from the breach of contract;¹⁴² secondly, where it would face serious difficulties in detecting whether there has been a breach of contract;¹⁴³ thirdly, where it would not be able to obtain substitute goods, property or services which would make damages an inadequate remedy;¹⁴⁴ fourthly, where a third party will suffer a loss instead of, or in addition to the non-breaching party;¹⁴⁵ fifthly, where the non-breaching party risks insolvency if it has to wait for damages from the breaching party;¹⁴⁶ sixthly, where the non-breaching party has an exceptional interest in ensuring that the breaching party performs such that the court would award an account of profits;¹⁴⁷ and finally, more generally, in those circumstances where deterrence is an essential element of a lawful scheme.¹⁴⁸

The court said the legitimate interest of the non-breaching party is in the enforcement of the primary obligation or in some form of appropriate alternative performance.¹⁴⁹ Also that the nature and breadth of the interest(s) sought to be protected varies from case to case.¹⁵⁰ A determination of the appropriate remedy for the breaching party's failure to perform requires consideration of whether the interests of the non-breaching party is satisfied by compensation or only by some more extensive remedy. Lords Neuberger and Sumption¹⁵¹ confirmed that in many situations the interests of the non-breaching party will be satisfied by monetary compensation alone and in this regard referred to 'straightforward damages clauses' as an example. In that circumstance they said the *Dunlop* formulation would be adequate.

However in more complex circumstances where the non-breaching party's expectations are not satisfied by compensation the parties may wish to agree upon a stipulation providing for recovery of an amount in excess of the non-breaching party's loss and include non-compensatory objectives that deter breach.¹⁵² *Cavendish* clarified that loss is no longer the only benchmark against which stipulated sums are assessed as a

¹³⁷ Ibid 1204-5 [32]; 1274 [243].

¹³⁸ Ibid 1204-5 [32]; 1278 [255].

¹³⁹ Ibid 1202-1205 [28]-[32]; 1226 [99]; 1247 [152]; 1278 [255].

¹⁴⁰ Ibid 1202-1205 [28]-[32]; 1226 [99]; 1247 [152]; 1278 [255].

¹⁴¹ See Hugh Beale, 'Damages' in Hugh Beale (gen ed) *Chitty on Contracts, Second Cumulative Supplement to the Thirty Second Edition* (Sweet and Maxwell, 2017) 187, 220-231 [26.195]-[26.210]; Mindy Chen-Wishart, *Contract Law* (Oxford University Press, 6th ed, 2018) 565-6.

¹⁴² *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1202, [28].

¹⁴³ Ibid 1254, [172].

¹⁴⁴ See Beale, above n 141, 224 [26.201].

¹⁴⁵ *ParkingEye Ltd v Beavis* [2016] AC 1172, 1226 [99].

¹⁴⁶ For example, *Thames Valley Power Ltd v Total Gas and Power Ltd* (2006) 1 Lloyd's Rep 441, 455 [64].

¹⁴⁷ For example, *A-G v Blake* [2000] 3 WLR 625; *Esso Petroleum Co Ltd v Niad Ltd* [2001] All ER (D) 324.

¹⁴⁸ For example, *ParkingEye Ltd v Beavis* [2016] AC 1172, 1226 [99]; 1262 [199].

¹⁴⁹ Ibid 1204-5 [32]; 1278 [255].

¹⁵⁰ Ibid 1202-1205 [32]; and see also Lord Hodge at 1278 [255].

¹⁵¹ Ibid 1204-5 [32]; 1278 [255].

¹⁵² Ibid 1202-1205 [28]-[32]; 1226 [99]; 1247 [152]; 1278 [255].

liquidated damages clause extending beyond compensation is now regarded as valid.¹⁵³ Solene Rowan¹⁵⁴ observes this development in the law is reflective of a more liberal approach to the respect given to the autonomy of contracting parties and their reasons for agreeing to a stipulation going beyond compensation. In practical terms it provides the court with increased flexibility to enforce stipulations of this nature.

In *Cavendish* the court found the non-breaching party (*Cavendish*) had a legitimate interest which justified a remedy beyond compensation. The impugned stipulations were not compensatory and sought to deter breach yet the court found them to be valid and enforceable as they sought to protect the legitimate interests of the purchaser (*Cavendish*) in maintaining the goodwill of the business which was critical. In *ParkingEye* a far broader meaning was given to legitimate interests and the court identified three, firstly it was in the interests of other users of the car park overstaying be reduced which increased the likelihood of obtaining a car park spot, secondly readily available car park spots would attract more customers to the shopping centre and thus benefit the retailers and thirdly the £85 charge would ultimately benefit the owner of the centre and the operator.

4.6.5 How to Measure Legitimate Interests

In circumstances where the non-breaching party is entitled to rely on stipulations extending beyond compensation the court must be able to measure those legitimate interests. Factors¹⁵⁵ courts may take into account to achieve this objective will includes, firstly determination of the importance of the primary obligation which has been breached and the seriousness of the consequences following from the breach. Both of these considerations were relied upon in *Cavendish* where the court emphasises the impugned stipulations had been inserted into the agreement to ensure the loyalty of the seller (ie: *Makdessi*) and to protect the goodwill of the business which was of critical importance to the purchaser (ie: *Cavendish*). A significant part of the sale price was attributable to goodwill and without it the value of the business would be much less.¹⁵⁶ Breach of the restrictive covenants would impact on the whole business and seriously affect its value and defeat the purchaser's commercial objective in purchasing the business.¹⁵⁷ Accordingly, the purchaser had a legitimate interest in protection of the goodwill. The court placed great importance on these considerations when it analysed *Dunlop* and concurred with the reasoning of Lord Atkinson. In decisions post *Cavendish* these factors were taken into account in relation to the enforceability of stipulated damages provisions.¹⁵⁸ Secondly consideration of the impact of the breach on third parties. In *ParkingEye* the court took into account the impact that breach of performance had on third parties in its finding that a legitimate interest extends beyond compensation. The third party was the owner of the carpark. The court found the £85 charge and operation of the parking scheme served the interests of the landowner as well as the operator, as the landowner received a fee from the operator for the right to manage the car park and also enabled it to lease retail sites for which the car park was a valuable facility.¹⁵⁹ Thirdly consideration of

¹⁵³ Ibid 1202-1205 [28]-[32]; 1226 [99]; 1247 [152]; 1278 [255].

¹⁵⁴ Solene Rowan, "The 'Legitimate Interest in Performance' in the Law of Penalties" [2019] *The Cambridge Law Journal* 1.5.

¹⁵⁵ Ibid 17.

¹⁵⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1217-8 [75].

¹⁵⁷ Ibid 1257 [180]-[181].

¹⁵⁸ See *Gray v Braid Group (Holdings) Ltd* 2017 SC 409; and *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017).

¹⁵⁹ *ParkingEye Ltd v Beavis* [2016] AC 1172, 1226 [99]; 1260 [193]; 1284 [286].

protection of the public interest. In *ParkingEye* the court found the £85 charge which deterred motorists from parking beyond two hours served the public interest, as consumers and retailers benefited from having free parking for the two hour period. The charge deterred commuters from overstaying and permitted the operator to efficiently manage the use of parking spaces.¹⁶⁰ Fourthly protection of non-financial expectations is a relevant consideration. The enforcement of a stipulated sum which protects a non-financial interest is evident for example from the Scots decision in *Gray* which was concerned with the bad leaver provision in a company's Articles of Association. A company director committed bribery offences and was obliged to sell his £20.6 million shareholding back to the company for £2,500. The stipulation was found to be enforceable as the company had an interest in the faithful and diligent performance by shareholders of their duties as employees (ie: directors) and also in preservation of the reputation of the company. Even though these interests were non-financial the company was entitled to protect them. Finally the presence or absence of certain characteristics of the parties may be of relevance. In *Cavendish* Lords Neuberger and Sumption¹⁶¹ referred to the parties having been properly advised and of comparable bargaining power. The court found the contract had been negotiated over many months, the parties were commercially sophisticated, they dealt with each other on an equal basis and each was advised by specialise lawyers.¹⁶² In that circumstance "the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach". These types of considerations do not relate to the terms or objectives of the contract or to the consequences of breach. They concern the attributes of the parties to the *Cavendish* share sale agreement and the circumstances in which that agreement was negotiated. Contracts entered into by sophisticated contracting parties containing stipulations that go beyond compensation will be enforced.¹⁶³

It is to be observed from the examination of these five factors which courts have taken into account when considering legitimate interests in performance that they are broad and all-embracing and extend beyond just the interests of the contracting parties. This breadth of coverage may cause difficulties in future unless the courts set out some boundaries and guidelines as to which interests are permissible for courts to consider.¹⁶⁴

4.6.6 The Simple-Complex Distinction

The Court was critical of the *Dunlop* formulation as being a 'straightjacket'¹⁶⁵ and having been applied as 'immutable rules of general application'.¹⁶⁶ Despite these criticisms the Court considered, but did not overrule *Dunlop*. Lords Neuberger and Sumption stated that the great majority of cases decided in England since *Dunlop* concerned more or less 'standard damages clauses in consumer contracts'.¹⁶⁷ Also they referred to "simple damages clauses in standard contracts"¹⁶⁸ in which Lord Dunedin's four propositions had

¹⁶⁰ Ibid 1226 [98].

¹⁶¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1205-6 [35]; 1247 [152].

¹⁶² Ibid 1219-1220 [82]; 1257 [181].

¹⁶³ See *BHL v Leumi ABL Ltd* [2017] EWHC 1871 (QB) (28 July 2017).

¹⁶⁴ See the discussion in chapter 5 at [5.2.8.2] of suggested limits to legitimate interests.

¹⁶⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1270 [225].

¹⁶⁶ Ibid 1204 [31].

¹⁶⁷ Ibid 1201 [25]. In *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* (2005) BLR 271, 280 Jackson LJ noted he was only referred to four authorities where the relevant clause had been struck down as a penalty, ie: *Commissioner of Public Works v Hills* [1906] AC 368; *Bridge v Campbell Discount Co Ltd* [1962] AC 600; *Workers Trust and Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573; *Ariston SRL v Charly Records* (Unreported, Court of Appeal, 13 March 1990).

¹⁶⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1199 [22].

'proved perfectly adequate'.¹⁶⁹ The point to note is that in these references it is the clause itself which is the focus of consideration. As Lord Hodge¹⁷⁰ observed this is a clause expressly "fixing the level of damages to be paid on breach". On this basis this chapter argues a typical liquidated damages clause in a standard form construction contract stipulating for payment of money upon breach would amount to a straightforward clause attracting the *Dunlop* formulation rather than the legitimate interests test. However, in the less straightforward stipulation involving "more complex cases",¹⁷¹ the court searches for a broader formulation based on considerations of the commercial justification for stipulations which might otherwise be found to be penal. This broader formulation was expressed in the legitimate interests test¹⁷² and is not limited to an examination of the stipulation but rather requires a consideration of the circumstances surrounding performance of the contract. Where the legitimate interests which the non-breaching party may have in performance extend beyond monetary compensation then application of the new test raises a number of issues. Firstly, it removes the need to consider whether the stipulated sum was a genuine pre-estimate of the loss the non-breaching party would suffer by reason of the breach of contract, and secondly, the court has removed reliance on commercial purpose as an excuse for inserting into the contract what would otherwise constitute a penalty.

The simple-complex distinction retains the *Dunlop* formulation¹⁷³ as well as advancing the modern broader approach focusing on the 'legitimate interests' of the non-breaching party in contractual performance. The upshot of this development is that different tests are to be applied depending on the question of characterisation. The difficulty is that the Court did not set out any criteria or guidelines to assist with the question of characterisation and this may lead to uncertainty and what Halson refers to as 'boundary disputes'¹⁷⁴ as to which test is to be applied in any given circumstance. To avoid these problems legal advisors need to be vigilant and have the court determine the question of characterisation of the clause or the contract at an early stage of litigation.¹⁷⁵ There may be shades of grey in deciding which test to apply and the outcomes of particular cases may differ due to the *Cavendish* test raising the bar and enforcement being more likely than a determination that a stipulation is an unenforceable penalty.¹⁷⁶

The simple-complex distinction is difficult to comprehend given that the £85 charge in *ParkingEye* was a monetary stipulation in a consumer contract. The Court applied the legitimate interests test rather than the *Dunlop* formulation to determine whether the stipulation offended the penalty doctrine. This may be explained on the basis the Court was suggesting that what appeared to be a simply worded clause was one that sought to protect a complex set of legitimate interests beyond the mere payment of money. The breadth of those interests would only be ascertained when the Court looked outside the words of the stipulation to the complexity of the scheme or the interest(s) it was supporting. To complete this task the Court must do

¹⁶⁹ Ibid 1201 [25].

¹⁷⁰ Ibid 1278 [255].

¹⁷¹ Ibid 1199 [2].

¹⁷² Ibid 1204–5 [32], 1247 [152], 1278 [255], 1286 [294].

¹⁷³ In *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 255, 628 [322], Nettle J accepted that *Dunlop* should continue to apply to simple cases. This was referred to in *Café Du Liban Pty Ltd v Bespoke Garage Pty Ltd* [2017] NSWSC 779 (16 June 2017) [73].

¹⁷⁴ Halson, above n 110, 72 [2.76].

¹⁷⁵ This argument is fully developed in chapter 5 at [5.2.8.4].

¹⁷⁶ See the discussion in chapter 5 at [5.2.8.4] regarding the future conduct of litigation and obtaining a procedural ruling from the court.

more than construe the stipulation and consider the particular breach; the court must undertake a contextual construction of the stipulation and analyse the breach in an effort to uncover the legitimate interests of the non-breaching party that the stipulation sought to protect. This means drafting practices require alteration so that the legitimate interests intended to be protected by the stipulation form part of the contract.¹⁷⁷

The analysis above suggests application of the penalty doctrine post-*Cavendish* requires consideration of four key issues:

- i) characterisation of the contract/clause: a straightforward clause which attracts the *Dunlop* formulation or a complex contract which attracts the legitimate interests test;
- ii) threshold issue: is the impugned stipulation in substance a secondary obligation engaged upon breach of a primary obligation;¹⁷⁸
- iii) identification of the extent and nature of the 'legitimate interests' of the non-breaching party in having the primary obligation performed; and
- iv) having regard to those 'legitimate interests', determine whether the secondary obligation is exorbitant or unconscionable in amount or in its effect.

4.6.6.1 Possible Inconsistent Results

Application of the different tests may lead to inconsistent results when applied to the same facts. For example, in *ParkingEye* if the traditional *Dunlop* formulation had been applied the stipulation would have been found to be a penalty as £85 was not a genuine pre-estimate of the appellant's loss¹⁷⁹ and the charge was designed to deter breach.¹⁸⁰ Applying the *Cavendish* test, the operator had a legitimate interest in ensuring limited free parking for the benefit of retailers and customers as the parking charges were an essential part of a lawful parking scheme. Furthermore, the charge was not manifestly excessive when compared to the level of charges imposed by other local authorities and operators for overstaying.¹⁸¹

By way of further example, in *Cavendish*, if the traditional *Dunlop* formulation had been applied the stipulations would have been found to be a penalty as Makdessi risked losing over US\$100 million due to his breaches of the agreement, and this amount was out of all proportion to the loss attributable to these breaches and acted as a deterrent. Applying the *Cavendish* test the appellant had a legitimate interest in the preservation of the goodwill of the business it was purchasing and for which it was paying a very large amount of money. The shares being purchased by the appellant would be reduced in value if Makdessi was found to be in breach of the non-competition covenants in the agreement. Accordingly the stipulations which were designed to deter *Makdessi* from breach were not penal. The focus then turns to whether a reduction of the sale price of in excess of US\$100 million for *Makdessi's* breach could be justified as not extravagant. *Makdessi's* loyalty and protection of the goodwill of the business he was selling was regarded as critical to

¹⁷⁷ See Halson, above, n 110, 54-57, [2.47] and 179-180, [5.73]-[5.79].

¹⁷⁸ *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017) [41].

¹⁷⁹ See *ParkingEye Ltd v Beavis* [2015] EWCA Civ 402 (23 April 2015) [5], [25] where the Court of Appeal explains that *ParkingEye* did not suffer any specific financial loss if a motorist overstayed, because if the space in question had been vacated, it would have either remained unoccupied or would have been occupied by another car free of charge.

¹⁸⁰ *ParkingEye Ltd v Beavis* [2015] EWCA Civ 402 (23 April 2015) [98].

¹⁸¹ *Ibid* [100]; and see Chen-Wishart, above n 141, 566-7.

the sale process and under these circumstances unconscionability and extravagance must have been assessed by the Court on the basis of a worst-case scenario.¹⁸²

These examples confirm the importance of the court determining the questions of characterisation at an early stage of the litigation. *Cavendish* has introduced a more flexible test than the *Dunlop* dichotomy to determine whether a stipulation is penal. However the *Cavendish* test has injected uncertainty as regards the question of characterisation which impacts upon the relevant test to be applied. This thesis argues below in chapter 5 that such uncertainty can be alleviated by early judicial ruling.¹⁸³ The *Cavendish* legitimate interest test has raised the bar so it is very difficult to hereafter successfully argue that a stipulation activated by a breach of contract is an unenforceable penalty. This is despite decisions post-*Cavendish* where stipulations have been found to be a penalty¹⁸⁴ which confirm that the penalty doctrine is not a dead letter. As Lord Hodge¹⁸⁵ said, it is only “egregious contractual provisions” that are not enforced. Analysis of the judgment in a recent decision where the legitimate interests test was applied and the stipulation found to be a penalty follows in the case study below.

4.7 Case Study: *Vivienne Westwood Ltd v Conduit Street Development Ltd*

In *Vivienne Westwood Ltd v Conduit Street Development Ltd*¹⁸⁶ a premium fashion brand entered into a commercial arrangement for its flagship store in Mayfair in London. This arrangement included a side letter to a lease. The two documents were executed on the same day and the side letter contained a rent reduction to the rental amount nominated in the lease. This practise is common in the retail context¹⁸⁷ where a landlord is willing to offer a lower rental to a particular tenant (whose reputation or business type may assist to boost market rents in the locality or may support the landlord’s wider tenant mix objectives), but without this concession appearing in the lease itself, as this could adversely affect comparable values.

The side letter provided the landlord could terminate the arrangement with immediate effect if the tenant breached any term of the side letter or the lease. In the event of termination, the rent was to be immediately payable at the higher rate set out in the lease as if the side letter had never existed. The tenant breached its obligation to pay the rental on time and the landlord purported to terminate the arrangement in the side letter and pursued the tenant for the higher rental pursuant to the lease. The tenant argued the arrangement was an unenforceable penalty.

The principal issue articulated by the judge¹⁸⁸ was whether the landlord’s right to terminate the side letter upon any breach of contract by the tenant, thereby rendering the higher rent payable in accordance with the lease was a penalty. The judge¹⁸⁹ acknowledged that the law of penalties had been comprehensively

¹⁸² Ibid 567.

¹⁸³ See the discussion in chapter 5 at [5.2.8.4].

¹⁸⁴ See for example, *Gray v Braid Group (Holdings) Ltd* 2017 SC 409; *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017).

¹⁸⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1280, [266].

¹⁸⁶ *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017).

¹⁸⁷ See Gwendoline Davies, Martin McKeague, ‘Prime Fashion + Prime Location = Prime Setting for a Contractual Side Letter Penalty’, <https://waltermorris.co.uk/publications/prime-fashion-prime-location-prime-setting-contractual-side-letter-penalty-dispute/>

¹⁸⁸ *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017) [35].

¹⁸⁹ Ibid [38].

reviewed in *Cavendish* and he explained the new test in the following terms: a penalty is a contractual provision that imposes a detriment on the breaching party which is out of all proportion to any legitimate interests the non-breaching party has in performance of that obligation. The judge broke the test down into the following four key issues:

- the threshold issue of whether the penalty doctrine is engaged;
- consideration of the landlord's legitimate interests in performance;
- consideration of the kinds of breach that would entitle the landlord to terminate; and
- consideration of whether the landlord's interests in the higher rental were exorbitant or unconscionable.

4.7.1 ***The threshold issue: is the penalty doctrine engaged at all?***

As a threshold issue the judge was to determine whether the higher rental obligation was a secondary obligation engaged upon breach of the primary obligation. He found¹⁹⁰ that in substance the true primary obligation of the tenant was payment of the rent at the lower level specified in the side letter as well as performing its other obligations in the lease. In the event of breach of any of those primary obligations the tenant was obliged to perform a secondary obligation ie: payment of rent at the higher level.

The true bargain concluded by the landlord and tenant was that, in return for having a tenant of the plaintiff's reputation, the landlord would accept a reduced rent, which was below the market rent it would otherwise have obtained. The judge found¹⁹¹ because of the side letter there was no primary obligation on the tenant to pay the higher rental. The substance of the transaction¹⁹² and the true primary obligation was for the tenant to pay the lower rental with a default to the higher rental in the event of any breach of contract.

The judge¹⁹³ referred to the conclusions of Lords Neuberger, Sumption and Carnwath¹⁹⁴ in *Cavendish* on the construction of clause 5.1 of the share sale agreement where they had found that the forfeiture of a valuable right to receive money as a result of a breach of contract was a primary obligation and as such did not engage the penalty doctrine. This finding was dependent on the nature of the breach (ie: competition with the business being sold), its close relationship to the value of the shares for which the seller was being paid, and the consequences of breach for the seller. The judge urged caution¹⁹⁵ in applying the reasoning of the three Lords in *Cavendish* to the very different facts of the present case as the rent could be increased due to failure by the tenant to perform any one of its obligations, regardless of the impact of the breach. This is to be distinguished from the *Cavendish* situation where a reduction of the price payable for a shareholding in a company consequent upon breach by the seller of a centrally important non-competition obligation.

The judge found¹⁹⁶ that as the side letter permitted the landlord to impose a greater obligation on the tenant upon any breach of any obligation of the lease then the secondary obligation was capable of being a penalty.

¹⁹⁰ Ibid [42]-[49].

¹⁹¹ Ibid [44].

¹⁹² Ibid [48].

¹⁹³ Ibid [45].

¹⁹⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1217, [74], 1220, [83].

¹⁹⁵ *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017) [46].

¹⁹⁶ Ibid [49].

Accordingly, the threshold issue was satisfied which engaged the penalty doctrine. The question of whether the increased rental was a penalty depends on the legitimate interests of the landlord in having the tenant comply with its obligations in the lease, and whether the burden of the secondary obligation was exorbitant or unconscionable compared with any loss likely to flow from the tenant's breach. In the alternative, the enquiry was whether the landlord's legitimate interests extended beyond pecuniary compensation for any loss caused by the particular breach by the tenant so as to justify the extent of the secondary obligation. As the threshold issue was satisfied, the judge moved forward and applied the legitimate interests test.

4.7.2 *Legitimate interest in performance*

The judge had to determine whether the purpose of the increased rental stipulation was to protect any legitimate interest of the landlord. The landlord argued it had a legitimate interest in having the tenant perform all of its obligations promptly. There is an obvious cashflow benefit to the landlord due to prompt payment of rental and in the rent increasing to full market rent in the event of the tenant breaching any of its obligations. The tenant argued the landlord's legitimate interests did not extend to an entitlement to payment of the higher rent, which it had agreed to forego by the side letter. The payment of the higher rental, upon any breach of the arrangement however minor or short-lived, was not part of the true bargain that had been made between the parties. In determining this issue the judge found¹⁹⁷ the reduced rental was a substantial term of the bargain and therefore the landlord could not argue it had a legitimate interest in the rental reverting to the high level as this would be a legitimate interest in non-performance of the tenant's obligations and not a legitimate interest in their performance.

The main difficulty faced by the landlord was that uncompensated loss or harm would be hardly likely to flow from minor, one-off breaches of covenant (which had occurred here) when compared to sustained or more serious breaches; yet the financial adjustment stipulated by the side letter was substantial. Under the side letter, the same substantial financial adjustment applied whether the breach was one-off, minor, serious or repeated and had no regard to the nature of the obligation breached or any actual or likely consequences for the landlord. Consistent with Lord Dunedin's proposition 4(c) the judge found¹⁹⁸ that a stipulation having this effect has long been recognised as one of the hallmarks of a penalty.

4.7.3 *What kind of breach entitles the landlord to terminate?*

The landlord had the right to terminate the side letter in the event of "breach" of any of the terms of the side letter or the lease. The landlord argued that the word "materially" should be implied into the side letter before the word "breach" to prevent the side letter from having a wholly uncommercial and unintended effect. Similarly, the tenant argued the reduced rental, the subject of the side letter, was properly to be regarded as part of the substantial bargain made by the parties. Accordingly, it submitted the parties could not have intended that a trivial breach of contract by the tenant (ie: delayed payment of rent) would entitle the landlord to put an end to the side letter. The judge¹⁹⁹ agreed with the landlord that a qualification was necessarily implicit in the terms of the side letter and determined²⁰⁰ that if the terms of the side letter were to have any

¹⁹⁷ Ibid [52].

¹⁹⁸ Ibid [53].

¹⁹⁹ Ibid [58].

²⁰⁰ Ibid [58]-[59].

sensible commercial effect it was necessary to exclude trivial (or de minimis) breaches from triggering the landlord's right to terminate the side letter.

4.7.4 Was the landlord's interest in the higher rent obligation exorbitant or unconscionable?

It was then necessary for the judge to determine whether the secondary obligation of payment of the higher rental was so onerous as to be unenforceable. The judge²⁰¹ focused his consideration on whether the specified consequences of termination of the side letter for any non-trivial breach was exorbitant or unconscionable, having regard to the disparity with the loss likely to flow from any breach. Thus the judge²⁰² found that the obligation to pay rent at a higher rate regardless of the nature and consequences of the breach and when it occurred was “no doubt” penal in nature. The judge took into account that a penalty ought not lightly be inferred when the contract had been freely negotiated by legally advised parties of equal bargaining power. Importantly, the judge took into account²⁰³ the higher rental was payable, retrospectively and into the future, in addition to the other remedies the landlord had for breach of any tenant obligation.

The judge concluded the consequences of the tenant's trivial breach were out of all proportion to the legitimate interests of the landlord in having the tenant comply with every one of its obligations rather than pay full compensation for any breach. Two factors tipped the balance in favour of the tenant:

- a) The rental increase applied for whatever remained of the first ten years of the rental term regardless of the nature and seriousness of the non-trivial breach and when it occurred; and
- b) The increased rental was payable in addition to interest on any overdue payment, any costs incurred by reason of the breach, and damages for loss caused by the breach.

The judge found²⁰⁴ the obligation to pay the increased rent was “a blunt instrument” which may give rise to a very substantial and disproportionate financial detriment. This obligation did not amount to a proper proportionate, protection of the landlord's legitimate interests in the tenant's performance of its obligations under the lease and was therefore unenforceable.

This decision is the first English case to have applied the reformulated *Cavendish* test for penalties and found the stipulation to be a penalty. The decision is a very useful application of the legitimate interests test to a commercial arrangement. The judge approached his task in a methodological manner by firstly determining as a threshold issue whether the penalty doctrine is engaged. There is no consideration of the simple-complex distinction referred to above as the judge must have considered the matter was not straightforward due to the intermingling of the lease and the side letter. Only thereafter did the judge consider the legitimate interests of the non-breaching party in performance of the contract. Once satisfied that they existed the final part of the analysis examined whether those interests are exorbitant or unconscionable. The decision highlights the risk to commercial parties when they draft agreed remedy stipulations such as termination arrangements which give one of them a substantial benefit or which imposes a significant financial detriment on the other party as a consequence of breach and regardless of the

²⁰¹ Ibid [62].

²⁰² Ibid [63].

²⁰³ Ibid [63].

²⁰⁴ Ibid [65].

seriousness of that breach. The fact that the parties are sophisticated and well advised and of equal bargaining power is of little importance if the court determines that the stipulation in their agreement is a penalty.

PART IV

4.8 Conclusion

The value the non-breaching party places on its legitimate interests in performance of the contract should be reflected in the amount of the stipulated sum. To be enforceable, the stipulation must not be extravagant or unconscionable when compared to the legitimate interests which it sought to protect. Lords Neuberger and Sumption use the expression ‘out of all proportion’,²⁰⁵ and Lord Mance prefers ‘extravagant, exorbitant or unconscionable’,²⁰⁶ whereas Lord Hodge uses ‘exorbitant or unconscionable’²⁰⁷ and said that criterion “should prevent the enforcement of only egregious contractual provisions”.²⁰⁸ Irrespective of which expression is used the Court intended the expressions to ‘mean much the same’.²⁰⁹ They all operate on the basis of giving a ‘broad margin of error’²¹⁰ or subject to a ‘low level of review’,²¹¹ and ‘the parties are allowed a generous margin’²¹² before the Court will find the stipulated sum to be an unenforceable penalty. Engagement of the penalty doctrine is not a regular occurrence²¹³ and henceforth it is likely its utility will be minimised further. However as the decision in the *Vivienne Westwood* case demonstrates the penalty doctrine is not a dead letter. Proportionality and prevention of punishment are necessary elements of the modern approach to the penalty doctrine formulated in *Cavendish* and as the facts in *Cavendish* demonstrate there is a very generous margin which the courts respect.

In *Cavendish* Lords Neuberger and Sumption²¹⁴ summarise their understanding of the penalty doctrine as did Lord Mance²¹⁵ and Lord Hodge²¹⁶ where they confirmed application of the modern formulation of the penalty doctrine requires a determination of the question of whether a stipulation is a penalty which is a matter of the proper construction of the contract. The real question in future will always be whether the stipulation is penal or punitive in nature²¹⁷ rather than whether it is a genuine pre-estimate of loss. The difficulty with such a formulation is exemplified by Mathias Chung²¹⁸ who suggests this inquiry risks becoming “circular and tautologous”. A penalty can only exist where a secondary obligation is imposed upon breach of a primary obligation. It is to be distinguished from a conditional primary obligation which operates

²⁰⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32].

²⁰⁶ *Ibid* 1247 [152].

²⁰⁷ *Ibid* 1247 [152] (Lord Mance), 1278 [255] (Lord Hodge).

²⁰⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1280, [266].

²⁰⁹ *Ibid* 1204 [31] (Lords Neuberger and Sumption), 1285–6 [293] (Lord Toulson).

²¹⁰ Halson, above n 110, 57 [2.48].

²¹¹ *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005) [51].

²¹² *Ibid* [43].

²¹³ See *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* (2005) BLR 271.280, [48]; and Roger ter Haar, Camilla ter Haar, *Remedies in Construction Law* (Informa Law, 2010) 185, [14.11].

²¹⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1191–210 [1]–[43].

²¹⁵ *Ibid* 1239–54 [126]–[170].

²¹⁶ *Ibid* 1267–80 [219]–[267].

²¹⁷ *Ibid* 1194–5 [9], 1204 [31], 1274 [243].

²¹⁸ Mathias Chung, “Shylock’s Construction Law: The Brave New Life of Liquidated Damages?” (2017) 33 *Construction Law Journal* 173.184.

on events that are not breaches of contract.²¹⁹ Whether a stipulation imposes a secondary obligation upon a breach of contract is a question of substance and not form²²⁰ and drafting techniques may not be effective if the true construction of the stipulation is that it is conditioned upon breach of the contract.²²¹

Cavendish confirms that since the penalty doctrine is an interference with freedom of contract²²² a negotiated contract between properly advised parties of comparable bargaining power will give rise to “a strong initial presumption” that the parties are the best judges of what is legitimate in a stipulation dealing with the consequences of breach.²²³ The party alleging a stipulation is a penalty bears the onus of establishing that the secondary obligation is exorbitant, extravagant or unconscionable.²²⁴ A stipulation that in substance imposes a secondary obligation for breach of a primary obligation will be a penalty if it imposes on the breaching party a detriment out of all proportion to any legitimate interests of the non-breaching party in the performance of the primary obligation²²⁵ or which is exorbitant, extravagant or unconscionable in comparison with the value of those legitimate interests.²²⁶

This chapter argues that in applying the legitimate interests test courts will need to consider the circumstances in which the contract was made. Once a stipulation is characterised as a penalty then the consequence is that it is wholly unenforceable.²²⁷ There is no power in English courts to partially enforce the stipulation to the extent that it is not penal or to enforce it only on terms that would amount to rewriting the contract. Furthermore a penalty is not confined to the payment of money as it can include the transfer of property²²⁸ and a stipulation which provides for payment to be made (or other obligations performed) upon an event other than a breach of contract will not engage the penalty doctrine.²²⁹ The definition of a penalty stated by Lord Dunedin in *Dunlop* ie: a clause that provided for the payment of a sum that was greater than a genuine pre-estimate of loss will no longer apply generally.²³⁰

This Chapter considers how the English courts commencing with the decision of Coleman J in *Lordsvale*,²³¹ sought to develop a ‘more accessible paraphrase of the concept of penalty’²³² leading to adoption of Coleman J’s re-characterisation of the traditional *Dunlop* formulation by the Court of Appeal.²³³ The UK Supreme Court had the perfect opportunity in the *Cavendish* appeal to harmonise recent differences which had developed in the common law and in particular the *Andrews* decision to re-enliven a jurisdiction in equity to relieve against penalties. The court bluntly determined *Andrews* was wrong and further provided for the simple-complex distinction and found the traditional *Dunlop* formulation continues to apply to straightforward damages clauses in standard contracts. However for less straightforward commercial or complex contracts

²¹⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [14].

²²⁰ *Ibid* 1197 [15].

²²¹ *Ibid* 1279 [258].

²²² *Ibid* 1205 [33], 1205–6 [35].

²²³ *Ibid* 1205–6 [35].

²²⁴ *Ibid* 1244 [143].

²²⁵ *Ibid* 1204–5 [32].

²²⁶ *Ibid* 1247 [152], 1278 [255].

²²⁷ *Ibid* 1194–5 [9], 1285 [291].

²²⁸ *Ibid* 1197 [16].

²²⁹ *Ibid* 1209–10 [43], 1240 [130], 1279 [258], 1285 [291]–[292].

²³⁰ *Ibid* 1201 [25], 1205–6 [35], 1245 [145], 1270 [225], 1285 [292].

²³¹ *Lordsvale Finance Plc v Bank of Zambia* [1996] QB 752, 762.

²³² *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2003] EWCA Civ 1669 (21 November 2003) [13].

²³³ *Ibid*; *Murray v Leisureplay Plc* [2005] EWCA Civ 963 (28 July 2005).

the legitimate interests of the non-breaching party in performance of the contract are now the focus of consideration when the stipulated sum is challenged as a penalty. As such the unexplained distinction may lead to confusion. Despite the *ParkingEye* contract being a simple consumer arrangement the UK Supreme Court applied the legitimate interests test to determine whether the parking charge was a penalty. If the *Dunlop* formulation had been applied in *Cavendish* or *ParkingEye* this chapter argues the results would have been rather different. Accordingly the characterisation of the contract and the stipulation in question as either simple or complex is of some importance. An answer to the question of characterisation at an early stage in legal proceedings is therefore fundamental.

The *Cavendish* approach is more flexible than the straightjacketed *Dunlop* formulation as it recognises and respects that contracting parties may have legitimate interests in having the contract performed as opposed to the recovery of compensation for breach measured by a pre-estimate of loss. If so, the issue then becomes whether payment of the amount of the sum stipulated imposes on the breaching party something that is not proportionate to the legitimate interests the stipulation is to protect.²³⁴ The non-breaching party who seeks to enforce payment of the stipulated sum will stress the legitimate interests it seeks to protect when it included the stipulated sum into the contract whereas the breaching party challenging the validity of the stipulated sum will argue it imposes a punishment out of all proportion to the legitimate interests asserted by the non-breaching party and is therefore extravagant, exorbitant or unconscionable and not be enforceable. This chapter argues it is then increasingly difficult to engage the penalty doctrine to impugn stipulations in complex contracts which means stipulated sums which are included are highly likely to be enforced. In this light the *Cavendish* approach promotes increased contractual certainty as it gives the parties greater confidence that their commercial bargain will be upheld. Additionally it increases the use of such provisions in commercial contracts.

Consistent with David Ibbetson's observation²³⁵ 'the common law has many virtues; tidiness is not one of them' the UK Supreme Court has left the door open for fruitful debate as to the exact meaning of 'legitimate interests' and examination of the proper boundaries for the expressions 'extravagant', 'exorbitant' or 'unconscionable'. Each case will thereby be specifically fact dependent and it will be important for the drafters of stipulations providing for payment of money upon breach of contract to make it clear exactly which 'legitimate interests' the stipulation is aims to protect.²³⁶ In *Cavendish* and *ParkingEye*, the relevant legitimate interests were not documented in the respective contractual arrangements but were the subject of argument before the court on the basis of what in the normal course one would expect them to be.²³⁷ For example, for *Cavendish*, the legitimate interests were found to be that *Cavendish*, as purchaser of the business, had a "very substantial and legitimate interest" in protecting the value of the company's goodwill. This was effected "by giving the sellers a strong financial incentive to remain loyal".²³⁸ Lord Mance added that the stipulations were fairly designed to protect against competition that was difficult to detect.²³⁹ In

²³⁴ For example, see *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017).

²³⁵ David Ibbetson, *A Historical Introduction to the Law of Obligations* (Oxford University Press, 2002) 294.

²³⁶ Halson, above n 110, has provided some 'Drafting Guides' at 179–80 [5.73]–[5.79].

²³⁷ Halson, above, n 110, 54-57 [2.47] provides examples from older and more recent cases and illustrates the legitimate interests considered by the courts.

²³⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1217-8, [75], 1281-2 [274]

²³⁹ *Ibid* 1237 [122].

ParkingEye the legitimate interests of the operator included consideration of the business model for its business which was premised on large numbers of people successfully using the car park. It therefore “had a legitimate interest to protect” when it “imposed the parking charge in order to encourage the prompt turnover of car park spaces”.²⁴⁰ However, the court also took into account the legitimate interests of the landowner and the customers of the retail shopping complex.

The last three Chapters including this one consider the rationale for the penalty doctrine and analyse the recent changes to the treatment of stipulated sums in Australia by the *Andrews* decision, as well as in England with the *Cavendish* decision. The next chapter deals with an analysis of the *Paciocco* decision in Australia, where the High Court reaffirmed the correctness of *Andrews* and adopted the *Cavendish* reformulation of the penalty doctrine in circumstances where there has been a breach of contract. Consistent with the other decisions considered to date, the emphasis in *Paciocco* is on the pretext that stipulations which aim to punish the breaching party are not enforced.

²⁴⁰ *ParkingEye Ltd v Beavis* [2015] EWCA Civ 402 (23 April 2015) [99], [193], [286].

Chapter 5

Changes to the Common Law in Australia: *Paciocco* and the Legitimate Interests Test

5.1 Introduction

This Chapter analyses the High Court decision in *Paciocco* which reshaped the common law treatment of the penalty doctrine in Australia post-*Cavendish*. In this decision the High Court considers the principles governing the identification and proof of a penalty on breach of contract and explains how Lord Dunedin's four propositions are to be understood and applied in Australia.¹

This chapter argues that the practical long term effect of *Paciocco* is to severely restrict the ability of contracting parties to successfully argue a liquidated damages clause activated by a breach of contract is a penalty. *Paciocco* is significant as it adopts a test based on the legitimate interests of the non-breaching party in performance of the contract to determine if an impugned stipulation is an unenforceable penalty. This is consistent with the UK Supreme Court decision in *Cavendish*.

In *Paciocco*, the High Court upheld the decision of the Full Federal Court² in favour of ANZ and brought an end to six years of protracted litigation. The Court³ was required to construe a stipulation requiring payment of fees to the ANZ consequent upon a breach of contract by customers. A stipulation of this type engages the penalty doctrine in its 'standard application'.⁴ Accordingly, the opportunity to respond to the criticism levelled at *Andrews* and, in particular, by *Cavendish*⁵ as well as by influential scholars,⁶ did not strictly arise. The High Court affirmed 'the governing principles (to determine whether the late payment fee in question was unenforceable as a penalty at common law) are to be found in *Andrews* and *Dunlop*'.⁷ One of the major conclusions in *Paciocco* is that the concept of 'damage' goes well beyond loss recoverable for breach of contract at common law,⁸ and the focus is on the legitimate interests of the non-breaching party in performance of the contract which are sought to be protected by the stipulation. These 'interests' were described in different terms by the judges in *Paciocco*, but with a preponderance to commercial, business and financial interests.⁹ A stipulation will be a penalty if 'it bears no relation to' the interest;¹⁰ is 'plainly

¹ See Hugh Fraser JA, "2017 WA Lee Lecture: The Australian Law of Contractual Penalties" (2018) 18 QUT Law Review 111.112.

² *Paciocco v Australia & New Zealand Banking Group Ltd* (2015) 321 ALR 684.

³ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 566–7 [115].

⁴ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 662 [10], ie: the law of penalties, in its standard application, is attracted where a contract stipulates that on breach the contract-breaker will pay an agreed sum which exceeds what can be regarded as a genuine pre-estimate of the damage likely to be caused by the breach.

⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1207–9 [41]–[42].

⁶ J W Carter et al, 'Contractual Penalties: Resurrecting the Equitable Jurisdiction' (2013) 30 *Journal of Contract Law* 99.

⁷ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 566–7 [115]. Note that in *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656 the parties had agreed that the *Dunlop* principles applied.

⁸ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 556 [65].

⁹ Kiefel J at ibid 547 [29] said 'interest may be of a business or financial nature', and at 549 [35] "wider commercial interests"; and Gageler J at 579 [161] referred to "interests that the innocent party has in contractual performance which are intangible and unquantified" and at 581 [166] said an "inquiry into the commercial circumstances" and at 583 [172] and 584 [176] he said 'commercial interests'; Keane J at 613 [272] said 'the legitimate interests of ANZ ...

excessive ... in comparison with the interest';¹¹ or 'extravagant, exorbitant and unconscionable'.¹² It is not sufficient that the stipulated sum be 'merely disproportionate'. Instead, it must be 'out of all proportion'.¹³

This Chapter is divided into three Parts. Part I describes the course of the *Paciocco* litigation in the Federal Court following the remitter by the High Court in *Andrews*. Part II analyses the High Court decision including its confirmation of the rationale for the penalty doctrine discussed in chapter 2, the current status of Lord Dunedin's four propositions and how the legitimate interests test is to be applied, it explains how the decision provides two approaches for assessing legitimate interests ie: narrow and expansive; that to determine whether a stipulation has the aim of punishment requires a purpose based test and examines why the customers' statutory claims were dismissed. Part III considers the significance of *Paciocco* and confirms the legitimate interests test is very broad and suggests some possible limits to its application, examines some difficulties that will arise when applying the decision, including its impact on contract drafting and makes recommendations for the efficient conduct of litigation.¹⁴ This Part concludes that the scope for future application of the penalty doctrine has been clarified and will be of limited application which will encourage stronger contracting parties to include liquidated damages clauses in their contracts in the comfortable expectation that they will be enforced.

PART I

Part I examines the course of the litigation in the Federal Court following the remitter by the High Court in *Andrews*.

5.2 The Course of the *Paciocco* Litigation in the Federal Court

5.2.1 *Paciocco* at First Instance: Gordon J

Following the decision in *Andrews*, the representative proceeding¹⁵ was remitted back to the Federal Court for trial before Gordon J. When the proceeding returned to that Court, Mr Andrews was no longer the nominated applicant for the class as he had been replaced by Mr Paciocco. The proceeding concerned complaints about ANZ charging credit card account holders and deposit account holders with a number of different fees in circumstances where the customer(s) had failed to make the minimum monthly payment on time. The fees charged by ANZ were non-payment fees, over-limit fees, honour fees, dishonour fees and late payment fees. Collectively these fees were referred to in the proceeding as the exception fees. The

understanding of the commercial context in which that interest requires protection'. This Chapter will use the expression 'commercial interests' to describe the interests referred to in the judgments in *Paciocco*.

¹⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 547–8 [32].

¹¹ *Ibid* 548 [34].

¹² *Ibid* 548 [34], 612 [270]; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1278 [255].

¹³ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 547–8 [32], 553–4 [54], 554–5 [57], 557 [69], 578 [156], 607 [256].

¹⁴ See *Civil Procedure Act 2010* (Vic) s 7 which provides that the overarching purpose of the Act and the Rules of Court in civil proceedings is to facilitate the just, efficient, timely and cost-effective resolution of the real issues in dispute.

¹⁵ Part IVA of the *Federal Court of Australia Act 1976* (Cth) and div 9.3 of the *Federal Court Rules 2011* (Cth) provide a regime for commencing class actions (otherwise known as Representative Proceedings) in the Federal Court, which has been in place since March 1992.

applicants alleged that all of the exception fees were unenforceable penalties and also that ANZ was in breach of certain statutory prohibitions relating to unconscionable conduct and unjust or unfair contract terms in their consumer contracts.¹⁶ Gordon J found that save for the late payment fee the balance of the exception fees charged by ANZ were not penalties and as none of the exception fees were found to have offended the statutory prohibitions those causes of action all failed.

5.2.2 Gordon J: Structure of Analysis

Upon remitter of the proceeding Gordon J formulated the question she was to answer in the following terms: “as a matter of construction of the relevant contract, was the requirement to pay the fee to be regarded as security for performance by the customer of other obligations to ANZ, or was it a fee to be charged in accordance with pre-existing arrangements, according to whether ANZ chose to provide something more and further to the customer, for example, by ANZ authorising payments upon instructions by the customer upon which ANZ otherwise was not obliged to act, or refusing further accommodation”.¹⁷

To answer this question her Honour applied *Andrews* and developed the following six step ‘structure of analysis’¹⁸ that she said “may (not must)” be used when deciding whether a stipulation is an unenforceable penalty:¹⁹

- “1. Identify the terms and inherent circumstances of the contract, judged at the time of the making of the contract.”²⁰
2. Identify the event or transaction which gives rise to the imposition of the stipulation.²¹
3. Identify if the stipulation is payable on breach of a term of the contract (a necessary element at law but not in equity). This necessarily involves consideration of the substance of the term, including whether the term is security for, and in terrorem of, the satisfaction of the term.
4. Identify if the stipulation, as a matter of substance, is collateral (or accessory) to a primary stipulation in favour of one contracting party and the collateral stipulation, upon failure of the primary stipulation, imposes upon the other contracting party an additional detriment in the nature of a security for, and in terrorem of, the satisfaction of the primary stipulation.
5. If the answer to either question 3 or 4 is yes, then further questions arise (at law and in equity)²² including:
 - 5.1 Is the sum stipulated a genuine pre-estimate of damage?
 - 5.2 Is the sum stipulated extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved?
 - 5.3 Is the stipulation payable on the occurrence of one or more or all of several events of varying seriousness?
 These questions are necessarily interrelated.
6. If the answer to question 5 is that the sum stipulated is not a genuine pre-estimate of damage and

¹⁶ *Australian Securities and Investments Commission Act 2001 (Cth)* ss 12CB, 12CC; *Fair Trading Act 1999 (Vic)* ss 8, 8A, 32W, 32X; *National Consumer Credit Protection Act 2009 (Cth)* sch 1 (‘National Credit Code’) s 76; *Australian Securities and Investments Commission Act 2001 (Cth)* s 12BG.

¹⁷ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 263 [38].

¹⁸ The expression was used by Allsop CJ in *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 218 [20].

¹⁹ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 258, [15], citations omitted.

²⁰ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86–7; *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170.

²¹ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86–7; *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 217 [12].

²² *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 236 [77].

is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have been sustained by the breach, or the failure of the primary stipulation upon which the stipulation was conditioned, then the stipulation is unenforceable to the extent that the stipulation exceeded that amount. Put another way, the party harmed by the breach or the failure of the primary stipulation may only enforce the stipulation to the extent of that party's proved loss."²³

Her Honour noted steps 5 and 6 (ie: is the stipulated sum extravagant and unconscionable, and if so, what is the party's proved loss?) were to be addressed last as they are applicable at law and in equity.²⁴

It is apparent from this six step test that her Honour acknowledged *Andrews* had confirmed the existence of a common law test for penalty applicable to situations where there had been a breach of contract²⁵ and an equitable jurisdiction to relieve against penalties that would apply in circumstances where there had been a failure of a primary obligation.²⁶ This has been referred to above in chapter 3 as "the general penalty doctrine" theory.²⁷

Steps 3 and 4 followed from *Andrews*. Gordon J found the late payment fee was payable upon breach of contract and also that it functioned as collateral thereby securing the customer's compliance with a primary obligation ie: making the minimum monthly payment on time. In applying step 5 her Honour compared the amount of the late payment fee which ranged from \$20–\$35 to the actual loss suffered by ANZ as a result of the late payment. Expert evidence presented on behalf of the customers estimated ANZ's loss to be between \$0.50–\$3 per instance of late payment.²⁸ That expert concluded an amount in this range reflected ANZ's increased operational costs and would restore ANZ to the position it would have occupied had the minimum monthly payment been made on time. Also of relevance was ANZ's concession that it had not carried out any pre-estimation of loss when determining the amount of the late payment fee and that the same fee was payable irrespective of the seriousness of the customer's breach. Gordon J found the actual loss suffered by ANZ would have been less than \$3 per transaction and compared to that loss a late payment fee in the range of \$20–\$35 was grossly disproportionate and a penalty.

The figure calculated by the expert for ANZ, was significantly higher than the amount calculated by the expert for the customers as he took into account not only ANZ's operational costs²⁹ but two further integers of costs, namely, the requirement for increased loss provisioning³⁰ and the increased cost of regulatory

²³ Ibid 216–17 [10].

²⁴ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 258 [16].

²⁵ In *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [9], the High Court confirmed the test set out in *Legione v Hateley* (1983) 152 CLR 406, 445.

²⁶ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216–17 [10]–[12].

²⁷ See chapter 3 at [3.4.2].

²⁸ *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249, 290 [173], 292 [186], 302 [241].

²⁹ Operational costs were the costs of ensuring that the payments the customers were required to make, were actually made. Those costs were largely incurred by staff contacting customers. See *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 555–6 [58]–[65].

³⁰ ANZ's increase in loss provisioning represented the reduction in the value to ANZ of the customers' debt because of the increased risk of default. See *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 555–6 [58]–[65].

capital.³¹ Her Honour preferred the evidence of the customers' expert and found the expert for the ANZ had calculated costs too broadly 'in a theoretical accounting sense' instead of calculating the actual loss or damage relevant for the purposes of the six step structure of analysis she was to apply.³²

ANZ appealed the finding that the late payment fee was a penalty and Mr Paciocco appealed the finding that the other exception fees were not characterized as penalties and including the findings dismissing the statutory causes of action.

5.2.3 Appeal to the Full Court of the Federal Court

The primary judgment of the Full Court was delivered by Allsop CJ who found her Honour had correctly characterised the late payment fee as prima facie penal in nature as it was payable upon breach of contract or as a collateral or accessory stipulation as security for or in terrorem of the primary stipulation (ie: timely payment according to the terms of the credit advanced by ANZ).³³ The Full Court approved Gordon J six step test however the Court found her Honour had erred as she conflated the distinct enquiries in steps 5 and 6 of her analysis.³⁴ Step 5 enquires whether the stipulation is penal in character, and this is determined by reference to the commercial interests of the non-breaching party in performance of the contract, at the time the contract was entered into (ie: an ex ante approach), whereas step 6 requires a look backward to the remedial consequences of the characterisation and enquires what amount the non-breaching party can recover if the stipulation is found to be a penalty, and this is determined by reference to the actual loss suffered (ie: an ex post approach) by that party.

Gordon J erred in limiting her analysis of loss to the damage ANZ would be likely to suffer from the customers' breach of contract. The Full Court undertook its own assessment of whether the late payment fee was properly to be characterised as extravagant or unconscionable. ANZ argued Gordon J had conducted an ex post analysis of the damages arising from the breach, in a situation where an ex ante analysis of the greatest conceivable loss was required. Also it argued her Honour failed to take account of ANZ's 'economic interests sought to be protected by the fee'.³⁵ Allsop CJ agreed with this submission³⁶ and found certain other costs the ANZ expert had taken into account, (ie: provisioning and regulatory capital costs) were commercial interests of ANZ meriting protection by the sum stipulated,³⁷ and were part of the costs of running a bank. The court concluded the late payment fee was not a penalty as in the circumstances it was not exorbitant or unconscionable. The Full Court also dismissed the appeal regarding the statutory causes of action pursued by the customers because when all the circumstances (as required by the statutes) were considered the evidence did not permit a finding that the fees were exorbitant or unconscionable.

The decision of the Full Court was appealed to the High Court where it was dismissed by a majority.³⁸ The

³¹ Increasing the cost of regulating capital represented the capital that ANZ needed to retain as a 'buffer' which it could use in the event the customer defaulted. See *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 555-6 [58]-[65].

³² *Ibid* 284 [140].

³³ *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 232 [89], 289 [371], 295 [398].

³⁴ *Ibid* 236-7 [113]-[117].

³⁵ *Ibid* 247 [169].

³⁶ *Ibid* 237 [117], 242-3 [147].

³⁷ *Ibid* 246 [164], 247 [167].

³⁸ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

decision of the High Court is analysed in Part II.

PART II

5.2.4 High Court

In *Cavendish*, Lords Neuberger and Sumption, in particular, were critical of the decision in *Andrews* on the basis it represents ‘a radical departure from the previous understanding of the law’.³⁹ This criticism was firstly addressed by French CJ⁴⁰ who said that whilst infrequent there was nothing novel about ‘emphatic disagreement between our jurisdictions in relation to the common law and equitable doctrines’.⁴¹ The other judge who expressly dealt with the criticism of *Andrews* was Gageler J⁴² who said the views expressed in *Cavendish* were ‘wrong and appear to be based on a misunderstanding of *Andrews*’. He explained⁴³ *Andrews* had not disturbed the settled understanding in Australia that a stipulation imposing a penalty is not enforceable at common law without the discretionary intervention of equity. He confirmed any suggestion *AMEV*⁴⁴ stood for the proposition that the penalty doctrine is a rule of law and not equity was dismissed in *Andrews*. There is a difference of opinion between the highest courts in England and Australia as to the existence of an equitable jurisdiction which can relieve against penalty clauses. This difference is dependent on an analysis of the history of penal bonds over a number of centuries. For the reasons discussed in Chapter 3 little will turn on this difference due to the very limited scope for application of the equitable jurisdiction and the remedy available in equity⁴⁵ ie: scaling down the stipulation to a sum representing recoverable loss. Insofar as breach of contract is concerned both England and Australia adopt a legitimate interests test for commercial contracts with the *Dunlop* formulation applying to more straightforward contract clauses. The difficulty with this question of characterisation was addressed in chapter 4.⁴⁶

In the High Court appeal, the challenge was limited to the question of whether the late payment fee was a penalty. The majority found the late payment fee was not a penalty and the conduct of ANZ in charging this fee did not offend the statutory prohibitions providing protection from unconscionable conduct, unjust transactions and unfair contract terms. The majority applied the propositions formulated in *Dunlop* and *Ringrow* and held it was necessary to determine whether the late payment fee was out of all proportion to the legitimate interests of ANZ in performance of the contract by the customers. The Court found the fee was not a genuine pre-estimate of damage⁴⁷ but, from an ex ante perspective, it was not disproportionate to the range of possible losses ANZ could suffer due to a customer’s failure to make the minimum monthly payment on time. Consistent with the decision of the Full Federal Court the late payment fee was found to be a legitimate attempt by ANZ to protect its interests in performance of the contract with customers by taking

³⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1207–9 [41]–[42].

⁴⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 538–9 [7].

⁴¹ *Ibid.*

⁴² *Ibid* 568 [121].

⁴³ *Ibid* 568 [122].

⁴⁴ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170.

⁴⁵ As explained by Gageler J in *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 569 [124]–[125].

⁴⁶ See chapter 4 at [4.6.6].

⁴⁷ This had been admitted by ANZ in paragraph 39(a)(ii) of its Amended Defence: see *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 241 [139].

into account a range of costs, including operational costs, increased loss provisioning and increases in regulatory capital costs.

The inquiry into whether a stipulation is a penalty is a legal question concerned with its construction which requires consideration of the substance of the clause. This question is not answered by a consideration of the subjective intentions or motivations of the parties, nor is it determined by reference to whether the parties actually intended the stipulation to be punitive or a deterrent or a genuine pre-estimate of damages.⁴⁸ Provided the quantum of the stipulation is not out of all proportion with the legitimate interests of the non-breaching party it is not relevant that the quantum does not actually coincide with the legitimate interests. The facts of *Paciocco* bear this out as the ANZ expert identified three categories of loss which it linked to the failure by the customers to make the minimum monthly payment on time so as to justify imposition of the late payment fee, even though those categories of losses had not been relied upon by ANZ when it set the quantum of the fee.⁴⁹

In the High Court, the customers for the first time sought to adduce evidence to rebut the opinion of the ANZ expert. The immediate difficulty with this approach is that it offends the discretionary rule of practice that parties should not be permitted on appeal to present arguments not run in the court(s) below.⁵⁰ Keane J⁵¹ dealt with the customers' application dismissively, as follows: "The Full Court was not invited to reject Mr Inglis' approach on the basis that his calculations were unreliable.⁵² To the extent that the appellant's argument in this Court sought to advance such a contention, it should not be entertained. The Full Court cannot be said to have erred in failing to accept an argument that was not put to it; and, in any event, even if one puts Mr Inglis' calculations to one side, Mr Regan's⁵³ evidence does not support the conclusion that the late payment fee was a penalty".

As the expert for the customers failed to take into account ANZ increased loss provisioning and increases in regulatory capital costs for the purposes of his expert evidence, the customers therefore failed to fulfill their onus of proving that the late payment fee amounted to a penalty.

Furthermore the court found when ANZ's expert evidence was taken into account, it could not conclude a late payment fee in the range of \$20–\$35 was out of all proportion to the commercial interests of ANZ. The fact ANZ did not attempt to calculate the actual loss it would suffer if a customer fails to make a minimum monthly payment on time was not fatal. The Court found if ANZ had undertaken such a calculation then that calculation would have tended to suggest the fee it was charging was not a penalty. A variety of policy factors militated against the Court intervening in the circumstances, including the difficulty in determining the level of interest and bank charges that would be 'reasonable' and the values of commercial certainty and

⁴⁸ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 602, [243], citing *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359, 400.

⁴⁹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 555-6, [58]-[65].

⁵⁰ See generally, *Suttor v Gundowda* (1950) 81 CLR 418, 437; and *Coulton v Holcombe* (1986) 162 CLR 1.8.

⁵¹ *Ibid* 601 [239]–[240].

⁵² Mr Inglis was the expert for ANZ.

⁵³ Mr Regan was the expert for the customers.

freedom of contract.⁵⁴

Each of the judges in the majority and Nettle J, in dissent, explained the continued relevance of *Dunlop* and that is examined next in this Part.

5.2.5 The Status of Lord Dunedin's Tests of Construction in Propositions 4(a)–(d) post-*Paciocco*

The various judgments in *Paciocco* provide detailed discussion explaining how Lord Dunedin's four propositions are to be applied in Australia. *Paciocco* confirms the *Dunlop* formulation remains important and relevant and has a continued role to play in determination of whether a stipulation is characterised as liquidated damages or a penalty. The judges in *Paciocco* sought to explain the utility of Lord Dunedin's tests of construction provided in propositions 4(a)–(d).⁵⁵ A number of common elements are discernible⁵⁶ from the judgments and they will now be examined.

Propositions 4(a)–(d) were not intended to operate as legal rules.⁵⁷ None of them is determinative and they do not all have to be satisfied. Lord Dunedin said the purpose of the propositions is to assist in the construction of the impugned stipulation to determine whether it is penal in character. The propositions are 'intended as guidance only'⁵⁸ and are 'no more than a listing of considerations'.⁵⁹

Proposition 4(a)⁶⁰ uses the expression 'extravagant and unconscionable in amount in comparison with the greatest loss'. This expression is intended to cover the 'more general run of cases' where breach engages an obligation to pay a specified sum⁶¹ and as Kiefel J notes it would be 'unduly restrictive' to limit loss to damages for breach of contract.⁶² In *Ringrow*, for a 'typical penalty case'⁶³ the test is said to require the court to 'compare what would be recoverable as unliquidated damages with the sum of money stipulated as payable on breach'. The stipulated sum must be proportionate to the interests of the non-breaching party sought to be protected by the contract. However the High Court warned in *AMEV-UDC Finance Ltd v Austin*⁶⁴ that the 'courts should not ... be too ready to find the requisite degree of disproportion lest they impinge on the parties' freedom to settle for themselves the rights and liabilities following breach of a contract'.

Proposition 4(b)⁶⁵ applies to stipulations requiring the payment of a greater sum of money than ought to have

⁵⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 594–5 [220], 604–5 [250]–[251].

⁵⁵ The propositions set out in chapter 2 at [2.2.1].

⁵⁶ John G H Stumbles, 'Paciocco in the High Court: Penalties and Late Payment Fees' (2017) 91 *Australian Law Journal* 969, 974–5.

⁵⁷ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 575 [147]–[149].

⁵⁸ *Ibid* 547–8 [32].

⁵⁹ *Ibid* 575–6 [150].

⁶⁰ Proposition 4(a) states "It will be held to be a penalty if 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". See *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87.

⁶¹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 608–9 [261].

⁶² *Ibid* 547–8 [32]–[33].

⁶³ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 665–6 [21].

⁶⁴ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193–4.

⁶⁵ Proposition 4(b) states "it will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid ...". See *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87.

been paid. For example,⁶⁶ if B owes A \$100 payable on 1 March, a clause of their agreement stipulating for the payment of \$1,000 as damages for default in payment would be a penalty. This proposition derives from penal bonds that secured the payment of a lesser sum of money by requiring the payment of a greater sum upon failure to pay the lesser sum when due. Those bonds were the subject of relief in Chancery upon tender of the principal sum and interest.⁶⁷ In the *Paciocco* appeal the customers argued the late payment fee engaged proposition 4(b) and that this supports the characterisation of the late payment fee as a penalty. Kiefel J⁶⁸ observes this test ‘has a narrow range of operation ... and is confined to the simplest of cases’. In the Full Court Allsop CJ noted that proposition 4(b) could not be engaged as the late payment fee could be either less than or exceed the sum due by the customer to ANZ.⁶⁹ Keane J found proposition 4(b) is not engaged as ‘the late payment fee was not necessarily a demand for payment of a larger sum upon failure to pay a smaller sum’.⁷⁰ At least since *Hungerfords v Walker*⁷¹ was decided in 1989 which confirmed damages for breach of contract may include damages in the nature of interest and lost opportunity costs proposition 4(b) is of limited practical significance and ultimately it was not relevant to the determination of the *Paciocco* appeal. *Paciocco* also confirms damage includes broader commercial interests sought to be protected by the impugned stipulation.⁷²

Proposition 4(c)⁷³ concerns a payment obligation arising on the occurrence of one or more events some of which may occasion serious damage and others which may occasion only minimal damage. This proposition is a presumption (‘but no more’) ‘albeit a weak one’.⁷⁴ Gageler J⁷⁵ found proposition 4(c) to be only ‘weakly indicative’ of the late payment fee operating as a penalty. It may be rebutted for example where the damages are uncertain and difficult to ascertain accurately.⁷⁶ In the *Paciocco* appeal itself this proposition was rebutted on the evidence where Keane J⁷⁷ found Mr Paciocco had elected to arrange his affairs in such a way that he risked the ANZ charging the late payment fee. Furthermore the evidence established the fee ‘was not apt in the circumstances of its contemplated operation to have an effect in terrorem of Mr Paciocco’.⁷⁸

⁶⁶ See the example in J W Carter, *Contract Law in Australia* (LexisNexis, 7th ed, 2018) 864 [37.13] as follows: “Assume that a contract requires A to pay B \$500 on a certain date as the price of services rendered. Lord Dunedin’s second rule applies if the contract stipulates that B must pay \$1,000 by way of agreed damages. Since the extra sum is due immediately, the clause is in effect a retrospective increase in the contract price”. See also *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 101-2.

⁶⁷ *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 241 [135].

⁶⁸ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 549 [35].

⁶⁹ *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 241 [137].

⁷⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 609 [262].

⁷¹ *Hungerfords v Walker* (1989) 171 CLR 125 ruled that if a breach of contract deprived a plaintiff of a specific sum of money that it would otherwise have had at its disposal, then damages can be awarded for the loss of the use of the money.

⁷² *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 549 [35], 609–10 [263].

⁷³ Proposition 4(c) states “There is a presumption (but no more) that it is a penalty when ‘a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and other but trifling damage ...”. See *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87.

⁷⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 610 [265].

⁷⁵ *Ibid* 581–2 [168].

⁷⁶ *Ibid* 549–50 [36]–[38].

⁷⁷ *Ibid* 610 [265].

⁷⁸ *Ibid*.

The test in proposition 4(d)⁷⁹ applied in *Paciocco* because ANZ's damage arising from the customers' failure to make the minimum monthly payment on time was difficult to calculate but not necessarily impossible to assess. Proposition 4(d) was particularly appropriate as the interests ANZ sought to protect by the late payment fee extended 'beyond an interest in the recovery of compensation for loss caused by breach of the payment obligation'.⁸⁰

In the *Paciocco* appeal propositions 4(a) and 4(d) were the most relevant for the purpose of characterisation of the late payment fee as a penalty. However they were not the only considerations engaging the Court. Proposition 3⁸¹ provides that to determine whether a stipulation has a penal character the terms and the 'inherent circumstances of each contract' must be considered.⁸² Kiefel J⁸³ observed that characterisation of a stipulation is not controlled by 'the language of the contract alone'. This is evident from Lord Dunedin's reference to the 'inherent circumstances' of the contract which include the position of the non-breaching party whose legitimate interests in performance of the contract are intended to be protected by the stipulation. Gageler J⁸⁴ said the 'inherent circumstances' are 'not confined to circumstances which bore only on the attribution of legal meaning but extended to all of the circumstances which bore on the objective resolution of the ultimate question of characterisation'.

Consistently with *Cavendish*, the *Dunlop* formulation will continue to apply but only to the more general run of contracts where the 'standard application' of the penalty doctrine is engaged and the legitimate interests test will in future apply to commercially complex contracts. However as *Paciocco* and *ParkingEye* demonstrate, well-informed minds can differ as to whether the clause or contract is simple or complex.⁸⁵

On the facts in *Paciocco*, propositions 5 and 6 above were decisive. The expert evidence relied upon by the customers was that ANZ's losses were about \$3 for each late payment. This is to be compared with the late payment fee of \$35 (subsequently reduced to \$20) charged by ANZ. The majority found this expert evidence was limited only to an examination of ANZ's operational costs (ie: the costs of its staff contacting customers and administration costs). The expert for ANZ gave evidence there were other impacts on ANZ when a customer failed to make the minimum monthly payment on time represented by the requirement on ANZ to make provision in its accounts for what it may not recover and the further requirement that it hold additional capital to cover unexpected losses. These additional costs requirements injured the financial position of ANZ and this was reflected in potential costs to the bank. Although compliance with these regulatory and accounting requirements were not recoverable by ANZ as damages for breach of contract, the High Court determined they should be taken into account in the assessment of whether the late payment fee was a

⁷⁹ Proposition 4(d) states "It is no obstacle to the sum stipulated being a genuine pre-estimate of damage that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties ...". See *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87-8.

⁸⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 550 [41].

⁸¹ Proposition 3 states "The question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judges of as at the time of the making of the contract, not as at the time of the breach ...". See *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87.

⁸² *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86-7.

⁸³ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 547 [31].

⁸⁴ *Ibid* 574-5 [146].

⁸⁵ See the discussion about the "simple-complex distinction" in chapter 4 at [4.6.6].

penalty.⁸⁶

5.2.5.1 *Paciocco* Applies the Legitimate Interests Test

The point of uncertainty that arises is mostly concerned with the question of how to identify and value the non-breaching party's legitimate interests in performance of the contract. Two approaches can be discerned from the judgments in *Paciocco*, namely:

- i) the narrow interests protected by the bargain approach adopted by Nettle J in dissent, and
- ii) the expansive purpose approach adopted by the majority.

The two approaches follow different paths to determine the performance interest of the non-breaching party, namely, when does the non-breaching party have an interest in the consequences of performance and the extent to which the available remedies are a reference point to the enquiry. Nettle J's interests protected by the bargain approach is narrow and concentrates on the interests actually protected by the bargain whereas the purpose approach is expansive and concentrates on the subjective interests of the non-breaching party.⁸⁷

5.2.5.1.1 The Narrow Approach

The essence of the narrow approach adopted by Nettle J is that it is only those interests actually protected by the bargain which can be considered as amounting to the non-breaching party's legitimate interests in performance of the contract. Nettle J said:

“The stipulation will be regarded as a penalty unless there is some aspect of the contract which makes it possible to say that the amount of the obligation is not wholly disproportionate to the interest protected by the bargain.”⁸⁸

Legitimate interests can be protected under a contract where for instance the breaching party takes responsibility for performing a particular contractual obligation and in the ordinary course this occurs when the interest is in performance of a primary obligation, eg: timely completion of a construction project. Another instance where an interest is protected under a contract arises in situations where a court is likely to award damages. An interest can be protected in both senses referred to above. For example, a builder who has performed work and been promised payment has an interest in performance so as to receive payment, and also in the sense that if payment is not made a court is likely to award damages for breach of contract. Application of the Nettle J narrow approach concludes the damages a court may award for breach of contract will normally reflect the value of the interest the non-breaching party has in performance. Pursuant to this narrow approach, if a stipulated sum payable upon breach is grossly disproportionate to the damages a court may award it will be found to be a penalty.⁸⁹

Nettle J's analysis of the facts illustrates how the narrow approach operates. ANZ sought to justify the late

⁸⁶ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 556 [65] per Kiefel J; 582-3 [171]-[172] per Gageler J; 598-9 [231]-[232], 615 [279] per Keane J.

⁸⁷ Sam Cathro, Simon Connell, 'New Variations on the Rule Against Penalties: Options for New Zealand' (2017) 27 *New Zealand Universities Law Review* 1087.1100.

⁸⁸ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 631, [331].

⁸⁹ *Ibid* 631-2, [331]-[333].

payment fee based on three categories of loss (ie: increase in provision for bad or doubtful debts,⁹⁰ increase in regulatory capital costs,⁹¹ and operational costs⁹²). When the customers entered into their contracts with ANZ none of them could be said to have agreed to protect ANZ from those specific heads of loss. Only one of the categories of loss would have been recoverable as damages for breach of contract (ie: operational costs) as the others were too remote (ie: provisioning costs and regulatory capital costs).⁹³ When Nettle J applied the narrow approach the only category of loss he found to be protected by the contract was ANZ's operational costs and this was the only cost that could be regarded as part of ANZ's performance interest. The two other remote costs were costs ANZ could be said to have an interest in avoiding but were not part of the bundle of interests protected by the fee stipulated in the bank's contract with its customers.

Nettle J treated the arrangement between ANZ and the customers as 'straightforward' and applied Dunlop to assess the validity of the impugned stipulation. His Honour regarded the appeal as one which did not require a consideration of legitimate interests or commercial interests. His Honour compared the amount of the late payment fee with his analysis of the expert evidence and arrived at a maximum possible figure for recoverable damages of \$6.90 (ie: \$2 "average" costs of replacement of regulatory capital and \$4.90 for "average" operational costs) and concluded, consistently with Gordon J at first instance, the late payment fee charged by ANZ was an unenforceable penalty as it was "grossly disproportionate to the greatest amount of damages recoverable for breach".⁹⁴ Nettle J undertook a very specific and detailed analysis of the expert evidence and provided a critical assessment of the evidence of ANZ's expert. He found loss provisioning, regulatory capital costs and some operating costs could not properly be taken into account by ANZ as in many cases these costs were no more than estimates of possible future costs and were not recoverable as damages for breach of contract.⁹⁵ No member of the majority took issue with any of Nettle J's criticisms of the evidence of the bank's expert.

Nettle J's interests protected by the bargain approach although narrowly focused is pragmatic in that it compares the non-breaching party's interest in performance to the damages it would be awarded for breach of contract. In this way it is apparent the narrow approach is constrained and only focuses on interests actually communicated to the other party which are objectively apparent and as such form part of the bargain which justifies an entitlement to protection.

5.2.5.1.2 The Expansive Approach

The majority adopted a different and subjective approach. The interests the expansive approach is concerned with are not limited to those interests specifically intended to be protected by the contract. Pursuant to this approach a stipulated sum which might otherwise be a penalty may be justified by reference to an interest which is neither one for which the breaching party assumes responsibility under the contract and nor is it one likely to give rise to a damages award. Pursuant to this approach whatever damages the court might have awarded had the non-breaching party sued on the breach of primary obligation is of limited

⁹⁰ Ibid 637-8, [350]-[360].

⁹¹ Ibid 639-640, [361]-[366].

⁹² Ibid 641-2, [367]-[369].

⁹³ The point was accepted by Gageler J, *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 582-3, [171].

⁹⁴ Ibid 642, [370].

⁹⁵ Ibid 637 [351], 640 [364], 641-2 [368]-[369].

relevance.

In *Paciocco* the majority concerned themselves with ANZ's 'interests' in the wide sense of accepting as relevant the three heads of loss ANZ asserted it had an interest in protecting when a customer defaults. The majority did not focus on the limited interests ANZ had actually agreed should be protected under its contracts with its customers. Keane J went to great lengths to set out what he regarded as ANZ's legitimate interests and found ANZ had an interest in making a profit and concluded that even if a provision in a contract achieves a profit for the non-breaching party at the expense of the breaching party that will not engage the penalty doctrine.⁹⁶ ANZ could operate more profitably if customers made their payments on time as it could reinvest the funds paid in a timely fashion and then reduce the cost of its services to all customers and thereby secure more customers and higher revenues.⁹⁷ Furthermore ANZ was entitled to a 'reward' for the risk it assumed in granting loans.⁹⁸ For these reasons he found ANZ was entitled to charge the late payment fee and justification for the level of the fee did not turn on the banks claimed interests being protected under the contracts with customers. The other majority judges also referred to ANZ's interests but were not as explicit in identifying exactly what those interests were⁹⁹ but agreed the late payment fee could be justified by reference to losses which would be too remote to recover in an action for damages for breach of contract.¹⁰⁰

By way of comparison in *ParkingEye* the UK Supreme Court referred to the 'objectives' of the operator which justified it charging the late parking fee although those objectives were not referred to in the contract with the parking customers. The parking charge of £85 was found to have two main objectives, firstly management of the efficient use of the car park in the interests of customers of the retail outlets by deterring misuse and secondly providing an income to the operator which would permit it to meet its costs and make a profit.¹⁰¹ As the operator had a legitimate interest extending beyond recovery of loss the stipulated parking charge of £85 was found to be not out of all proportion to those interests and it was therefore not a penalty.¹⁰²

The difficulty with the expansive approach is that the court does not focus on the non-breaching party's limited interests actually contracted for and in effect permits the non-breaching party to retrospectively recover for damage done to its interests not the subject of the bargain. As Jessica Palmer¹⁰³ explains this approach allows "adjudication of parties' individual motivations that are not necessarily the subject of mutual agreement."

The majority concluded each of the interests relied upon by ANZ to justify its late payment fee (ie: actual operating costs, accounting charges for loss provisioning and regulatory capital costs) were relevant

⁹⁶ Ibid 595, [221].

⁹⁷ Ibid 614-5, [278].

⁹⁸ Ibid 614-5, [278].

⁹⁹ Ibid 556-7, [66], 584, [176].

¹⁰⁰ Ibid 556-7, [66], 584, [176], 616, [283].

¹⁰¹ *ParkingEye Ltd v Beavis* [2016] AC 1172, 1226, [98].

¹⁰² Ibid 1226-7, [99]-[100].

¹⁰³ Jessica Palmer, 'Implications of the New Rule Against Penalties' (2016) 47 (2) Victorian University of Wellington Law Review 305.324.

legitimate interests and that ANZ expert evidence supporting them should not have been rejected by Gordon J. This conclusion confirms what Lord Hodge said in *Cavendish*,¹⁰⁴ namely the determination of proportionality is ‘ultimately a value judgment by the Court’. Gageler J¹⁰⁵ accepted provisioning costs and regulatory capital costs would not be compensable at the suit of ANZ against a customer however he acknowledges these two categories of costs represent ANZ’s ‘commercial interests’¹⁰⁶ in ensuring timely payment by its customers of their minimum monthly payment on time. Both Kiefel¹⁰⁷ and Gageler JJ¹⁰⁸ said ‘provisioning costs directly affected recorded profit, and regulatory capital costs were a real outgoing’. Keane J¹⁰⁹ observed these commercial interests extend to the ‘reward for risk’ assumed by ANZ in granting credit to its customers and to the achievement of profit which arises from timely payment by customers. Gageler J¹¹⁰ said that subject to the stipulation not having a punitive operation a party seeking to protect its commercial interests in these circumstances is not to be limited by considerations of causation or remoteness of damage.

The court failed to provide guidance on what the legitimacy requirement of "legitimate interests" actually means however interests found to be legitimate include deterrence of breach¹¹¹ and the entitlement to make a profit.¹¹² Punishment for breach is not legitimate but precisely what this means is far from clear. An explanation for the requirement that there be a legitimate interest in performance is best met by focusing on the value of performance which can be compared to the quantum of the stipulated sum and potentially what damages might be available to limit legitimacy to the remedies a court may grant. This can be reconciled with Nettle J’s narrow approach and in this way the remedies available from a court are a useful comparison point when determining the legitimacy of any interest sought to be relied upon by the non-breaching party.¹¹³

However, the majority adopted the expansive approach and found ANZ’s ‘interests’ were not confined to the reimbursement of operating costs directly resulting from the customers’ defaults but extended to ANZ’s interests in maintaining or enhancing its revenue stream to make a profit.¹¹⁴ Their Honours found the failure by customers to make the minimum monthly payment on time impacted on ANZ’s interests in its operational costs, loss provisioning and increased regulatory capital costs.¹¹⁵ As these costs were greater than the amount of the late payment fee imposed by ANZ the fee itself was not a penalty. This expansive approach amounted to an abandonment of a central aspect of Lord Dunedin’s proposition 2¹¹⁶ which has now been replaced insofar as commercial contracts are concerned by a test requiring an inquiry into the legitimate interests of the non-breaching party in performance of the contract rather than a consideration of whether the

¹⁰⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1284 [287].

¹⁰⁵ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 582–3 [171].

¹⁰⁶ *Ibid* 583 [172].

¹⁰⁷ *Ibid* 556 [62]–[65].

¹⁰⁸ *Ibid* 583 [172].

¹⁰⁹ *Ibid* 614–15 [277]–[278].

¹¹⁰ *Ibid* 579–80 [161]–[162]; see also 547–8 [32] (Kiefel J); 616 [283] (Keane J).

¹¹¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1275, [248].

¹¹² *Ibid* 1204–5, [32], 1247, [152], 1276, [249]; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 613–615, [271]–[279], 628–632, [322]–[334].

¹¹³ Jessica Palmer, ‘Implications of the New Rule Against Penalties’ (2016) 47 (2) *Victorian University of Wellington Law Review* 305, 324.

¹¹⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 593 [216], 614 [277].

¹¹⁵ *Ibid* 555 [58].

¹¹⁶ Proposition 2 states “The essence of a penalty is 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 ...”. See *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86.

stipulated sum is a genuine pre-estimate of loss. These interests are primarily of a financial, business or commercial nature and the test in *Paciocco* is satisfied by the expansive approach adopted by the majority. This is consistent with the modern approach adopted by the UK Supreme Court in *Cavendish*,¹¹⁷ and will make it very difficult for contracting parties to successfully impugn liquidated damages clauses activated by a breach of contract in the future. The judgments in *Paciocco* demonstrate the importance of which test is to be applied by the court to determine whether a stipulation is a penalty.

The next section of this Part considers the manner in which *Paciocco* confirmed the rationale for the penalty doctrine which has been discussed earlier.

5.2.6 Stipulations That Aim to Punish Will Not Be Enforced: Purpose Based Tests

In *Paciocco*, the majority agreed the rationale for the penalty doctrine is that stipulations which have the aim or purpose of punishment will not be enforced. This rationale is supported by a careful analysis of a number of authorities that preceded *Dunlop*, including *Clydebank*.¹¹⁸ The majority differed in the language used to express the tests advanced for establishing whether a stipulation is a penalty. This chapter argues three purpose based tests were provided by the majority, namely, a purpose test by Kiefel J (French CJ agreeing), a sole purpose test by Gageler J, and a predominant purpose test by Keane J.

Firstly, the test formulated by Kiefel J (French CJ concurring)¹¹⁹ was a purpose test in the following terms:¹²⁰ The basal purpose of the larger principle, or policy, of the law ... is that a sum may not be stipulated for payment on default if it is stipulated as a threat over the person obliged to perform; it may not be stipulated where the purpose and effect of requiring payment is to punish the defaulting party ... it may be inferred from this policy that a sum stipulated for payment on default is a penalty if it bears no relation to the possible damage to or interest of the innocent party.

In *Arab Bank Australia Pty Ltd v Sayde Developments Pty Ltd*, McDougall J¹²¹ observed Kiefel J was doing no more than drawing attention to the function the impugned stipulation was intended to perform in the overall context of the contractual and wider commercial relationship for the purpose of inquiring if the sum stipulated for amounted to a penalty.

Secondly, Gageler J¹²² favoured a sole purpose test and said the relevant inquiry was 'whether the conclusion objectively to be drawn from the totality of the circumstances is that the only purpose of the stipulation was to punish'. His Honour said further:¹²³

The relevant indicator of punishment lies in the negative incentive to perform being so far out of proportion

¹¹⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1280, [266] where Lord Hodge said "the criterion of exorbitance or unconscionableness should prevent the enforcement of only egregious contractual provisions ...".

¹¹⁸ Prevention of punishment as the rationale for the penalty doctrine was articulated in a line of Scottish cases from the mid-19th century which were summarised by Lord Hodge in *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1277–8 [253]; see also *ibid* 570 [131].

¹¹⁹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 536 [2].

¹²⁰ *Ibid* 547–8 [32]. Kiefel J also relied on *Legione v Hateley* (1983) 152 CLR 406, 445; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32], 1246 [148], 1274 [243].

¹²¹ (2016) 93 NSWLR 231, 244–5 [79].

¹²² *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 578 [158].

¹²³ *Ibid* 580–1 [164]–[166].

with the positive interest in performance that the negative incentive amounts to deterrence by threat of punishment ... the description of a penalty as a threat to be enforced in *terrorem* ... captures the essence of the conception to which the whole of the analysis is directed.

Gageler J's test appears to be narrower than Kiefel J's purpose test however it is not clear that what Kiefel J said should be read as indicating disagreement with Gageler J's sole purpose test.¹²⁴ The focus of both tests is on stipulations, the aim or purpose of which is punishment of the breaching party. This will be established if the stipulated sum is out of all proportion. To that extent each of the tests is consistent with *Dunlop*.

Thirdly, Keane J¹²⁵ formulates his predominant purpose test in the following terms: 'only in cases where gross disproportion is such as to point to a predominant punitive purpose have agreed payments payable on breach of contract been struck down as penalties'. Keane J¹²⁶ went on to say the real objection, as a matter of public policy, to a penalty clause operating upon breach is 'that it is no part of the law of contract to allow one party to punish the other for non-performance'.

In the end result, despite the different wording of the three purpose based tests each member of the majority after applying their respective tests agreed the late payment fee was not a penalty which suggests differences refusing to enforce stipulations imposing punishment for breach of contract is articulated in *Legione v Hateley*,¹²⁷ which provides a definition of penalty which is affirmed in *Andrews*¹²⁸ and *Cavendish*.¹²⁹ In *Paciocco* the Court also confirms punishment informed an understanding of the penalty doctrine¹³⁰ and the Court stresses it should not be too ready to find a stipulation was a penalty as it is a 'high hurdle'.¹³¹ The emphasis on punishment is consistent with Lord Dunedin's proposition 2¹³² which uses the expression 'in *terrorem*'. Proposition 2 proceeds on the basis a determination of whether a stipulation is a penalty would be made without having regard to whether it is a genuine pre-estimate. Contrary to the suggestion by Lord Radcliffe in *Bridge v Campbell Discount Co Ltd*¹³³ that the expression 'in *terrorem*' does not assist with an understanding of the penalty doctrine, Gageler J¹³⁴ held 'the description captures the essence of the conception to which the whole of the analysis is directed'. This reasoning goes some way to explaining why he adopted a sole purpose test. Similarly, Keane J¹³⁵ said 'it is not difficult to accept that a clause which has a deterrent effect by virtue of the prospect of punishment with which it confronts a defaulting provision should be characterised as a penalty'.

¹²⁴ *Arab Bank Australia Pty Ltd v Sayde Developments Pty Ltd* (2016-2017) 93 NSWLR 231, 244–5 [79].

¹²⁵ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 595 [221].

¹²⁶ *Ibid* 605–6 [253], citing *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204 [31], 1246 [148], 1278 [254], 1285 [291].

¹²⁷ (1983) 152 CLR 406, 445.

¹²⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216 [9].

¹²⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204 [31]. Note the qualification. However, Lords Neuberger and Sumption said that insofar as the definition refers to 'punishment', this definition seems to us to get closer to the concept of a penalty than any other definition we have seen.

¹³⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 545 [22], 547–8 [32], 567 [118], 569–70 [127], 570–1 [131]–[132], 577–8 [155], 578 [158], 580 [164], 593–4 [217], 605–6 [253]–[255].

¹³¹ *Ibid* 553 [53].

¹³² See chapter 2 at [2.2.1].

¹³³ *Bridge v Campbell Discount Co Ltd* [1962] AC 600, 622.

¹³⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 580–1 [165].

¹³⁵ *Ibid* 607 [259].

In *Cavendish*¹³⁶ the Court notes deterrence is not necessarily indicative of penalty and it held the fact a stipulation influences or induces a party's behavior does not mean the stipulation is 'inherently penal or contrary to the policy of the law'. Keane J¹³⁷ observed 'the courts have consistently refused to countenance the enforcement of attempts to impose punishment by contract as a sanction for non-performance or to threaten such punishment'. The consequence of a finding that the purpose of a stipulation is punishment is unenforceability at common law or partial enforcement or scaling down in equity. A rationale for the penalty doctrine based on punishment is consistent with the *Dunlop* formulation which itself was based on 'centuries of equity jurisprudence'.¹³⁸ Stipulations requiring payment of money consequent upon breach in amounts that are extravagant, exorbitant, unconscionable and out of all proportion will be found to be in the nature of punishment and therefore unenforceable.

The final section of this Part examines why the High Court refused to uphold the statutory claims advanced by the customers.

5.2.7 The '[A]ir of [U]nreality' of the Statutory Claims

The customers invoked three statutory regimes in their claims against ANZ:

- Section 12CB of the *Australian Securities Investments Commission Act 2001* (Cth) ('ASIC Act') and s 8 of the *Fair Trading Act 1999* (Vic) ('FTA')¹³⁹ which operated concurrently and prohibited 'unconscionable conduct' in connection with the supply of financial services;
- Section 76 of the *National Credit Code*, in force pursuant to the *National Consumer Credit Protection Act 2009* (Cth) which regulated the provision of credit and allowed for re-opening of 'unjust transactions' ('unjust' includes 'unconscionable, harsh and oppressive'); and
- the regime that rendered void 'unfair' contract terms pursuant to Part 2B of the *FTA* and ss 12BF and 12BG of the *ASIC Act*.

The statutory claims had all been dismissed by Gordon J and the Full Federal Court as the evidence failed to establish the fee was exorbitant or unconscionable. The categories of costs relied upon by ANZ were not exceptional or unusual as they were costs that arose in the normal course of the bank's business and were permissible by accounting standards and prudential requirements. In the High Court the majority were unanimous in their opinion as to the inutility of the statutory claims. French CJ¹⁴⁰ and Kiefel J¹⁴¹ agreed with Keane J who dismissed each of the statutory claim and Gageler J¹⁴² also agreed with the decision of the Full Federal Court that the customers had failed to demonstrate the late payment fee contravened any of the applicable statutory norms.

¹³⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204 [31].

¹³⁷ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 606 [254].

¹³⁸ Christopher J Rossiter, *Penalties and Forfeiture: Judicial Review of Contractual Penalties and Relief against Forfeiture of Proprietary Interests* (Law Book Co, 1992) 33.

¹³⁹ Note: later replaced by ss 20–2 of the *Australian Consumer Law and Fair Trading Act 2012* (Vic).

¹⁴⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 536 [2].

¹⁴¹ *Ibid* 557 [70].

¹⁴² *Ibid* 590 [202].

The thrust of the customers' claims for statutory relief is based upon two factors: firstly, the 'huge disparity'¹⁴³ between the amount of the late payment fee charged by ANZ and its actual costs (based on the evidence of its expert), and secondly, the 'general disparity'¹⁴⁴ of bargaining power between ANZ and its customers. Keane J¹⁴⁵ observed that power imbalances are 'an all-pervading feature of a capitalist economy'¹⁴⁶ and do not of themselves make the behaviour of ANZ thereby unconscionable. The late payment fee was in all material respects, the same amount as that charged by competitor banks and there was no suggestion the banking market as a whole was 'unlawfully skewed'.¹⁴⁷ The statutes did not require the Court to 'assume the role of a price regulator'.¹⁴⁸

Keane J made a number of critical 'general observations'¹⁴⁹ about the customers' statutory claims which proved to be fatal. Firstly, there was no allegation by the customers of any dishonesty or abuse of market power by ANZ or that ANZ had concealed the requirements of the late payment fee or that Mr Paciocco was unable to understand the effect of his contract with ANZ or that he had entered into the contract due to financial pressure placed on him by ANZ. Secondly, Mr Paciocco was under no obligation to use the credit card accounts and he was free to terminate them. Thirdly, there was no suggestion Mr Paciocco was treated any less favourably than he would have been treated by any other supplier of credit card facilities. Fourthly, in the absence of any or all of these factors the customers' statutory claims took on an 'air of unreality'.¹⁵⁰

The unconscionable conduct claim is based on 'the general disparity in bargaining power'¹⁵¹ between ANZ and the customers. This claim was dismissed on the basis the 'mere existence of disparity'¹⁵² is not sufficient to attract the operation of the statute. The existence of a disparity of bargaining power does not establish that a party which enjoys the superior power acts unconscionably by exercising that power. The customers' claims failed as their argument was too narrowly focused on certain subsections of the statutes rather than taking account of the specific language of the statute ie: 'all of the circumstances' and also due to the erroneously narrow assumptions made by their expert (ie: limited to operational costs) as to the legitimate interests of ANZ in performance of the contract with its customers. The claim based on unjust transactions also failed for the same reasons. The statutory claim based on unfair contract terms had been dismissed by Allsop CJ in the Full Court¹⁵³ as the contract provisions had been clearly disclosed by ANZ; in most instances they could have been avoided; there was no trickery by ANZ; the contracts were terminable at will by the customers; and the late payment fee could be avoided by the conduct of the customers which was not unreasonable. Keane J held this conclusion was correct and further the requirement of s 32W of the FTA that the term be 'to the detriment of the customer' was not satisfied as payment of the late payment fee was not a detriment to Mr Paciocco but rather it was 'an expense which he chose to risk as more convenient to him than paying his credit card account on time'.

¹⁴³ Ibid 618–19 [292].

¹⁴⁴ Ibid 619–20 [293].

¹⁴⁵ See generally ibid 616–18 [286]–[291].

¹⁴⁶ Ibid 619–20 [293].

¹⁴⁷ Ibid 618 [290].

¹⁴⁸ Ibid 622 [302].

¹⁴⁹ Ibid 617 [288].

¹⁵⁰ Ibid 617–18 [289].

¹⁵¹ Ibid 619–20 [293].

¹⁵² Ibid.

¹⁵³ *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 287 [358].

It is apparent from the way the statutory claims were treated by the Full Federal Court and the High Court in particular that they were unsustainable at every level and misconceived. Breach of statutory provisions dealing with unconscionability and unfair contract terms will not be established merely by advancing criticism of the level of the price payable for the supply of a service particularly in a competitive market and in circumstances where there is no evidence of any misuse of market power, concealment or financial pressure.

PART III

5.2.8 What Is the Significance of *Paciocco*?

Paciocco confirmed *Andrews* was correctly decided and recognised a dormant jurisdiction in equity to provide relief against penalties in circumstances where there has been failure of a primary obligation.¹⁵⁴ Gageler J¹⁵⁵ emphasised *Andrews* is significant for explaining the concept of a penalty as punishment for non-observance of a contractual stipulation, and he endorsed Lord Dunedin's speech in *Dunlop* as the 'product of centuries of equity jurisprudence'. For the purpose of determining legitimate interests the notion of 'damage' extends beyond what is recoverable as damages for breach of contract at common law. What is to be considered is the nature of the legitimate interests of the non-breaching party in performance of the contract sought to be protected by the impugned stipulation. It is difficult to decide if there is, or where there is, a dividing line between the precise business, financial and commercial interests of ANZ that were to be protected by the late payment fee and the actual loss and damage suffered by ANZ. The legitimate interests of ANZ that were to be protected, and the loss and damage alleged to be likely to be suffered by ANZ upon breach, were difficult to identify with any certainty. Despite this uncertainty Kiefel J found 'ANZ's interests in this case are not as diffuse as those considered in *Dunlop*, *Clydebank* and *Cavendish*'.¹⁵⁶ This confirms legitimate interests may extend beyond compensable loss or money.¹⁵⁷ For example in *Clydebank* the court considered the interests of the Spanish government in having new frigates manufactured and delivered on time; in *Dunlop* the court considered the interests *Dunlop* had in the orderly marketing of its products; and in *Cavendish* the court considered the interests of the purchaser of shares in a business in enforcing covenants to protect the goodwill of the business it was purchasing. Each of the transactions was different. It is to be noted that in *Dunlop* and *Clydebank* the nature of the non-breaching party's interests sought to be protected by the stipulation and which would be injured by the breach meant it would be difficult, if not impossible, to estimate and prove loss and damage. In that circumstance where there were difficulties of proof and uncertainty of loss it was reasonable for the parties to have agreed upon a liquidated amount.¹⁵⁸ In *Cavendish* the Court observed there was good reason to leave the assessment of the value of a complex interest in the goodwill of the business the subject of the share sale agreement to the negotiation of the parties especially when the court may not be in a position to value the interest itself.¹⁵⁹ That is consistent

¹⁵⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 568 [121]

¹⁵⁵ *Ibid* 569–70 [127]

¹⁵⁶ *Ibid* 554–5 [57].

¹⁵⁷ See the discussion in chapter 4 at [4.6.1].

¹⁵⁸ *Ibid* 551–2 [48].

¹⁵⁹ *Ibid*; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1217–18 [75].

with Lord Dunedin's proposition 4(d).

5.2.8.1 The Legitimate Interests Test is Very Broad

Paciocco explains that determination of whether a stipulation is unconscionable, extravagant and exorbitant can only be decided by reference to 'all of the circumstances' of each case. It is not enough that the stipulated sum lacks proportion. It must be out of all proportion to any legitimate interests of the non-breaching party in performance of the primary obligation. Litigation post-*Paciocco* will explore the limits of the legitimate interests that may be protected by a stipulated sum. At this early stage no empirical studies have been completed although one is presenting underway.¹⁶⁰ *Paciocco* provided little guidance other than confirming that legitimate interests extend beyond damages for breach of contract and may include a party's interests in maintaining the profitability of its business. It is permissible to take into account common and fixed costs as well as variable and incidental costs.¹⁶¹ This is consistent with the Expansive Approach discussed above¹⁶² and confirms there is vast scope for the court to take account of a broad range of disparate interests which will potentially be far-reaching. It may be difficult for the court and legal advisers to assess the extravagance or unconscionability of the sum stipulated where there is uncertainty about what constitutes legitimate interests. It will be difficult for the breaching party to predict which legitimate interests in performance are reflected in the make-up of the stipulated sum (this will not be a concern in circumstances where the legitimate interests are listed in the contract) and to determine whether that sum is extravagant or unconscionable and therefore unenforceable as a penalty. The danger that lurks is how to determine the boundaries between those interests that a court will take into account as relevant and those other types of interests that a court will regard as irrelevant and refuse to take into account. That difficulty was apparent in the way the experts treated ANZ's losses. The customers' expert adopted a narrow approach whereas the bank's expert adopted a broader approach. Consistent with incremental development of the common law it will be for the judges to determine the appropriate boundaries on a case by case basis. However as a starting proposition *Paciocco* referred to the use by Lord Dunedin of the expression 'inherent circumstances of the contract'. This is an indicator that the court should have regard to all of the circumstances which bear on the objective resolution of the ultimate question of characterisation of the stipulation.¹⁶³ By any measure this provides a broad scope for the consideration of legitimate interests and is suggestive that the narrow interests protected by the breach approach adopted by Nettle J will be seen as far too restrictive.

5.2.8.2 Suggested Limits to Legitimate Interests

The legitimate interests test permits the non-breaching party to protect interests beyond those that are recoverable as damages for breach of contract at common law. The question that arises is whether this position is sustainable.¹⁶⁴ This chapter argues it will be necessary for the courts to provide some boundaries and what follows are some suggested limits that may apply to a determination of relevant legitimate

¹⁶⁰ John Eldridge is presently engaged in a thorough and rigorous examination of the first instance authorities in both England and Australia in the course of a project funded by the Society of Construction Law, Australia. See John Eldridge, 'The New Law of Penalties: Mapping the Terrain' (2018) *Journal of Business Law* 637.649 at fn 55.

¹⁶¹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 583 [174].

¹⁶² See chapter 5 at [5.2.5.1.2] above.

¹⁶³ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 547 [31], 574–5 [146], 613 [273].

¹⁶⁴ Larissa Welms and John Naughton, 'The 'Interest' Based Penalty Tests in *Paciocco* and *Cavendish/ParkingEye* and the Law of Penalties and Damages in Australia and the United Kingdom' (2018) 44 *University of Western Australia Law Review* 157.168

interests.

Nicholas Tiverios¹⁶⁵ has observed that the penalty doctrine “prevents clauses that impermissibly derogate too far from the state’s jurisdiction to impose remedies for a breach of contract”. The law requires proportionality between what contracting parties can apportion between themselves in their stipulations for agreed remedies, and what can be awarded as damages for breach of contract. This is reflected in the penalty doctrine. This chapter argues further development of the penalty doctrine jurisprudence may be able to address the imbalance in a number of ways by courts analysing legitimate interests in the following ways. Firstly,¹⁶⁶ legitimate interests of the non-breaching party extend beyond compensation for breach “such that compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter’s primary obligation”.¹⁶⁷ This is consistent with the Expansive Approach above. The validity of a stipulation is tested by comparing the stipulated sum and the damage generally suffered by the non-breaching party, as distinct from compensable loss pursuant to the rules in *Hadley v Baxendale*.¹⁶⁸ Applying the Expansive Approach means that determination of the penal character of an impugned stipulation will be at the whim of judges rather than subject to the limitations the law provides for the recovery of damages for breach of contract. The job for the court is to set acceptable parameters for what can and cannot be recovered. Accordingly the Narrow Approach advocated by Nettle J may be more appropriate to maintain the balance between the disproportion between liquidated damages and legally recoverable damages.

Secondly, the courts could develop the concept of ‘interests’ against which the proportionality of an impugned stipulation is measured. For example, the concept of legitimate interests introduced by Lords Neuberger and Sumption in *Cavendish*¹⁶⁹ and adopted in *Paciocco* could be narrowed. By determining those interests not recognised as ‘legitimate interests’ will provide some parameters to the operation of the doctrine. The recognition that the legitimate interests need to be ‘commercial interests’¹⁷⁰ or limited to those identified as being of a ‘business or financial nature’¹⁷¹ may assist to narrow the field. Whilst such limits may have some effect it is open to question whether in practice this limit would be significant. Thirdly, the court may in the future consider confining ‘interests’ to what Stumbles refers to as “exceptional cases”,¹⁷² although he concedes there is no clarity as to when a case is exceptional. Fourthly, in future the jurisprudence could be developed to limit what is captured by the legitimate interests test by reference to the purpose of the contract, which requires a determination of where the burden of ensuring the protection of legitimate interests is allocated between the non-breaching party and the breaching party. By way of illustration if *ParkingEye* is examined it is questionable whether it could be said that upon the proper construction of the contract *Beavis*’s agreement to paying the parking fee of £85 if he stayed beyond the permissible two hours included his agreement to assume the burden of traffic maximisation at the shopping complex and the

¹⁶⁵ Nicholas A Tiverios, “A Restatement of Relief Against Contractual Penalties (1): Underlying Principles in Equity and at Common Law (2017) 11 Journal of Equity 1, 21-2.

¹⁶⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204-5 [32].

¹⁶⁷ Stumbles, above n 56, 981.

¹⁶⁸ *Hadley v Baxendale* (1854) 9 Ex 341; 156 ER 145.

¹⁶⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204 [32]; see also *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 595 [222], 607 [256], 616 [283].

¹⁷⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 581 [166]; 583-4 [172]-[176].

¹⁷¹ *Ibid* 547 [29].

¹⁷² Stumbles, above n 56, 981.

consequent maintenance and development of the business of the shop owners and the parking centre owner. Similarly, in *Paciocco* it is questionable whether the customers' undertaking to pay the late payment fee, included an agreement to assume responsibility for ANZ's risks associated with late payment and as evidenced by operating costs, loss provisioning and provision of increased regulatory capital. By way of contract, in *Cavendish*, Mr Makdessi was responsible for protecting the goodwill of the business he was selling. The question which arises is whether the consequences of his breach (ie: forfeiting US\$100 million) is proportionate to the purpose of the contract. If a purpose of the contract approach were to be applied the inquiry would become one that considers whether the burden imposed on the breaching party by the stipulation is proportionate to the contractual purpose. If this approach were to be adopted there is a strong likelihood that *ParkingEye* and *Paciocco* would have been differently decided. Further in each of these instances the contracts had not been negotiated between parties of equal bargaining strength but that consideration did not apply in *Cavendish*.

5.2.8.3 Drafting Practices Will Change

This chapter argues drafting practices will change it. It will be prudent, if not essential, in future, for drafters to include as a schedule to the contract or within the defined terms¹⁷³ a list of the interests said to be covered by the liquidated damages clause. Drafters of commercial contracts would, in future, be wise to provide for stipulations which include a sliding scale of money payable upon breach based on the type of delay or default. Providing an explanation for the make-up of the elements, commercial interests and amounts which equate to the liquidated damages sum will assist to protect the stipulated sum from attack as a penalty.¹⁷⁴ In the event the calculation is too difficult to break down, it would be prudent for the drafter to provide an explanation for those difficulties and include it as the best justification for the stipulated sum.

In England this has commenced and contracts are being drafted to express the legitimate interests in performance. Boilerplate clauses such as 'the parties confirm that these liquidated damages are reasonable and proportionate to protect [Party A]'s legitimate interests in performance'¹⁷⁵ are being used. Clauses of this nature seek to confirm what the parties have agreed is appropriate and reasonable, even if non-compensatory in nature.

5.2.8.4 Future Conduct of Litigation: Procedural Ruling from the Court

This thesis argues the introduction of a legitimate interests test for complex contracts and the retention of the *Dunlop* formulation for 'straightforward' clauses means procedural difficulties will arise in litigation. In legal proceedings where the defendant pleads a stipulation is a penalty it will now be prudent legal practice to

¹⁷³ Nicholas J Simpson, 'Penalty Doctrine and *Paciocco v Australia and New Zealand Banking Group Ltd* (Paper presented at the College of Law, 11 October 2016) 13–14; see 'Drafting Guides' in Roger Halson, *Liquidated Damages and Penalty Clauses* (Oxford University Press, 2018) 179–80, [5.73]-[5.79]; and "Drafting Liquidated Damages Clauses' in S A Christensen, W D Duncan, *The Construction and Performance of Commercial Contracts* (The Federation Press, 2nd ed, 2018) 165-167.

¹⁷⁴ A useful example of this approach can be found in *State of Tasmania v Leighton Contractors Pty Ltd [No 3]* [2004] TASSC 132 (16 November 2004) [236] where the liquidated damages sum was calculated taking into account factors such as principal's time (50 per cent), principal's representatives time (75 per cent), legal advisers' time (2 hours), contract advisers' time (2 hours), principal's site representatives time (100 per cent), site engineer, clerk of works, OHS/secretary, technical support, 2 x site vehicles etc.

¹⁷⁵ Solene Rowen, 'The 'Legitimate Interest in Performance' in the Law of Penalties' [2019] Cambridge Law Journal 1.26-7.

request the court to conduct a separate trial of a question¹⁷⁶ to determine the characterization of the stipulation or contract as simple or complex. The Rules of Court provide a process for this to occur and as a general proposition it is appropriate for a court to order determination of a preliminary question before trial if the determination of that question will put an end to the proceeding, or if there is a clear line of demarcation between issues and determination of one issue is likely to save inconvenience and expense.¹⁷⁷ The result in *Paciocco* demonstrates the importance of a determination of the question of characterisation as application of the different tests to the same facts can lead to different results which was demonstrated in the examples set out above in chapter 4.¹⁷⁸ Determination of the preliminary question will need to be requested from the court at the earliest possible stage in the litigation as the answer to the question will dictate how the case is to be pleaded by both parties and will provide guidance about the expert evidence which will need to be presented at trial. Sackville JA¹⁷⁹ recently acknowledged cases involving the penalty doctrine (eg: the *Paciocco* litigation) have been conducted by reference to extensive expert evidence designed to enable the court to determine whether there was a justifiable commercial rationale for the imposition of the detriment alleged to be a penalty.

Any refusal by the court to determine the preliminary question will lead to the production of complex pleadings where the parties will be required to plead many alternative formulations of their position. For example, the plaintiff sues to recover liquidated damages; the defendant will plead the stipulation is an unenforceable penalty, alternatively that the stipulation can only be partially enforced in equity. The plaintiff would then plead in a reply that if the liquidated damages clause was found to be a penalty at common law, then it has an alternative claim for unliquidated damages and, in the further alternative, if the defendant is entitled to relief in equity then the stipulation is to be enforced only to the extent of the amount of unliquidated damages. The pleadings would also need to plead a *Dunlop* entitlement in cases where the court finds the clause is simple or straightforward. In the alternative it would be necessary to plead the plaintiff's legitimate interests protected by the stipulation on the assumption the court finds the contract is complex. These complexities confirm the importance of the need for early intervention by the court to determine the preliminary issue of characterisation. In the absence of appropriate early guidance from the court procedural difficulties will abound.

One further procedural issue involves the use of extensive expert evidence to assist the court to determine whether there is a justifiable commercial rationale for the imposition of the detriment alleged to be a penalty. This is how both parties faced the task in *Paciocco*.¹⁸⁰ However in that case the experts were not asked the same questions and approached their task from different perspectives and hence arrived at results that set them far apart. Once the Court in *Paciocco* determined a legitimate interests test was to apply it found the report from the customers' expert had failed to take into account all of the relevant interests of ANZ that its

¹⁷⁶ See for example, r 47.04 ('Separate Trial of Question') in *Supreme Court (General Civil Procedure) Rules 2015* (Vic). A useful summary of the relevant principles is contained in *Vale v Daumeke* [2015] VSC 342 (17 July 2015).

¹⁷⁷ *Dunstan v Simmie & Co Pty Ltd* [1978] VR 669.

¹⁷⁸ See the discussion in chapter 4 at [4.6.6.1].

¹⁷⁹ *Arab Bank Australia Pty Ltd v Sayde Developments Pty Ltd* (2016-2017) 93 NSWLR 231.234, [8], and citing *Paciocco v Australia and New Zealand Banking Group Ltd* (2014) 309 ALR 249 (Gordon J); *Paciocco v Australia & New Zealand Banking Group Ltd* (2015) 321 ALR 584 (FCAFC); and *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

¹⁸⁰ See also *Arab Bank Australia Pty Ltd v Sayde Developments Pty Ltd* (2016-2017) 93 NSWLR 231, 245–8 [81]–[99].

own expert had considered in his expert report. Once the Court reached this position the only relevant evidence left for consideration was that of the expert for ANZ. Accordingly in future it will be prudent for the judge at an early stage in the litigation to direct the solicitors for the parties to agree on a list of common questions or assumptions for the experts to opine upon so that when they produce their expert reports they each answer the same questions based on the same assumptions and do not ‘pass like ships in the night’, as was the case in *Paciocco*. What is recommended above can have important consequences. During the High Court appeal for the first time the customers sought to advance argument that the approach adopted by the ANZ expert should have been rejected because his calculations were unreliable.¹⁸¹ No doubt this tactic was pursued as that evidence of alleged unreliability would have advanced the customers' case to confirm the late payment fee was a penalty. Keane J rejected the application in robust language¹⁸² and found¹⁸³ the evidence of the customers' expert proceeded on “too narrow a view of the legitimate interests of ANZ protected by the late payment fee”, which meant the customers' case failed. The expert evidence should have been presented in such a way that both experts delivered reports dealing with their primary contentions (ie: for the customers that only ANZ's operational costs were relevant) and an alternative contention (eg: for the customers that if the provisioning and additional regulatory capital costs were relevant then an alternative conclusion and calculation would be advanced).

It is a modern phenomenon of commercial litigation and civil procedure that experts are required to attend a conclave which is usually conducted by a facilitator¹⁸⁴ shortly prior to commencement of trial. The aim of the conclave is for the experts to confer together in a neutral environment (in the absence of lawyers) and discuss the issues and produce a joint report setting out the matters upon which they agree and those they do not agree upon, and provide the reasons where there is disagreement. This procedure will work well where the experts start from a common position.

This chapter argues operation of the penalty doctrine has been significantly narrowed by *Paciocco* which will make it harder for challenges to succeed. This narrowing suggests it is likely there will be an increase in the use of liquidated damages clauses in commercial contracts. Stronger contracting parties will now be more inclined to insist on including liquidated damages clauses in their contracts. These contracting parties will be attracted to using such clauses because of their ability to protect a wider scope of commercial interests, for example, protection of reputation and wider business, commercial, financial and economic interests both tangible and intangible.¹⁸⁵

5.2.9 Conclusion

Paciocco is a significant decision because it explains the boundaries of Lord Dunedin's four propositions and

¹⁸¹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 601 [240].

¹⁸² *Ibid* 601 [239]-[240].

¹⁸³ *Ibid* 601 [240].

¹⁸⁴ Simon McKenzie, "Expert Conferences in the Kilmore East Bushfire Proceeding" (13 August 2016); Supreme Court of Victoria, Practice Notes, PNCC1 Commercial Court [15.27] and Schedule 9; Paula Gerber, Brennan J Ong, 'Best Practice in Construction Disputes' Avoidance, Management and Resolution' (LexisNexis, 2013) 446-449 [18.31]-[18.34].

¹⁸⁵ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 579 [161]; Larissa Welmans and John Naughton, 'The 'Interest' Based Penalty Tests in *Paciocco* and *Cavendish/ParkingEye* and the Law of Penalties and Damages in Australia and the United Kingdom' (2018) 43 *University of Western Australia Law Review* 174.

when an ‘interests’ test is to be applied. *Paciocco* did not concern itself with *Andrews* as the Court was dealing with a stipulated sum payable upon breach of contract which is the ‘standard application’ of the penalty doctrine as explained in *Ringrow*.¹⁸⁶ In circumstances where damages are difficult to calculate¹⁸⁷ the High Court held the question of whether a stipulation is a penalty may be determined by an examination of the legitimate interests of the non-breaching party and this is despite the fact the non-breaching party would not be able to recover damages at law for the interference with such commercial interests. The majority and Nettle J (in dissent) differed on the issue of whether the facts in the *Paciocco* appeal established that ANZ’s damages arising from the customers’ failure to make the minimum monthly payment on time were difficult to estimate. Lord Dunedin’s four propositions remain relevant for less complex clauses where a breach of contract triggers the payment of money. None of the four propositions are determinative¹⁸⁸ and it is not necessary that all be satisfied. They were intended as guidance only¹⁸⁹ and to assist with determining whether the stipulation is penal in character.

Following *Andrews* and *Paciocco*, the relevant principles for application of the penalty doctrine are that a clause stipulating for payment of a sum (or a performance obligation) which is extravagant, unconscionable and out of all proportion to the non-breaching party’s legitimate interests sought to be protected by the stipulation will be a penalty. Further, if the stipulation is to secure performance of a collateral benefit, but does not have the purpose of protecting a legitimate interest it will be a penalty. Application of the traditional *Dunlop* formulation to determine if a stipulation is a penalty is no longer relevant for complex commercial contracts. For that type of contract the inquiry has shifted from consideration of Lord Dunedin’s four propositions to Lord Atkinson’s focus on a commercial interests approach as endorsed in *Cavendish* and *Paciocco*. Lord Atkinson’s speech in *Dunlop* recognised Dunlop’s wider interest in price maintenance across all of its retailers and was not limited to the harm caused by the breach in question. A stipulation will not be a penalty simply because the sum or performance obligation stipulated for when entering into the contract is not a genuine pre-estimate of loss.¹⁹⁰ The current position is that to be a penalty the sum or performance obligation must be out of all proportion with the ‘interests’ it is seeking to protect.¹⁹¹ This is a significant adjustment as *Dunlop* had been accepted as authoritative in *Ringrow*¹⁹² and this was confirmed in *Andrews*¹⁹³ and *Paciocco*.¹⁹⁴ The *Dunlop* formulation has been relegated to the position where it is of assistance but the four propositions can no longer to be applied as a comprehensive formulaic test.¹⁹⁵ *Paciocco* provides contracting parties with greater assurance that their liquidated damages clause will be enforced. This sentiment was affirmed by Keane J¹⁹⁶ when he observed ‘given the importance of the values of commercial certainty and freedom of contract in the law, the courts will not lightly invalidate a contractual provision for an agreed payment on the ground that it has the character of punishment’.

¹⁸⁶ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 662 [10].

¹⁸⁷ See, eg, *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172.

¹⁸⁸ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 575 [147].

¹⁸⁹ *Ibid* 547–8 [32].

¹⁹⁰ *Ibid* 556 [65].

¹⁹¹ *Ibid*.

¹⁹² *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 663 [12].

¹⁹³ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 218 [15].

¹⁹⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

¹⁹⁵ *Ibid* 546 [27], 547–8 [32], 575 [147], 611–12 [268], 626–7 [318].

¹⁹⁶ *Ibid* 594–5 [220].

This chapter argues the effect of *Paciocco* will be a substantial reduction in the number of cases where a breaching party succeeds in establishing that a stipulation is a penalty. This outcome is likely due to the difficulty that now exists in proving that a stipulation is a penalty. A number of factors¹⁹⁷ are of particular importance in this regard and include firstly, the requirement that the degree of disproportion must be found on a comparison between the amount of the impugned stipulation and not merely the recoverable damages for breach but also the damage to any other legitimate interest which will include commercial and financial interests that all result from the breach. A second consideration is that to characterize a stipulation as a penalty is an exception. This is due to the requirement that the extent of the disproportion between the amount of the stipulated sum payable upon breach and the non-breaching party's interest in performance of the contract must be such as to establish that the purpose of the stipulation is punishment of the breaching party. A third matter is that notwithstanding Lord Dunedin's proposition 4(c), the onus of proof always remains on the party challenging the stipulation as penal. The difficulty created by this factor is that it will be a difficult onus to fulfill where the interests protected by the alleged penalty will include commercial, financial, economic and other intangible interests of which the party asserting penalty stipulation may be ignorant. It is to be noted that the customers' expert evidence in *Paciocco* failed on this point. A final factor is that any difficulty in pre-estimating possible loss is likely to make it more difficult for the party asserting penalty to satisfy its onus of proof.

This chapter has argued further that it will be necessary for the court to impose some boundaries upon legitimate interests and also that a procedural ruling from the court on the question of characterisation will be essential as the answer to the question dictates which test is to apply.

The next Chapter considers the interplay between unconscionability in the narrow *Dunlop* sense and the common law concept of unconscionable conduct together with duress, undue influence and misrepresentation, and the penalty doctrine.

¹⁹⁷ See Hugh Fraser JA, '2017 WA Lee Lecture: The Australian Law of Contractual Penalties' (2018) QUT Law Review 111.126.

Chapter 6

Unconscionability, Vitiating Factors and the Penalty Doctrine

6.1 Introduction

This chapter argues there is a discernible distinction between the concept of ‘unconscionability in the *Dunlop* sense’ which is referable to the operation of the penalty doctrine and the concept of unconscionable dealing that operates in equity. The relief equity provides against unconscionable bargains and related conduct “is long established and well known”.¹ However, the jurisdiction to set aside a contract due to unconscionability is not unlimited. Court intervention only arises where specific criteria are met. In the traditional penalty case,² unconscionability in the *Dunlop* sense requires the court to assess the stipulated sum which is payable for breach of the contract, and decide whether it is out of all proportion to the greatest loss that may arise from the breach. This is to be compared with the modern penalty case exemplified by decisions such as *Cavendish* and *Paciocco*, where the court must consider the legitimate interests of the non-breaching party in contractual performance are sought to be protected by the stipulation. The non-breaching party must establish that the stipulated sum is extravagant or unconscionable when compared to the legitimate interests of the breaching party. In *Bridge v Campbell Discount Co Ltd*³ in 1962, Viscount Radcliffe observed in a case involving a penalty under a hire purchase agreement that: “unconscionable must not be taken to be a panacea for adjusting any contract between competent persons when it shows a rough edge to one side or the other”.

This chapter is divided into three Parts. Part I argues that the differences between the two concepts outline above by addressing why the fallback submission in *Cavendish* is relevant and that the expression ‘unconscionability in the *Dunlop* sense’ is a narrow concept and one of limited application. Part II considers the boundaries of the equitable doctrine of unconscionability and its relationship with the vitiating factors and in particular, its overlap with substantive unconscionability. Part III concludes with the suggestion that the penalty doctrine and unconscionability in the *Dunlop* sense have no role to play in application of the vitiating factors including unconscionability in equity.

PART I

6.2 Four Differences

This chapter argues that the differences between the two concepts of unconscionability are highlighted by four limiting factors. These are as follows:

- i) circumstances which justify court intervention;
- ii) timing applicable to each concept;
- iii) available remedies; and

¹ *Pitt v Holt* [2012] Ch 132, 187 [165].

² For example, *Clydebank Engineering and Ship Building Co Ltd v Yzquierdo y Castaneda* [1905] AC 6; *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79.

³ *Bridge v Campbell Discount Co Ltd* [1962] AC 600, 626.

iv) contractual certainty.

6.2.1 Circumstances Which Justify Court Intervention

The court will only intervene on the ground of unconscionability in equity if it can be established that the stronger party, by its conduct, took unfair advantage of the weaker party during negotiations to enter into the contract. Such considerations do not apply to the penalty doctrine, which *Cavendish*⁴ confirmed is a rule for controlling remedies for breach of contract. The focus of the court's attention is to determine whether the stipulated sum was intended to protect the legitimate interests of the non-breaching party and if so whether, in the circumstances, the obligation imposed by the stipulation (ie: usually, the payment of money) was exorbitant, extravagant or unconscionable.⁵ Unlike unconscionability in equity it does not depend, for its operation, on a finding that one party took unfair advantage of the other, even though the court may take into consideration the circumstances of contract formation.⁶ It is to be appreciated that the former concept is conduct based and the latter concept is not.

6.2.2 Timing Applicable to Each Concept

When a court enquires into alleged unconscionable conduct, it examines the conduct of the stronger party during the time of contract formation. In the case of a stipulated payment impugned as a penalty, the question is whether, after taking into account the legitimate interests of the non-breaching party the stipulation is unconscionable and extravagant in amount when compared to that party's interests in performance of the contract but measured from the date of entry into the contract.

6.2.3 Available Remedies

Different remedies are available for unconscionability in the *Dunlop* sense and unconscionable conduct in equity. In the case of the penalty doctrine both in equity and at common law, if the stipulated sum is successfully impugned as a penalty the court will only refuse to give full force and effect to the stipulation itself and otherwise keep the remainder of the contract alive. At common law, if the impugned stipulation is found to be a penalty the remedy available to the non-breaching party is limited to recovery of an amount that represents the measure of damages recoverable for breach of contract. In equity, following *Andrews*, if a stipulation is found to be a penalty the non-breaching party is limited to recovering 'compensation' equal to the amount which represents "the prejudice suffered by failure of the primary stipulation".⁷ In that circumstance, the relevant measure "usually happened to be equivalent to"⁸ damages for breach of contract. By way of contrast, the remedy available to the weaker party where the court finds a transaction has been tainted by unconscionable conduct, is much wider. In that circumstance the whole contract is voidable and the usual remedy is rescission, subject to conditions where necessary or appropriate. The legal effect of a court order for rescission of a contract is that future performance of the whole contract is brought to an end.⁹ Accordingly, the remedies that apply are at opposite ends of a spectrum.

⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1208-9, [42].

⁵ *Ibid* 1247, [152].

⁶ *Ibid* 1205, [35], 1247, [152].

⁷ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216-17, [10].

⁸ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 193, citing *Elsley v JG Collins Insurance Agencies Ltd* (1978) 83 DLR (3d) 1, 13.

⁹ *Heyman v Darwins Ltd* [1942] AC 356.399.

6.2.4 Contractual Certainty

One of the main objections to the application of equitable principles into the resolution of commercial disputes is the discretionary nature of equitable remedies and the need for predictability and certainty of outcome.¹⁰

An appreciation of the distinction between the two concepts, referred to above is important for the purposes of the penalty doctrine because (since *Paciocco* was decided) on the basis that if the *Dunlop* formulation is applied to a “straightforward” stipulation requiring the payment of money upon breach of contract, then unconscionability in the *Dunlop* sense is part of the test to be applied (ie: Lord Dunedin’s proposition 4(a)) to determine whether the stipulation is a genuine pre-estimate of loss. If the *Paciocco* legitimate interests test is applied, unconscionability in the *Dunlop* sense is also relevant to that analysis because a non-breaching party with a legitimate interest is still required to establish that the stipulated sum sought to be enforced is not extravagant or unconscionable when compared to the legitimate interests the non-breaching party has in contractual performance that are sought to be protected by the stipulated sum. If the *Andrews* penalty doctrine in equity is applied, unconscionability in the *Dunlop* sense is also relevant as the court concerns itself with a determination of whether failure of the primary stipulation imposes on the breaching party “an additional detriment”. That detriment is measured by a consideration of whether the stipulated sum is extravagant or unconscionable as it is out of all proportion and whether it can be said to amount to “an additional detriment”.

6.3 The Fallback Submission in *Cavendish*

The distinction between the two concepts of unconscionability was also raised in argument in *Cavendish*.¹¹ The ‘primary case’ advanced by the appellant in this case was that the penalty doctrine should be abolished.¹² This submission was rejected¹³ on the ground, inter alia, that the doctrine exists to ‘restrain exorbitant or unconscionable consequences following from breach’.¹⁴ In most instances, the consequence arising from the breach is the payment of a sum of money that is out of all proportion. Thus it is suggested as the appellant’s fallback submission¹⁵ in the *Cavendish* appeal that the penalty doctrine should be ‘limited to confining unconscionability to circumstances of procedural misconduct, involving duress, undue influence, misrepresentation or something similar’.¹⁶ However this submission does not appear to have been

¹⁰ See *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana* [1983] QB 529.540 (Robert Goff LJ), cited with approval by Lord Diplock on appeal in *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana* [1983] 2 AC 694, 703-4; S A Christensen, and W D Duncan, *The Construction and Performance of Commercial Contracts* (Federation Press, 2nd ed, 2018) 17.

¹¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1253 [169].

¹² *Ibid* 1206 [36], 1251–3 [162]–[167], 1267 [217]–[218].

¹³ *Ibid* 1251 [162].

¹⁴ See also *ibid* 1279–80 [262]–[266] (Lord Hodge).

¹⁵ In a paper presented by Joanna Smith QC to the Society of Construction Law (UK) in December 2015 entitled ‘Liquidated Damages or Penalty: *Cavendish v Makdessi*’, after argument in the *Cavendish* appeal had been concluded and before judgment, Ms Smith QC (who appeared as lead counsel for *Cavendish*) made no mention of this particular aspect of her argument or submissions presented to the UK Supreme Court: Joanna Smith, ‘Liquidated Damages or Penalty: *Cavendish v Makdessi*’ (Paper presented at a meeting of the Society of Construction Law, London, 3 November 2015). In the circumstances, it may well have arisen during oral argument alone. In any event, if the submission was developed in argument the judgments do not record any of the arguments advanced for or against the fallback submission.

¹⁶ See S M Waddams, “Unconscionability in Contracts” (1976) 39 *Modern Law Review* 369 where the author suggested a very wide doctrine of unconscionability which would embrace not only the vitiating factors, but also a wide range of instances where the court intervenes because of underlying concerns about unfairness in

developed in argument by the appellant as such. It was rejected by Lord Mance, who said it had no basis in authority or principle and, if such a limitation were to apply, it would deprive the doctrine of any role at all.¹⁷ In the same manner none of the speeches of the other Lords refer to the appellant's fallback submission.

The court exercising its equitable jurisdiction has power to set aside a contract entered into without the genuine consent of one or both of the parties. In circumstances where there has been some defect in the essential voluntariness of contract formation, the court may order rescission of a contract due to the effect of a vitiating factor.¹⁸ This means is that unconscionable conduct requires the weaker party to have a special disadvantage of which the stronger party takes unfair advantage in order to obtain a benefit. In contrast it is to be noted that the statutory concept¹⁹ of unconscionability is not similarly constrained and may apply to circumstances beyond the reach of the general law. Vitiating factors which can undermine a contract include unconscionability, duress, undue influence, mistake, illegality and misrepresentation. These vitiating factors operate by interrogating the voluntariness of the conduct of the weaker party and in particular, specifically to determine whether consent was "full, free and informed".²⁰ In the event the UK Supreme Court had acceded to the fallback submission, the plaintiff needed to establish the impugned stipulations were agreed in circumstances involving, for example, unconscionable conduct, misrepresentation, duress or undue influence. On the facts none of this could have been established in *Cavendish* and the appeal was not conducted on this basis. Consistent with the first limiting factor referred to above, the court would have to concern itself with an examination of the parties' conduct involving consent and the process of contract formation and agreement rather than considering whether the stipulated sum was out of all proportion. The unsuccessful fallback submission in *Cavendish* prompts a consideration of these doctrines and whether they have any role to play in application of the penalty doctrine.

6.4 Unconscionability in the *Dunlop* Sense

Lord Denning has remarked 'there is vigilance of the common law which, while allowing freedom of contract, watches to see that it is not abused'.²¹ *Paciocco*²² confirmed that the common law does not enforce liquidated damages clauses or performance obligations, the purpose or aim of which is to punish the breaching party. In *Clydebank*, the Earl of Halsbury LC²³ confirmed that whatever expression is used to describe 'the sum stipulated for', the question must always be whether the construction of the stipulation renders the sum unconscionable and extravagant as well as one which the court ought not to enforce. In this sense, the expression 'unconscionable' focuses on performance of the contract and the monetary value of the stipulation ie: payment of a stipulated sum upon breach of contract and consideration of whether it is disproportionate. The Lord Chancellor also observed²⁴ 'it is impossible to lay down any abstract rule as to

transactions, including, for example, the rules relating to the incorporation and interpretation of exemption clauses in contracts, and the rules on forfeiture and penalty clauses.

¹⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1253 [169].

¹⁸ Peter Radan, John Gooley and Ilija Vickovich, *Principles of Australian Contract Law* (LexisNexis, 4th ed, 2018) pt IV. See also Mindy Chen-Wishart "The Nature of Vitiating Factors in Contract Law" in Gregory Klass, George Letsas, Prince Saprai (eds) *Philosophical Foundations of Contract Law* (Oxford University Press, 2014) 294.

¹⁹ See *Competition and Consumer Act 2010* (Cth) sch 2 ('*Australian Consumer Law*') s 22..

²⁰ *Zammit v Hyman* [1961] 1 WLR 1442.1446.

²¹ *John Lee and Son (Grantham) Ltd v Railway Executive* [1949] 2 All ER 581, 584.

²² *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 547 [29] (Kiefel J), 578 [158], 579 [159], 580 [164] (Gageler J); 595 [221], 601 [240], 612 [270] (Keane J).

²³ *Clydebank Engineering and Ship Building Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 10.

²⁴ *Ibid.*

what may or may not be extravagant or unconscionable to insist upon, without reference to the particular facts and circumstances which are established in the individual case’.

In *Dunlop*,²⁵ Lord Dunedin set out propositions 4(a)–(d) and suggested they are provided as rules of construction. Proposition 4(a)²⁶ uses the expression ‘unconscionable’ which is argued to be a narrow reference which is descriptive of the excessive nature of the sum stipulated for and a stipulation out of all proportion will be unconscionable in the *Dunlop* sense. ‘Unconscionable’ is used by Lord Dunedin as a synonym²⁷ for ‘extravagant’ and ‘exorbitant’ rather than introducing some element of equity into the exercise of the proper construction of the contractual stipulation.²⁸ Similarly the expression ‘unconscionable’ is not used by Lord Dunedin in proposition 4(a) as a reference to a cause of action or some recognised legal principle or doctrine. In 1915 the law did not recognise a cause of action based on unconscionable conduct, unconscionability or some freestanding legal principle the effect of which may have had some exculpatory effect. Thus the expression does not describe an independent test or justification for the characterisation of the sum stipulated for as disproportionate and, hence to be an unenforceable penalty.²⁹ It is to be remembered that in proposition 4(a) Lord Dunedin provides a disproportionate test which he regards as the relevant criteria ie: the stipulation will be a penalty ‘if 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’. As such a positive response to proposition 4(a) leads to the conclusion that the stipulated sum is unconscionable in the *Dunlop* sense and is therefore an unenforceable penalty.

In *Philips*³⁰ Lord Woolf referred to “situations where one of the parties to the contract is able to dominate the other as to the choice of terms of a contract”. He suggested this would be an exception to the normal operation of the penalty doctrine. Furthermore, in *Tasmania v Leighton Contractors Pty Ltd*,³¹ the Full Court said, “the question was whether, given the nature of the contract, its complexity, value and the bargaining strength of the parties the amount of \$8,000 was, in all the circumstances, a penalty as of the date of the agreement”. Finally, in *Yarra Capital Group Pty Ltd v Sklash Pty Ltd*,³² Chernov JA suggested that inequality of bargaining power or unconscionability was “a separate ground for striking down an agreed default provision as a penalty”. Despite these ruminations, there has been no decision where unconscionability in equity has been relied upon by a court to strike down a stipulated sum clause. The decisions which have considered Lord Dunedin’s four propositions have not taken this approach.

Roger Halson³³ reasons that “the descriptor ‘unconscionable’ is merely a label for a conclusion of law that follows from application of the propositions provided by Lord Dunedin to assist the task of construction” ie: a comparison of the sum stipulated for with the greatest loss arising from the breach. The expression

²⁵ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 86-8.

²⁶ *Ibid* 87.

²⁷ *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 233 [95], citing *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 667–9 [26]–[32].

²⁸ Elizabeth Peden, ‘Forfeiture of Deposits: Where Law and Equity Collide?’ (2012) 6 *Journal of Equity* 161, 175.

²⁹ Roger Halson, *Liquidated Damages and Penalty Clauses* (Oxford University Press, 2018) 112–14 [4.27]; Elizabeth Peden, ‘Penalty Clauses and What Would the High Court Have Made of Interstar Wholesale Finance Pty Ltd v Integral Home Loans?’ (2009) 23 (3) *Commercial Law Quarterly* 6, 10.

³⁰ *Philips Hong Kong Ltd v A-G Hong Kong* (1993) 61 BLR 41.58.

³¹ *Tasmania v Leighton Contractors Pty Ltd* (2005) 15 TasR 243, 256-259, [31].

³² *Yarra Capital Group Pty Ltd v Sklash Pty Ltd* [2006] VSCA 109 (18 May 2006), [19].

³³ Halson, above n 29, 112 [4.27].

unconscionable in the *Dunlop* sense does not refer to conduct that would otherwise match the understanding of unconscionable conduct in equity, or trigger the statutory protections against such conduct provided in the *Australian Consumer Law* but is descriptive of unsatisfactory outcomes which arise from a breach of contract. For example, in *Lansat Shipping Co Ltd v Glencore Grain BV (The Paragon)*³⁴ the court was concerned with the question of late redelivery of a ship, “The Paragon” which had been let on a charterparty. Although the ship was redelivered by the hirer to the charterer only seven days late, the stipulated payment for delay was in an amount equivalent of the fee for thirty days hire. This stipulation was found to be an unenforceable penalty on the basis the stipulated sum was out of all proportion to the loss suffered. However, it is important to note there was no unconscionable conduct in the making of the contract in question in this case that was relied upon to justify the penalty finding.

The expression ‘unconscionability’ does not appear to have been used in the fallback submission in *Cavendish* in the narrow *Dunlop* sense,³⁵ but rather as a reference to the doctrine of unconscionability in equity. In *AMEV-UDC*,³⁶ Mason and Wilson JJ suggested that a stipulation could be struck down as a penalty if it could be established there was unconscionable conduct by the non-breaching party. They said “the doctrine of penalty answers, in situations of the present kind, an important aspect of the criticism often levelled against unqualified freedom of contract, namely the possible inequality of bargaining power. In this way the courts strike a balance between the competing interests of freedom of contract and protection of weak contracting parties.”³⁷ The fallback submission in *Cavendish* was, in part, consistent with the arguments that have been made by some commentators that the penalty doctrine should be wholly assimilated into the wider notion of unconscionability.³⁸ These commentators advocate that in the absence of unconscionability, penalty clauses should be valid and enforceable. For example, Waddams argues that because “unconscionability or a similar principle of fairness” is “widely recognised” there is “strong reason to assimilate the law relating to penalty clauses”.³⁹ This argument is consistent with Dickson J in the Canadian Supreme Court decision of *Elsley v J G Collins Insurance Agencies Ltd*:⁴⁰ “the power to strike down a penalty clause ... is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression”.

The fallback submission is initially attractive as the doctrine of unconscionability in equity shares some features in common with the vitiating factors. However, the major difficulty which immediately arises is that any merged doctrine of unconscionability suffers from a profound vagueness as in particular, it would have

³⁴ *Lansat Shipping Co Ltd v Glencore Grain BV (The Paragon)* [2009] 1 Lloyd’s Rep 658, aff [2009] 2 Lloyd’s Rep 688.

³⁵ It is not clear from the way Lord Mance expressed the fallback submission whether he was intending to refer to unconscionability in the *Dunlop* sense (as that expression is used in this chapter) or the equitable doctrine of unconscionability. This chapter proceeds on the basis that his reference was to the latter concept because it is itself a recognised vitiating factor.

³⁶ *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170.

³⁷ *Ibid* 194.

³⁸ T A Downes, ‘Rethinking Penalty Clauses’ in Peter Birks (ed), *Wrongs and Remedies in the Twenty-First Century* (Clarendon Press, 1996) 250; Mindy Chen-Wishart, ‘Controlling the Power to Agree Damages’ in Peter Birks (ed), *Wrongs and Remedies in the Twenty-First Century* (Clarendon Press, 1996) 271; Waddams, “Unconscionability in Contracts” above n 16; Ontario Law Reform Commission, *Report on Amendment of the Law of Contract* (1987) 139. See also Nelson Enonchong, ‘The Modern English Doctrine of Unconscionability’ (2018) 34 *Journal of Contract Law* 211.227 especially at 134.

³⁹ See Halson above n 29, 113, [4.29], citing S M Waddams, *Canada Law Book, The Law of Damages* (at 2015) [8.130].

⁴⁰ *Elsley v J G Collins Insurance Agencies Ltd* (1978) 83 DLR (3d) 1.15.

been necessary for the UK Supreme Court to lay down specific guidelines and the requisite principles for determining its application and the elements required for the grant of any relief on the ground of such an enhanced doctrine of unconscionability. It is suggested⁴¹ that vagueness of application is one of the reasons why Lord Denning's attempt in *Lloyd's Bank Ltd v Bundy*⁴² to bring together the law on duress, unconscionable bargains and undue influence under the general principle of "inequality of bargaining power",⁴³ was ultimately unsuccessful.⁴⁴ Apart from the objection that the wider doctrine of unconscionability contended for by the appellant in *Cavendish* is too vague and elusive, there are practical difficulties in curtailing the operation of the penalty doctrine in the manner contended for due to the four limiting factors outlined.

PART II

6.5 The Equitable Doctrine of Unconscionable Conduct

Part II examines the equitable doctrine of unconscionable conduct and the vitiating factors referred to in the fallback submission in *Cavendish*. Unconscionability has been found to arise during the course of negotiating a contract. Courts can take account of vitiating factors to determine the question of whether to enforce a contract where it has been entered into by questionable means and primarily by the unacceptable conduct of the stronger party. The vitiating factors operate consequent upon an examination by the court of the conduct of the parties when they negotiated their contract, the substance of that contract and whether it should be enforced. Consistent with the first limiting factor above, unconscionability in the *Dunlop* sense, is not concerned with conduct as it has a different focus which concentrates on the amount of the sum stipulated for and a determination of whether it is disproportionate. The vitiating factors can all be explained on the basis that unconscionability found to arise during the course of negotiating the contract has been the traditional focus of legal doctrine, both at common law and in equity⁴⁵ where the equitable doctrine of unconscionable conduct focuses on the conduct of the stronger party, and can be divided into two forms of unfair bargaining behaviour procedural and substantive which are interrelated.⁴⁶

6.5.1 Procedural Unconscionability

Procedural unconscionability⁴⁷ exists in situations where the unconscionability arises from defects in the process of negotiating the agreement by which the stronger party by its conduct gains the benefit under challenge. It examines how each term became part of the contract, the fairness of the bargaining process and the method of making the contract which led to the stronger party gaining the benefit under challenge. It

⁴¹ Enonchong, above n 38, 227.

⁴² *Lloyd's Bank Ltd v Bundy* [1975] QB 326.339-340; see also Halson, above n 29 97-98, [4.10].

⁴³ Lord Denning sought to embrace five separate categories of case where relief is available, namely duress of goods, unconscionable transactions, undue influence, undue pressure and salvage agreements.

⁴⁴ The doctrine was not endorsed by the other members of the Court of Appeal (Cairns LJ and Sir Eric Sachs) and it was later specifically disapproved by Lord Scarman delivering the judgment of the House of Lords in *National Westminster Bank Plc v Morgan* [1985] AC 686, 707-8.

⁴⁵ Paul Vout, 'Notion of Unconscionability' in Paul Vout (ed) *Unconscionable Conduct: The Laws of Australia* (Thomson Reuters, 3rd ed, 2017) 123.141, [35.5.200]; *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.461 ('*Amadio*')

⁴⁶ P S Atiyah, *Essays on Contract* (Clarendon Press, 1986) 333-4.

⁴⁷ See generally, J R Peden, 'The Law of Unjust Contracts; Including the Contracts Review Act 1980 (NSW)' (Butterworths, 1982) 25.

is concerned with conduct and considers questions of consent and defects in the process of agreement, for example, by considering whether there has been duress, undue influence, misrepresentation or mistake. In that respect it overlaps with the vitiating factors. Most of the concerns with unfairness in the process of contract formation arise from the unconscionable outcomes that originate from one sided bargains. Outcomes that are viewed as grossly unfair lead to an enquiry about the negotiating process.

6.5.2 Substantive Unconscionability

Substantive unconscionability is assessed at the time the parties entered into their contract and is founded upon the unconscionability⁴⁸ of the outcome of the contract which would otherwise prevail if relief is not granted. It is concerned with contract terms which unreasonably favour the stronger party and where the unfair or disproportionate results are from a transaction, for example, excessive price, limitation or exclusion of remedies, disclaimer of warranties, repossession clauses, acceleration of payment clauses and penalty clauses.⁴⁹ Accordingly, it concerns dissatisfaction with the outcome of the contract where it is too one sided.⁵⁰ Substantive unconscionability⁵¹ looks to the injustice which would result if relief is not granted, irrespective of the conduct of the parties. Furthermore unconscionability may arise where there is an insistence by the non-breaching party on strict legal rights in circumstances where to do so is contrary to equity and good conscience because of the hardship which is caused to the breaching party. Paul Vout⁵² observes that courts have proceeded cautiously in this area as without a focus on specific acts of wrongful conduct the notion of unconscionability can become too subjective.

6.5.3 *Commercial Bank of Australia v Amadio* and General Principles

By itself, insisting on enforcement of the terms of a contract does not constitute unconscionable conduct.⁵³ It is necessary to establish that the terms themselves are unfair or unjust in the circumstances, that is, that substantive unconscionability is present. Courts exercising equitable jurisdiction can strike down transactions tainted by unconscionability. In *Commercial Bank of Australia Ltd v Amadio*,⁵⁴ the High Court provided a framework for application of the equitable doctrine of unconscionability, where Deane J identified the following three essential elements:⁵⁵

- i) A is under a special disadvantage or disability;
- ii) B had knowledge of A's disadvantage; and
- iii) B exploited that A's disadvantage unconscientiously in order to obtain A's consent to a transaction.

Deane J⁵⁶ concluded that the equitable principles concerning relief against unconscionable conduct are closely related to those concerned with undue influence. Although undue influence and unconscionable conduct will overlap, they have distinct spheres of operation.⁵⁷ Conduct⁵⁸ will not be found to be

⁴⁸ Ibid.

⁴⁹ Ibid 42-7.

⁵⁰ Stephen A Smith, *Contract Theory* (Oxford University Press, 2004) 340-364.

⁵¹ Paul Vout, 'Notion of Unconscionability' above n 45, 142 [35.5..210].

⁵² Ibid.

⁵³ See *Hurley v McDonald's Australia Ltd* [1999] FCA 1728 [24]-[31] (17 December 1999).

⁵⁴ *Amadio* (1983) 151 CLR 447.

⁵⁵ Ibid 474.

⁵⁶ Ibid.

⁵⁷ *Thorne v Kennedy* (2017) 350 ALR 1, 14 [40] ('*Thorne*').

unconscionable unless there is evidence that the weaker party has been subjected to a special disadvantage 'which seriously affects the ability of that party to make a judgment as to its own best interests'.⁵⁹ The stronger party must also unconscientiously take advantage of that special disadvantage.⁶⁰ Before there can be a finding of an unconscientious taking of advantage, it is also generally necessary to establish that the stronger party knew or ought to have known of the existence of the special disadvantage.⁶¹

In *Bridgewater v Leahy*⁶² the High Court acknowledged that the facts of a case may be such that a plaintiff can establish both undue influence and unconscionability.⁶³ Unconscionable conduct is conduct that is 'against conscience',⁶⁴ where the focus is on the behaviour or conduct of the contracting parties and in particular, the stronger party and it has been referred to as a 'concept better described than defined'.⁶⁵ In other applications, unconscionable conduct is a necessary element under a recognised legal doctrine, for example, the unconscionable departure from promises in the context of estoppel⁶⁶ and in situations where undue influence has been established.⁶⁷ Application of the *Amadio* principle is always dependent on the circumstances of each particular case and the conclusions reached will necessarily involve an element of impression. Similarly Spigelman CJ has stated that 'unconscionability is a well-established but narrow principle in equitable doctrine'⁶⁸ and situations where a contract will be set aside on the ground of unconscionability will frequently involve a significant inadequacy of consideration⁶⁹ or disadvantageous contractual terms, but neither is essential.⁷⁰

Courts have no general jurisdiction to intervene simply because a contract or a term of a contract appears to be harsh or unfair.⁷¹ Jurisdiction to grant relief against the effect of the terms of a contract is recognised, for example, on public policy grounds in instances of restraint of trade⁷² and penalty clauses.⁷³ In construction and engineering projects, particularly those involving sophisticated commercial parties which have been properly advised and have negotiated at arms' length, there is little room for questions of procedural unconscionability arising which concern entry into the contract. The reason for this is due to commercial

⁵⁸ Unconscionable conduct has recently been considered by the High Court in *ibid* 13–14 [37]–[40]. In that decision the court confirmed the principles of unconscionable conduct in equity had been restated in *Kakavas v Crown Melbourne Ltd* (2013) 250 CLR 392.

⁵⁹ *Amadio* (1983) 151 CLR 447, 462.

⁶⁰ *Ibid*; *Kakavas v Crown Melbourne Ltd* (2013) 250 CLR 392, 398 [6].

⁶¹ *Amadio* (1983) 151 CLR 447, 462.

⁶² *Bridgewater v Leahy* (1998) 194 CLR 457, 477–8.

⁶³ For example, *Verduci v Golotta* [2010] NSWSC 506 (20 May 2010) where a mortgage was held to be voidable on the grounds of both undue influence and unconscionability in circumstances where a solicitor's client borrowed money from the solicitor's father.

⁶⁴ See *Kakavas v Crown Melbourne Ltd* (2013) 250 CLR 392, 401 [18]; *Amadio* (1983) 151 CLR 447, 474.

⁶⁵ See *Antonovic v Volker* (1986) 7 NSWLR 151, 165.

⁶⁶ See Paul Vout, 'Estoppel' in Paul Vout (ed) *Unconscionable Conduct: The Laws of Australia* (Thomson Reuters, 3rd ed, 2017) 179.183 [35.6.10].

⁶⁷ See Sarah Worsfield, 'Undue Influence' in Paul Vout (ed) *Unconscionable Conduct: The Laws of Australia* (Thomson Reuters, 3rd ed, 2017) 415.419 [358.10].

⁶⁸ *Attorney-General (New South Wales) v World Best Holdings Ltd* (2005) 63 NSWLR 557, 583; see also J W Carter, *Contract Law in Australia* (LexisNexis, 7th ed, 2018) 525-6 [24.16].

⁶⁹ *Blomley v Ryan* (1956) 99 CLR 362, 405.

⁷⁰ *Amadio* (1983) 151 CLR 447, 475; *Antonovic v Volker* (1986) 7 NSWLR 151, 165.

⁷¹ See *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* (2005) BLR 271, 277, [37].

⁷² Justice J D Heydon, *The Restraint of Trade Doctrine* (Butterworths, 3rd ed, 2008) 19–26; *Nordenfelt v Maxim Nordenfelt Guns and Ammunition Co Ltd* [1894] AC 535, 565; *Peters (WA) Ltd v Petersville Ltd* (2001) 205 CLR 126, 139; see also *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 667–8 [27].

⁷³ See *Euro London Appointments Ltd v Claessens International Ltd* [2006] 2 Lloyd's Rep 436, 439-440 [17]; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1193–4 [7], 1194–5 [9], 1274 [243], 1276 [250].

businesses operating in the construction industry are unlikely to be found to be suffering from the required 'special disadvantage' necessary to invoke the equitable doctrine of unconscionability.⁷⁴

Consistent with the third limiting factor outlined earlier, the weaker party which successfully establishes unconscionability will usually seek to avoid the whole transaction by resisting the stronger party's action for specific performance of the contract.⁷⁵ Alternatively, the remedy of rescission is available where the weaker party is entitled to an order setting aside the transaction. Orders may be made on terms to avoid injustice to the weaker party,⁷⁶ and to provide consequential relief to restore both parties to the positions they were in prior to the impugned transaction. In certain circumstances other equitable remedies are available. For example, in *Amadio*,⁷⁷ the High Court discussed the option of imposing conditions upon an order for rescission. In *Schipp v Cameron*⁷⁸ the court made an order for equitable compensation.⁷⁹ An award of damages is not available as a remedy for a finding of unconscionable conduct.⁸⁰ However, there are statutory prohibitions against unconscionable conduct,⁸¹ and the available relief which includes damages exceeds that which is available under the general law.

6.6 Factors Which May Invalidate or Vitate a Contract

Unconscionability in equity forms part of the doctrinal foundation of the vitiating factors referred to in the fallback submission in *Cavendish* as each vitiating factor has in common the inequitable taking advantage of a weaker party that, in each instance, is by conduct that occurs during contract formation. A number of the vitiating factors are related doctrines or are recognised as having some overlap eg: unconscionable conduct and undue influence and undue influence and duress. Each are distinct legal doctrines which can be relied upon to vitiate a contract entered into in disadvantageous circumstances. The court can find a contract was induced by threats of physical or economic injury (ie: duress), due to the unconscionable exploitation of a relationship of confidence (ie: undue influence), or in circumstances where a contract has been entered into in a manner the law regards as unconscionable. These abuses of power may give rise to remedies either at common law, in equity or by statute.⁸² As such where there is evidence a contract was entered into without the genuine consent of one or both of the parties, the court is likely set aside the contract by an order for rescission.

Duress and misrepresentation concern issues of the procedural fairness of contract formation (ie: the means by which consent was obtained) rather than the substantive fairness of what was actually agreed (ie: the conduct of the breaching party). There are two aspects of procedural fairness. Firstly, it is concerned with the

⁷⁴ See generally Julian Bailey, *Construction Law* (Informa Law, 2nd ed, 2016) vol I, 118–19 [2.159].

⁷⁵ *Blomley v Ryan* (1956) 99 CLR 362.

⁷⁶ *Amadio* (1983) 151 CLR 447, 480–1.

⁷⁷ *Ibid* 481.

⁷⁸ *Schipp v Cameron* [1998] NSWSC 997 (9 July 1998).

⁷⁹ Equitable compensation is monetary relief awarded as an equitable rather than a statutory remedy (see *Supreme Court Act 1986* (Vic) s 38) for loss suffered by breach of an equitable obligation: J D Heydon, M J Leeming, P G Turner, *Meagher, Gummow and Lehane's Equity: Doctrines and Remedies* (LexisNexis, 5th ed, 2015) 801 [23.015].

⁸⁰ Carter, above n 68, 525 [24.13].

⁸¹ Sections 21 and 22 of *Australian Consumer Law*. If claims are successfully advanced under these provisions, the remedies available are broader and more flexible than those available under the general law. Those remedies include damages, injunction and discretionary consequential orders which will often achieve the same result as when a contract is rescinded at law.

⁸² See ss 20–8 of the *Australian Consumer Law*.

quality of the consent of the weaker party which may be affected by a lack of capacity; and secondly, it looks to the blameworthiness of the stronger party seeking to enforce the contract. The vitiating factors should not be used as a basis to set aside contracts simply because a court finds the substantive terms to be objectionable. Their use should be limited to controlling the process of contract formation to facilitate the setting aside of agreements only where there is evidence they are vitiated by factors such as duress, undue influence, misrepresentation, illegality or unconscionable conduct.

When considering Lord Mance's refusal to countenance the fallback submission in *Cavendish*, one of the key factors to be mindful of is the third limiting factor concerning different remedial regimes operating for the penalty doctrine and where unconscionability including the vitiating factors apply to a transaction. The outcomes are in stark contrast as on the one hand, successful reliance on the penalty doctrine at common law or in equity will result in a remedy equivalent to the non-breaching party recovering loss and damage ie: in both instances the recoverable amount will be consistent with the measure of damages for breach of contract. On the other hand, if a contract is rescinded because it was induced by one of the vitiating factors, the weaker party may be able to claim restitution,⁸³ or damages,⁸⁴ or equitable compensation⁸⁵ but only if a benefit was conferred during the life of the contract.

PART III

6.7 Conclusion

This chapter argues there are four discernible differences impacting the two different concepts. These arguments are pursued with some force against the penalty doctrine being confined to unconscionability in equity and the type of conduct that would activate the vitiating factors. Consistent with the first limiting factor, the penalty doctrine does not concern itself with contracts induced by misrepresentation or coercion or undue influence or those where equitable relief is granted on the grounds of mistake or duress,⁸⁶ nor is it concerned with conduct where the stronger party is alleged to have improperly taken advantage of the other party's special disadvantage. As Lord Dunedin explained in proposition 4(a)⁸⁷ the penalty doctrine is about extravagance of 'the sum stipulated for', where the disproportion must be at the level where it is out of all proportion, and therefore, in the nature of a punishment before it may be found to be unenforceable. In a decision preceding *Andrews*, *Cavendish* and *Paciocco*, Jackson J explained in *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd*⁸⁸ that from his analysis of the limited number of cases⁸⁹ where a stipulation had been found to be an unenforceable penalty there was, "in fact, a very wide gulf between (a) the level of damages likely to be suffered, and (b) the level of damages stipulated in the contract". The decisions in

⁸³ For duress, see *Universe Tankships of Monrovia v International Transport Workers Federation* [1983] 1 AC 366, 400.

⁸⁴ For duress, see *ibid* 385.

⁸⁵ For unconscionability, see *Schipp v Cameron* [1998] NSWSC 997 (9 July 1998). For undue influence, see *Hart v Burbidge* [2013] EWHC 1628 (Ch) (12 June 2013) [141]–[144].

⁸⁶ Research for this thesis has not discovered any decision in this regard.

⁸⁷ *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd* [1915] AC 79, 87.

⁸⁸ *Alfred McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] BLR 271.280, [48].

⁸⁹ Jackson J listed *Commissioner for Public Works v Hills* [1906] AC 368, *Bridge v Campbell Discount Co Ltd* [1962] AC 600, *Workers Trust and Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573, and *Ariston SRL v Charly Records* (Unreported, Court of Appeal, 13 March 1990).

Cavendish and *Paciocco* have not detracted from the conclusion of Jackson J. A finding that a stipulated sum is a penalty at common law will be exceptional because, as Kiefel J⁹⁰ observed in *Paciocco*, it is a 'high hurdle' to achieve⁹¹ hence why the expression 'unconscionability in the *Dunlop* sense' is a narrow one. It has a narrow field of operation referable solely to the penalty doctrine, and as such is concerned with disproportion and sums that are out of all proportion rather than the conduct of the parties which induced the contract or lead to the incorporation of unfair terms being the domain of unconscionability in equity.

The proposal advanced in *Cavendish* that the doctrine of penalties or unconscionability in the *Dunlop* sense can be limited or should be subsumed into the vitiating factors is not workable. If unconscionability in the *Dunlop* sense is made out, then consistent with the third limiting factor, the stipulated sum or performance obligation is an unenforceable penalty, and importantly, the contract will continue in existence for the purposes of continued performance and enforcement. To this extent, the bargain continues to be performed and provides contractual certainty as required by the fourth limiting factor above. The doctrine of unconscionability in equity and the vitiating factors are all based on unacceptable conduct and, if made out, a court is likely to rescind the whole transaction thus bringing to an end the parties' contractual relationship and concluding their transaction.

Despite its uncertain origins, separate existence of the penalty doctrine was respected by the UK Supreme Court in *Cavendish* when it refused to abolish it. The High Court has, to date, not had to entertain such a submission. Based on the state of the law in Australia represented by *Andrews* and *Paciocco*, there is little prospect that the highest appellate court would accede to such a submission in any event. This is the case due to the penalty doctrine still having a continuing role to play in the management of straightforward contract clauses and commercial contracts. Despite the limited operation of the doctrine in equity, *Andrews* has been applied in Australia by the Victorian Court of Appeal in *Cedar Meats*⁹² where a take-or-pay clause has been set aside as a penalty, and there have also been recent decisions in Scotland and England where *Cavendish* has been successfully applied and a stipulation set aside as a penalty.⁹³

This chapter argues that the primary reason why the penalty doctrine should not be limited by confining unconscionability in equity with the vitiating factors which are concerned with procedural unfairness is due to the concept of unconscionability in equity being different to unconscionability in the *Dunlop* sense. This chapter argues that unconscionability in the *Dunlop* sense concentrates on the amount of the stipulated sum and considers whether the amount is out of all proportion, whereas unconscionability in equity focuses on the conduct and behaviour of the parties and in particular, the stronger party. This conduct can be viewed in two ways; firstly, substantive unconscionable conduct or "transactional imbalance"⁹⁴ which is concerned with the unfairness in the terms of the contract and relates to unconscionability in the *Dunlop* sense and

⁹⁰ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 553 [53].

⁹¹ The expression was taken from the judgment of Middleton J in *Paciocco v Australia and New Zealand Banking Group Ltd* (2015) 236 FCR 199, 295 [400].

⁹² See *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd* (2014) 45 VR 79, and the discussion in chapter 3 at [3.51].

⁹³ *Gray v Braid Group (Holdings) Ltd* 2017 SC 409, and as discussed in Halson, above n 29, 55, [2.47], 183-188, [6.03]-[6.10]; *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (27 February 2017), and as discussed in Halson, above n 29, 53, [2.45], 180, [5.78].

⁹⁴ Enonchong, above n 38, 229.

represents the overlap between the two concepts. Secondly, procedural unconscionable conduct or “substantive unfairness”⁹⁵ concentrates on the unfair conduct around entry into the contract. It also includes instances of consent affected by vitiating factors such as misrepresentation, duress or undue influence. Consistent with the third limiting factor, for the court to intervene on the ground of unconscionable conduct it is essential to establish that the stronger party, by its conduct, took unfair advantage of the weaker party. That is not the case for the penalty doctrine as it does not depend for its operation on a finding that the stronger party took unfair advantage of the weaker party,⁹⁶ even though the court may consider the circumstances in which the contract was made.⁹⁷

Additionally, this chapter establishes that unconscionability in the *Dunlop* sense is a narrow and distinct concept aligned to the amount of the stipulated sum and it is not a concept that has any direct relationship to conduct which is the realm of unconscionability in equity and the vitiating factors. However, a stipulation could arguably give rise to substantive unconscionability in circumstances where it unreasonably favours the stronger party and the unfair or disproportionate results arising from the transaction. In circumstances of commercial contracting where the parties do not suffer from inequality of bargaining power, with sophisticated commercial people or entities with access to legal advice, the stipulation is unlikely to be subject to successful challenge on the ground of substantive unconscionability or penalty. In consumer contracting there is greater scope for abuse however situation there are statutory remedies available to protect the weaker party.

Inclusion of this chapter in the thesis is due to the unsuccessful fallback submission advanced in *Cavendish*. Four limiting factors are advanced which confirm there are serious differences in approach between the two concepts of unconscionability. The suggestion that the penalty doctrine should be limited to confining unconscionability to the vitiating factors has been repudiated, not the least because of the vagueness of the proposed outcome. Unconscionability in the *Dunlop* sense retains its relevance in the common law as the *Dunlop* test has been retained for straightforward clauses which provide for the payment of money upon breach. It also has a role to play in the legitimate interests test and the *Andrews* test in equity. To this point, this thesis has analysed the common law and its operation for nearly a century whilst governed by Lord Dunedin’s four propositions. The significant developments in the common law examined, in particular in chapters 3, 4 and 5, have been shown to have resulted in an expanded jurisdiction in equity in Australia however not England, which are of little practical effect. In situations where there has been a breach of contract, the new legitimate interests test will provide contracting parties with greater security that their allocation of risk in their contracts will in future be respected by the courts. This is likely to lead to the increased use of liquidated damages clauses in contracts.

The remaining chapters will provide a comparative analysis of the treatment of stipulated sums in other jurisdictions. Those treatments are of a number of different varieties, namely a statutory formulation in the *Conventional Penalties Act 1962 (South Africa)*; a law reform initiative in Scotland, and the draft Penalty Clauses (Scotland) Bill 2010, together with a range of initiatives developed in Europe ranging from soft law to

⁹⁵ For example, *Hart v O’Connor* [1985] 1 AC 1000.1017-18.

⁹⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1205, [34].

⁹⁷ *Ibid* 1205-6, [35], 1247, [152].

research projects aimed at the codification of European contract law. These various treatments are shown to be different to the common law model and in the main, involve the exercise of a judicial discretion to reduce grossly excessive sums.

Chapter 7

The Treatment of Penalty Stipulations in South Africa and Some Comparisons with the Common Law

7.1 Introduction

This chapter is the first of three Chapters providing a comparative perspective to this thesis. South Africa is selected on the basis it has a mixed legal system and treats penalties differently to the common law. It has a statutory regime which provides, in the first instance that penalty clauses, pre-estimates of loss and forfeiture clauses are valid and enforceable. Roman-Dutch law which provides for judicial reduction of excessive stipulations applies. The *Conventional Penalties Act 1962 (South Africa)* ('the Act') has been influential in the formulation of law reform proposals in the United Kingdom¹ and Scotland.² The approach for the treatment of contractual stipulations payable upon breach of contract provided in the Act has been considered in reports published by law reform organisations in England and Scotland which have formulated recommendations for potential reforms of the penalty doctrine in those countries. Furthermore, the treatment of penalty clauses adopted in the Act resembles the approach that is found in a number of international instruments which are analysed in chapter 9.

This Chapter consists of three Parts. Part I briefly introduces the South African mixed legal system and explains how agreed sums payable upon breach of contract have historically been treated. Part II analyses the statutory regulation of contractual stipulations ie: penalty clauses, pre-estimates of loss and forfeiture clauses, which provides a judicial discretion to reduce stipulated sums found to be excessive. Part III focuses on comparisons between the South African treatment of contractual stipulations payable upon breach of contract and the common law approach. Finally this chapter argues the South African approach to penalty stipulations is consistent with the common law rationale for the penalty doctrine advocated in Chapter 2, particularly that stipulated sums which aim to punish the breaching party, will not be enforced.

PART I

7.2 South Africa: A Mixed Jurisdiction — Introduction³

In 1910, the British colonies of the Cape of Good Hope, Natal, the Orange Free State and Transvaal were unified to form the Union of South Africa and thereafter in 1961, the Republic of South Africa was created.

¹ Law Commission, *Penalty Clauses and Forfeiture of Monies Paid*, Working Paper No 61 (1975) 18, 21. However, this report rejected the approach adopted in South Africa that extends the power to review penalties to provisions which state that a party is to remain liable to the performance of some obligation upon withdrawal from the agreement. See Roger Halson, *Liquidated Damages and Penalty Clauses* (Oxford University Press, 2018) 48–9 [2.36].

² Scottish Law Commission, *Discussion Paper on Penalty Clauses*, Discussion Paper No 103 (1997); Scottish Law Commission, *Report on Penalty Clauses*, Report No 171 (1999).

³ See generally Richard Manly, 'The *Conventional Penalties Act 1962* (South Africa): Comparative Observations with Recent Developments in the Common Law' (2017) 34 *International Construction Law Review* 155.

South Africa operates a mixed legal system incorporating traditional and civil law elements represented by uncodified Roman-Dutch law⁴ brought to the Cape of Good Hope in 1652 by the original Dutch settlers when it was under the administration of the Dutch East India Company. Following British occupation, which commenced in 1795 and the transfer in 1815 of the Cape of Good Hope to Great Britain, the English common law was adopted, and a system of customary law inherited from indigenous Africans was also applied. Following the Second Boer War⁵ and the establishment of the Union of South Africa,⁶ English and Roman-Dutch law were largely fused into a single system.⁷ These various legal traditions have had a complex interrelationship with the English influence being most apparent in procedural aspects of the legal system, and the Roman-Dutch influence most visible in substantive private law.

7.2.1 Operation of the Penalty Doctrine in South Africa Prior to 1934

In South Africa the principles governing the treatment of contractual stipulations payable upon breach of contract were not harmonious. This was largely due to some courts applying Roman-Dutch law, which enforced contractual stipulations subject to limitations, such as:

- i) they could not conflict with the usury laws;
- ii) they could only be activated upon a breach of contract;
- iii) parties could recover either the stipulated sum or damages, but not both; and
- iv) excessive or unconscionable⁸ amounts⁹ could be reduced by the Court.¹⁰

Other courts applied English common law principles, which considered whether the stipulated sum was a genuine pre-estimate or a penalty.¹¹

In 1933, the Appellate Division of the Supreme Court delivered its judgment in *Pearl Assurance Co Ltd v Government of the Union of South Africa*.¹² The majority affirmed the law of South Africa was represented by the Roman-Dutch legal principle governing the treatment of contractual stipulations payable upon a breach of contract, being that 'the Court had the power to reduce an unconscionable penalty to bring it into line with the plaintiff's probable interest in having the contract performed'.¹³

⁴ The law of 17th century Holland.

⁵ 1899–1902.

⁶ 1910.

⁷ William Tetley, 'Mixed Jurisdictions: Common Law vs Civil Law (Codified and Uncodified)' (Pt 1) (1999) 3 *Uniform Law Review* 591, 604–5; C G van der Merwe et al, 'The Republic of South Africa' in Vernon Valentine Palmer (ed), *Mixed Jurisdictions Worldwide: The Third Legal Family* (Cambridge University Press, 2nd ed, 2012) 95, 134, 149.

⁸ *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1933] AD 277, 286, 295.

⁹ 'Poena ingens' in Roman-Dutch law.

¹⁰ B A Hepple, 'Conventional Penalties Bill' (1961) 78 *South African Law Journal* 445, 446; C I Belcher, 'The Conventional Penalties Act 1962' (1964) 81 *South African Law Journal* 80, 82; P M A Hunt, 'General Principles of Contract' (1962) *Annual Survey of South African Law* 94; Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Oxford University Press, 1996) 109–10; Dale Hutchison and François du Bois, 'Contracts in General' in François du Bois (ed), *Wille's Principles of South African Law* (Juta and Co, 9th ed, 2007) 733, 886–7; G B Bradfield, *Christie's Law of Contract in South Africa* (LexisNexis, South Africa, 7th ed, 2016) 661–5.

¹¹ For example, see *Cape Town Council v Linder* (1889) 6 SC 410; *Otto v Lategan* (1892) 9 SC 250.

¹² *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1933] AD 277. The Appellate Division of the Supreme Court was replaced by the Supreme Court of Appeal in 1996 and is the highest court in the South African hierarchy of courts. The Constitutional Court deals only with constitutional matters. Appeals to the Privy Council were abolished in 1950.

¹³ E M Burchell, 'Recent Cases: Lex Commissoria, Penalties and the Doctrine of Severance' (1955) 72 *South African Law Journal* 117, 120.

7.2.2 Adoption of English Principles: 1934–62

In 1934, the Privy Council decided the *Pearl Assurance* appeal¹⁴ in which issue for determination by the Board was whether a sum stipulated as payable upon breach of contract was recoverable or subject to judicial reduction. The Board considered the inconsistent approaches which had been adopted in South Africa for the treatment of contractual stipulations payable upon breach of contract, and had to decide whether the Roman-Dutch approach or the English common law approach was the correct legal approach.

Lord Tomlin delivered the judgment of the Board and commenced his analysis by considering how penalty sums (*poena*) had historically been treated in Roman-Dutch law, which he described as: 'That law is a virile living system of law, ever seeking, as every such system must, to adapt itself consistently with its inherent basic principles to deal effectively with the increasing complexities of modern organised society.'¹⁵

Lord Tomlin went on to review the opinions of various legal scholars,¹⁶ whose opinions differed in the treatment of *poena*. On the one hand some scholars expressed the opinion that '*poena*',¹⁷ if found to be excessive, could be moderated by reduction of the amount payable,¹⁸ and the proper test to apply is to determine the amount of damages actually resulting from the breach. On the other hand others commented that a penalty stipulation could not be the subject of moderation,¹⁹ whilst some were of the further opinion that stipulations vastly in excess of real loss were not enforceable and a claim in damages could be pursued.²⁰ In explaining these inconsistent opinions, Lord Tomlin concluded it was part of a common desire in South Africa to reconcile the application of two principles of Roman-Dutch law: where one party should be held to its bargain, and the other should not be allowed to oppressively enrich itself at the expense of another.²¹

Lord Tomlin further analysed a line of decisions commencing in 1833 in the Supreme Court of the Cape of Good Hope, where the opinion of the scholar, Cornelis van Bynkershoek²² who favoured the English common law approach had been adopted and applied. However, he observed there had been a later change of emphasis, where the courts considered the intention of the parties as expressed in the contract.²³ Thereafter, various decisions from the Provincial Courts in Transvaal and Natal were analysed, where the Courts adopted an English common law approach by considering whether the stipulated sum was a pre-estimate of damage or a penalty.²⁴ He reviewed²⁵ the 1906 Privy Council decision of *Commissioner for*

¹⁴ *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1934] AC 570.

¹⁵ *Ibid* 579.

¹⁶ *Ibid* 580–2.

¹⁷ See Zimmermann, above n 10, 95–113.

¹⁸ The opinions of Charles Dumoulin (1500–66), Robert Pothier (1699–1772) and Johannes Voet (1647–1713) are discussed by the Privy Council at *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1934] AC 570, 581. See also the discussion about the utility of and respect South African courts give to the treatises in François du Bois, 'Sources of Common Law and Precedent' in François du Bois (ed), *Wille's Principles of South African Law* (Juta and Co, 9th ed, 2007) 64, 72–6.

¹⁹ The opinion of Azo of Bologna (1150–1220).

²⁰ The opinion of Cornelis van Bynkershoek (1673–1743).

²¹ *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1934] AC 570, 581.

²² His opinions published in *Quaestiones Juris Publici* (1737) were consistent with the English common law position.

²³ *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1934] AC 570, 582.

²⁴ *Ibid* 582–3.

²⁵ *Ibid* 583–4.

*Public Works v Hills*²⁶ which was an appeal from the Supreme Court of the Cape of Good Hope. The decision in *Hills* proceeded on the basis that in the Cape of Good Hope, the principles of Roman-Dutch law had by 1906 been adapted to the English common law approach. A stipulated sum, which did not fall into the category of pre-estimate of damage, was to be regarded as a penalty and could not be recovered unless, and only to the extent, to which damages were proved. Additionally he also took account of various South African decisions post-1906 and found them also to be consistent with the opinion expressed in *Hills*. Accordingly, after an examination of the conflicting opinions of influential Roman-Dutch legal scholars and various decisions from Provincial Courts and Appellate Courts, Lord Tomlin determined South African law had adapted to the extent that Roman-Dutch law no longer applied and English common law principles²⁷ represented the relevant law.

Following Lord Tomlin's review of the historical development of the law in South Africa, he summarised the applicable legal principle in the following terms:²⁸

- i) the field covered by the old '*poena*' over which the Court could always exercise a moderating jurisdiction in the event of excess, but having regard to the actual damage suffered, is occupied by pre-estimate of damage and penalty ascertained by reference to the intention of the parties found in the contract;
- ii) if the sum claimed fell into the first category of pre-estimate of damage, it could be recovered on proof of breach of contract without proof of damage and could not be reduced; and
- iii) if it fell into the second category of penalty, then actual proof of damage (but not exceeding the amount of the penalty) could alone be recovered.

In his restatement of the legal principles for the treatment of stipulated sums payable upon breach of contract, Lord Tomlin gave 'broad consideration of the way in which '*poena*' has [historically] been ... regarded ... under ... Roman-Dutch law'.²⁹ Thus he concluded that because of the departure from Roman-Dutch law, 'there was no room left for the old '*poena*' at all'.³⁰ As a result, the English common law penalty doctrine came to be formally adopted as South African law.³¹

7.2.3 Criticism from within South Africa

The decision of the Privy Council was not well received in South Africa,³² and dissatisfaction with the position became evident almost immediately. In 1935, an attempt was made to legislate on the matter of penalty clauses to return South African law to Roman-Dutch principles. The General Law Amendment Bill 1935

²⁶ *Commissioner for Public Works v Hills* [1906] AC 368 ('*Hills*').

²⁷ *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1934] AC 570, 583–4.

²⁸ *Ibid* 584.

²⁹ *Ibid* 580.

³⁰ *Ibid* 585.

³¹ Zimmermann, above n 10, 109; Andrew Robertson and Michael Tilbury, 'Unity, Divergence and Convergence in the Common Law of Obligations' in Andrew Robertson and Michael Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (Hart Publishing, 2016) 2; see also *Tobacco Manufacturers Committee v Jacob Green and Sons* [1953] 3 SA 480, 486–7.

³² Until 1950 the Privy Council was the highest court for the Union of South Africa. See Zimmermann, above n 10, 109; Franziska Myburgh and Reinhard Zimmermann, 'J C de Wet and the *Conventional Penalties Act 15 of 1962*' in Jacques du Plessis and Gerhard Lubbe (eds), *A Man of Principle: The Life and Legacy of J C de Wet* (Juta, 2013) 302, 307.

(South Africa) which became *The General Law Amendment Act 1935* (South Africa) was drafted and cl 110 was drafted in language that removed the distinction between penalty clauses and pre-estimates of damages for the purposes of enforcement.³³ However, cl 110 did not appear in the Act due to the failure to reach agreement as to the appropriate approach to be followed in South Africa.

Further criticism followed in 1943, with another commentator stating 'It is no reflection on the members of the Judicial Committee [in *The Pearl Assurance* appeal], therefore, to say that neither in the past nor in the case under consideration have they been happy in the application of a system of law with which they were not even on a footing of nodding acquaintance.'³⁴

In 1953, Van den Heever JA (in dissent) sitting in the Appellate Division of the Supreme Court³⁵ expressed the opinion that the reception of the English common law into South African law was not consistent with the principles of Roman-Dutch law. He considered it 'a blemish on our legal system which militates against good faith, trust and business morality'.

Following these criticisms, the move to provide statutory control of penalty clauses, in a manner consistent with Roman-Dutch principles, was enlivened and the Law Revision Committee was instructed to consider the situation. Thus it sought advice from Professor J C de Wet who became the prime mover behind the legislation,³⁶ produced a memorandum setting out his advice including recommendations, inter alia, that legislation was necessary, and as such any legislation should adopt a Roman-Dutch approach. Furthermore he advised that forfeiture clauses should be treated as penalty clauses and be subject to reduction.³⁷ Based on this work the *Conventional Penalties Act 1962* (South Africa) was enacted.

PART II

7.3 The Conventional Penalties Act 1962 (South Africa)

Enactment of the statute 'restored the culture of the old Roman-Dutch law, having been founded upon the opinion of Johannes Voet who stated that excessive penalties might be moderated by replacing them with a provision 'ad bonum et aequum'.³⁸ The Act consists of only four sections. Myburgh and Zimmermann³⁹

³³ Burchell, above n 13, 123 provides:
Draft clause 110 stated that whether money or property recoverable was a pre-estimate of damage or a penalty, it could be claimed by the creditor unless the debtor provide that the sum or the value of the property was grossly excessive in comparison with the loss, inconvenience, disappointment or annoyance suffered by the creditor. Conversely, if the creditor proved that his loss was greater than the amount or property specified, he could recover the excess unless it was clear that the parties intended that no more than the amount of the penalty should be recovered in any case ...

³⁴ Aquilius, 'Immorality and Illegality in Contract' (1943) 60 *South African Law Journal* 466, 476.

³⁵ *Tobacco Manufacturers Committee v Jacob Green and Sons* [1953] 3 SA 480, 493; see also Hepple, above n 10, 446; Belcher, above n 10, 82.

³⁶ See Halson, *Liquidated Damages and Penalty Clauses*, above n 1; see generally Myburgh and Zimmermann, above n 32, 302–34.

³⁷ Myburgh and Zimmermann, above n 32, 308–9.

³⁸ 'Ad bonum et aequum' translates to 'what is right and just'; see also Martin Hogg, *Promises and Contract Law: Comparative Perspectives* (Cambridge University Press, 2011) 398. Johannes Voet (1647–1713) was a law professor and author of *Commentarius ad Pandectas*, which remains an important source of South African law. Zimmermann, above n 10, 109 has described the event as follows: 'The development leading to the enactment of the South African *Conventional Penalties Act* is colourful, interesting and not atypical of the more recent South African legal history.'

observed the provisions are 'characterised by a high level of abstraction and constitute a framework of general principles; grappling with specific details is left to courts and academics. Thus the [Act], in terms of drafting style, shows greater affinity with the civilian codes than it does with common law statutes.' This Part analyses the four Sections of the Act. Sections 1 and 4 determine the scope of application of the Act, s 2 deals with the problem of cumulation of claims and s 3 relates to excessive penalties.

7.3.1 Section 1: Stipulations for Penalties in Case of Breach of Contract to be Enforceable

The long title of the Act provides 'for the enforceability of penalty stipulations, including stipulations based on pre-estimates of damage and of forfeiture clauses'. Section 1⁴⁰ renders all penalty stipulations to be valid and enforceable, and defines penalty stipulations in terms of which a person 'in respect of an act or omission in conflict with a contractual obligation' is liable to pay a sum of money or deliver or perform something for the benefit of his creditor 'either by way of penalty or as liquidated damages'.⁴¹ The reference in s 1 to 'an act or omission in conflict with a contractual obligation' indicates a breach of contract. It is settled law⁴² that in the absence of a breach of contract there can be no liability under a conventional penalty.

The expressions 'penalty' and 'penalty stipulation' have the meanings attributed to them in s 1, and they are not to be construed in a manner consistent with English common law doctrine. In assessing whether a contractual stipulation offends the Act, it is necessary to determine whether upon breach of contract by the debtor,⁴³ the stipulation requires a payment of money, or the delivery of a thing, or the performance of an obligation over and above what the debtor would be liable for under the contract.⁴⁴

7.3.2 Section 2: Prohibition on Cumulation of Remedies and Limitation on Recovery of Penalties in Respect of Defects or Delay

Section 2(1)⁴⁵ prohibits the creditor from recovering both damages and the stipulated sum⁴⁶ 'in respect of an act or omission which is the subject of the penalty stipulation'. The parties are free to agree otherwise. Section 2(1) places stringent requirements such an agreement as the relevant contract must 'expressly so provide'. The creditor is limited to recovery of the stipulated sum, unless the contract expressly permits recovery of damages eg: for defect or delay in lieu of the stipulated sum. By way of illustration, in *De Lange v Deeb*⁴⁷ the purchaser (appellant) under a contract for the sale of property defaulted in paying monthly instalments. The contract price was 12 400 rand and a deposit of 100 rand was paid. In the exercise of his contractual rights under clause 8 of the contract, the seller (respondent) cancelled the contract and resold

³⁹ Myburgh and Zimmermann, above n 32, 309; G H Treitel, *Remedies for Breach of Contract: A Comparative Account* (Clarendon Press, 1988) 208–44.

⁴⁰ The text of s 1 of the Act is set out in Appendix A.

⁴¹ In *Cape Town Municipality v F Robb and Co Ltd* [1966] 4 SA 329, 336 'liquidated damages' was held to mean 'a genuine covenanted pre-estimate of damage'.

⁴² *Da Mata v Otto, NO* [1972] 3 SA 858, 871 (Appellate Division).

⁴³ Hereafter I will refer to the debtor as the breaching party and the creditor as the non-breaching party.

⁴⁴ In *Parekh v Shah Jehan Cinemas Pty Ltd* [1982] 3 SA 618, the High Court held a stipulation that adds nothing to the breaching party's obligations and provides for payment of what is due under the contract cannot be a penalty. In *Premier Finance Corp (Pty) Ltd v Rotainers (Pty) Ltd* [1975] 1 SA 79, the High Court found that an acceleration clause was not penal because it governed the time of payment in the event of a breach of contract and did not place a significant additional burden on the breaching party.

⁴⁵ The text of s 2 of the Act is set out in Appendix A.

⁴⁶ See *Custom Credit Corporation (Pty) Ltd v Shembe* [1972] 3 SA 462; *Botha (now Griessel) v Finanscredit (Pty) Ltd* [1989] 3 SA 773, 795–6.

⁴⁷ *De Lange v Deeb* [1970] 1 SA 561, 563.

the property for 11 500 rand. On the date of cancellation of the contract the position between the parties was as follows: the appellant owed interest of 1.83 rand and had paid a deposit of 100 rand. The respondent claimed as damages the difference between the purchase price of 12 400 rand and the resale price of 11 500 rand, ie 900 rand. To this was added the arrears of interest of 1.83 rand and a credit of 100 rand was provided for the deposit resulting in the claim totalling 801.83 rand.

In reliance on s 2(1) of the Act, the defaulting purchaser argued the contract provided for recovery of a penalty in addition to the right to claim damages as it failed to 'expressly' provide for the recovery of 'damages in lieu of the penalty'. The argument was rejected by Smit JP on the basis the seller had claimed no part of the penalty but had credited the purchaser for the amount of the deposit paid in reduction of any damages and concluded by saying⁴⁸ that the only right to recover damages which the creditor has is "in lieu of the penalty". The express addition of these words to Smit JP's conclusion is however of no consequence. However it is important that the choice to recover damages is to be provided in the contract. Similarly, in *Tierfontein Boerdery (Edms) Bpk v Weber*⁴⁹ a contractual provision providing 'the purchaser shall forfeit all moneys paid ... without prejudice to the seller's other legal rights and remedies and the right to claim damages'⁵⁰ was held to grant the seller a choice in terms of s 2(1).

Section 2(2) prohibits the creditor from recovering the stipulated sum if it accepted defective or delayed performance, unless the sum was expressly stipulated for that defect or delay. Examples of situations covered by this subsection are demurrage clauses in charterparty contracts,⁵¹ and liquidated damages clauses typically found in construction contracts.⁵²

7.3.3 Section 3: Reduction of Excessive Penalty

Section 3 aims to protect the debtor and relates to excessive penalties, whereby the court is entitled to reduce excessive penalties 'to such extent as [they] may consider equitable in the circumstances'.

The purpose of the Act is to achieve a fair balance between the interests of the two parties and as such, it takes into account of the fact that the debtor 'is not infrequently a person who is not in a position to bargain with the creditor with equal strength'.⁵³ However it does not interfere with the sanctity of the contract to a greater extent than is necessary without prejudicing the creditor's legitimate concerns.⁵⁴ It is to be observed that the concepts of 'prejudice', 'out of proportion' and 'rightful interest' are not defined in the Act but left to the courts to discuss and define. Additionally, s 3 does not specify at which time the creditor's prejudice is to be assessed or whether this prejudice has to have been foreseeable. Section 3⁵⁵ provides the Court with a

⁴⁸ Ibid.

⁴⁹ *Tierfontein Boerdery (Edms) Bpk v Weber* [1974] 2 SA 445.

⁵⁰ Ibid 446.

⁵¹ B R Bamford, 'The *Conventional Penalties Act 1962*' (1972) 89 *South African Law Journal* 229, 231. Demurrage is a charge payable by the charterer to the shipowner of a chartered ship on failure to load or discharge the ship within the time agreed.

⁵² Hunt, above n 10, 96; Belcher, above n 10, 89. An example of a construction industry case is *Afriscan Construction (Pty) Ltd v Umkhanyakude District Municipality* [2005] JOL 14365 which is a decision of the High Court.

⁵³ *Western Credit Bank Ltd v Kajee* [1967] 4 SA 386, 390.

⁵⁴ Myburgh and Zimmermann, above n 32, 325.

⁵⁵ The text of s 3 of the Act is set out in Appendix A.

discretion to reduce the stipulated sum to the extent it considers equitable.⁵⁶ In exercising this discretion, the Court is required to consider three questions:

- i) Is the stipulated sum out of proportion to the prejudice suffered by the creditor as a result of the debtor's breach of contract?
- ii) Would it be equitable for the Court to reduce the stipulated sum? and
- iii) If so, to what extent?⁵⁷

7.3.3.1 Out of Proportion to the Prejudice: Actual Loss Recoverable rather than Legally Recoverable Loss

Section 3 empowers the Court to reduce the stipulated sum recoverable by the creditor upon a breach of the contract where it is excessive. The level of reduction represents an amount which equates to the financial value of the prejudice suffered by the creditor due to the breach of contract, thus '[O]ut of proportion' is the expression used in s 3 to describe the level of disproportion between the sum stipulated when compared to the amount of the financial value of the prejudice suffered by the creditor. To determine whether the stipulated sum is 'out of proportion' to the financial value of the prejudice, the Court is required to examine the 'actual loss' suffered by the creditor rather than restrictive legally recoverable loss.⁵⁸ 'Actual loss' is the relevant loss that is recoverable because s 3 requires the Court to take into account 'not only the creditor's proprietary interest, but every other rightful interest'⁵⁹ which may be affected by the act or omission in question.' This is an ex post approach to the calculation of loss and as such is consistent with the Roman-Dutch legal principle which refers to the date of the breach of contract in consideration of whether a poena was enforceable.⁶⁰

In 1961 B A Hepple⁶¹ commented on the Conventional Penalties Bill 1961 (South Africa) and referred to the opinion of the Roman-Dutch legal scholar, Cornelis Van Bynkershoek, that every stipulated sum which exceeded double the amount of the true loss was a penalty and thus could be reduced. Other legal commentators⁶² expressed differing opinions based on a conventional penalty which may be more than double the true loss and valid, provided it is not outrageous and out of all proportion to the actual loss. However, the decided cases outlined below do not support these generalisations.

In *Western Credit Bank Ltd v Kajee*,⁶³ Caney AJP set out the meaning of 'out of proportion' in the following terms:⁶⁴

⁵⁶ Equity as a system distinct from the common law does not prevail in South Africa (*Bank of Lisbon and South Africa Ltd v De Ormelas* [1988] 3 SA 580, 606). See also Van der Merwe et al, above n 7, 145–6.

⁵⁷ *Plumbago Financial Services (Pty) Ltd v Janap Joseph* [2008] 3 SA 47, 54–5 [24]; see also *Murcia Lands CC v Erinvale Country Estate Home Owners Association* [2004] 4 All SA 656, 659 [14] (High Court).

⁵⁸ Treitel, above n 39, 224; Hunt, above n 10, 95–6; *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352.

⁵⁹ 'Every other rightful interest' finds its counterpart in § 343 ('Reduction of the Penalty') of the German Civil Code (*Bürgerliches Gesetzbuch* [Civil Code] (Germany) ('BGB')). P M A Hunt has suggested that 'our courts may find occasion for the first time to have recourse to German law in interpreting a South African statute': see Hunt, above n 10, 98.

⁶⁰ *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1934] AC 570, 574.

⁶¹ Hepple, above n 10, 452.

⁶² Simon von Groenewegen, Simon van Leeuwen and Johannes Wessels, referred to in *ibid*.

⁶³ *Western Credit Bank Ltd v Kajee* [1967] 4 SA 386, 391; Hutchison and Du Bois, above n 10, 886–7.

⁶⁴ *Western Credit Bank Ltd v Kajee* [1967] 4 SA 386, 391.

[these] words ... do not postulate that the penalty must be outrageously excessive in relation to the prejudice for the court to intervene. If that had been intended, the legislature would have said so. What is contemplated, it seems to me, is that the penalty is to be reduced if it has no relation to the prejudice, if it is markedly, not infinitesimally, beyond the prejudice, if the excess is such that it would be unfair to the debtor not to reduce the penalty; but otherwise, if the amount of the penalty approximates that of the prejudice, the penalty should be awarded.

In a later decision in 1969, Synman J identified⁶⁵ the following interests that should be taken into consideration when deciding whether the stipulated sum is out of proportion to the prejudice suffered by the non-breaching party:

everything that can reasonably be considered to harm or hurt, or be calculated to harm or hurt a creditor in his property, his person, his reputation, his work, his activities, his convenience, his mind, or in any way whatever interferes with his rightful interest as a result of the act or omission of the debtor must if it is brought to the notice of the Court, be taken into account by the Court in deciding whether the penalty is out of proportion to the prejudice suffered by the creditor as a result of the act or omission of the debtor

In *Structural Mezzanine Investments (Pty) Ltd v Davids*,⁶⁶ the applicant provided a developer with a short-term loan of three million rand repayable in six months at 1.25 per cent per week. In the event of default, the interest rate would increase to 1.5 per cent per week. The developer defaulted, and the applicant successfully sued the guarantors. Yekiso J considered whether the Act applied to the stipulation regarding enforcement of interest upon default and found the interest was not disproportionate to the loss that would be suffered by the developer and was enforceable. Yekiso J took into account the capital amount advanced and the intended high risk accepted by the applicant, and concluded the interest rate was in the circumstances not disproportionate.

When deciding whether the amount of the sum stipulated is disproportionate to the financial value of the prejudice suffered by the creditor, the language used in s 3 confirms the Court may take into account matters well beyond the financial or commercial interests of the non-breaching party, or indeed the limits of its legally recoverable loss. Accordingly, the Court is always likely to approach the evidence concerning prejudice on a 'broad basis' and not undertake a 'meticulous analysis'.⁶⁷ Furthermore, the loss does not have to be foreseeable.⁶⁸

7.3.3.2 Prejudice

'[P]rejudice' is to be understood in a broad sense and should not be limited to the creditor's patrimonial loss.⁶⁹ This is made clear in the language used in s 3 which requires the court to take into consideration 'every ... rightful interest' of the non-breaching party.⁷⁰ *Western Credit Bank Ltd v Kajee* was the first

⁶⁵ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352.

⁶⁶ *Structural Mezzanine Investments (Pty) Ltd v Davids* [2010] 6 SA 622.

⁶⁷ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 353–4.

⁶⁸ *Ibid* 352–3.

⁶⁹ In South African law, 'patrimonial loss' includes medical costs, loss of income and the costs of repairs, which in turn fall under the heading of special damages. 'Non-patrimonial loss' includes pain and suffering, disfigurement, loss of amenities and injury to personality which fall under the heading of general damages.

⁷⁰ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352.

decision which considered the operation of the Act. Caney AJP⁷¹ said:

The penalty is to be reduced if it has no relation to the prejudice, if it is markedly, not infinitesimally beyond the prejudice, if the excess is such that it would be unfair to the debtor not to reduce the penalty; but otherwise, if the amount of the penalty approximates that of the prejudice, the penalty should be awarded.

In assessing prejudice and determining its financial value, the Court can take into account everything that harmed the creditor, his or her person, property or reputation⁷² and the test used to assess prejudice is subjective.⁷³ Accordingly, the elements of what constitutes the prejudice do not need to have been foreseeable or within the contemplation of the parties when they entered into their contract.⁷⁴ Prejudice includes far more than pecuniary loss and may, according to the circumstances, include 'impairment of reputation or personal dignity and possibly cover any substantial inconvenience'.⁷⁵ The decided cases reveal that, at least, the following matters fall within the scope of prejudice,⁷⁶ actual direct proprietary loss, monetary expenditure in connection with the contract or the subject matter of the contract, financial loss through reliance on funds due under the contract, impairment of reputation, impairment of personal dignity, substantial inconvenience, frustration of holiday plans, and loss of sentimental value. In addition to prejudice, the Court is likely to consider factors such as the prior conduct of the parties, the relationship between them, their relative bargaining positions, when they entered their contract, the nature of the business of the creditor, the reason for the breach, whether any apology or amends have been offered, and the effect on the creditor if the court exercises its discretion to reduce the amount of the stipulated sum.⁷⁷

In *Murcia Lands CC v Erinvale Country Estate Home Owner Association*, Budlender AJ said that where one is not dealing with monetary prejudice the Court should make 'a value judgement'⁷⁸ and decide whether the stipulated sum was 'unduly severe to an extent that it offends one's sense of justice and equity'.⁷⁹ Where the court finds a stipulated sum is 'markedly greater than the prejudice and if the excess is such that it would be unfair to enforce the penalty'⁸⁰ the sum may be reduced. Reliance on 'unfairness' is consistent with the principles of South African common law (ie *ius commune*) which have been 'constructed and administered such that one of its outstanding features is its broad equitable spirit, in the sense of being reasonable and impartial'.⁸¹ This discretion to reduce is very broad and the Court has the ability to provide a generous margin between the stipulated sum and the prejudice suffered by the creditor before the discretion will be exercised.

7.3.3.3 When Is Prejudice to Be Assessed?

⁷¹ *Western Credit Bank Ltd v Kajee* [1967] 4 SA 386, 391; see *ibid* 353 where Synman J doubted the suitability of the expression 'not infinitesimally'.

⁷² *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352–3.

⁷³ See Hutchison and du Bois, above n 10, 886; *ibid* 352.

⁷⁴ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352.

⁷⁵ Hunt, above n 10, 97–8; Hepple, above n 10; Bamford, above n 51, 232; *Western Credit Bank Ltd v Kajee* [1967] 4 SA 386, 394.

⁷⁶ Bamford, above n 51, 232; see *Burger v Western Credit Bank Ltd* [1970] 4 SA 74; *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352–3; *Bester v Smit* [1976] 4 SA 751, 795.

⁷⁷ Bamford, above n 51, 234; Myburgh and Zimmermann, above n 32, 332.

⁷⁸ *Murcia Lands CC v Erinvale Country Estate Home Owners Association* [2004] 4 All SA 656, 661 [27] (High Court). At 661 [25] the court said: 'The prejudice was prejudice to its right to enforce concerted action for the common good, and to its interest in obtaining corrected action.'

⁷⁹ *Western Bank Ltd v Meyer* [1973] 4 SA 697, 700.

⁸⁰ *Slip Knot Investments 777 (Pty) Ltd v Project Law Prop (Pty) Ltd* [2011] ZAGPJHC 21 (1 April 2011) [17].

⁸¹ Dale Hutchinson, *Wille's Principles of South African Law* (Juta and Co, 8th ed, 1991) 17, citing *Bank of Lisbon and South Africa Ltd v De Ormelas* [1988] 3 SA 580, 606.

P M A Hunt⁸² suggested the date of breach rather than the date of contract is the appropriate reference point to determine whether the stipulated sum is to be adjudged as disproportionate to the prejudice suffered by the creditor.⁸³ Hunt's conclusion was based on the contention that it would not be appropriate to reduce a stipulated sum after taking into account 'the prejudice suffered by the creditor' if the date of the contract was to be the material date for carrying out the assessment. This contention was confirmed in *Van Staden*.⁸⁴

7.3.3.4 Future Loss

The question arises as to how a creditor suffering ongoing damage into the future is to be treated. This issue was addressed in *Van Staden* where Synman J held that if harm or hurt might reasonably be expected to occur at some future date then 'the Court will have regard to it'.⁸⁵ However, the recovery of potential future or prospective damage would have to be governed by the need for the loss to crystallise in the sense that it became certain. It could not remain contingent.⁸⁶

7.3.3.5 When Will It Be 'Equitable' or Fair to Reduce the Penalty Stipulation?

Section 3 provides the court with the power to reduce a penalty sum where the penalty is out of proportion to the prejudice suffered by the creditor as a result of the breach.

Once the court is satisfied that the penalty sum is disproportionate, it is obliged to reduce it.⁸⁷ The question arises as to what amount should a penalty be reduced. The Act states the court must be guided by what it considers equitable in the circumstances. Myburgh and Zimmermann suggest the starting point may be to look at the patrimonial loss suffered by the non-breaching party.⁸⁸ However, in *Western Credit Bank Ltd v Kajee*⁸⁹ the court said it would neither confine itself to nor feel obliged to reduce the penalty to an equivalent of the creditor's patrimonial loss. By way of illustration, in *Western Bank Ltd v Lester*⁹⁰ the court reduced the penalty to a level that was described as 'harsh but not unjust or unfair'.⁹¹

Neither Roman-Dutch law nor the *ius commune* of South Africa accept a division of the law into common law and equity, as is the case in common law systems that operate in Australia and England.⁹² In South African law, the expression 'equity' is used in a popular sense as synonymous with fairness and justice.⁹³ For

⁸² Hunt, above n 10, 95–6.

⁸³ This was confirmed in *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352–3.

⁸⁴ Ibid.

⁸⁵ Ibid 353.

⁸⁶ In South Africa damages are recoverable for two forms of loss, namely 'actual damages' or 'prospective damages' (eg loss of profits). Such damages are only awarded as flow naturally and directly from the breach of contract (general or intrinsic damages), or as may be reasonably supposed to have been in the contemplation of the contracting parties at the time they made the contract as the probable consequence of the breach, where the parties have knowledge of special circumstances and contract on the basis of such knowledge (special, or extrinsic damages). See Hutchison and du Bois, above n 10, 883; Bradfield, above n 10, 649–50.

⁸⁷ In *Western Credit Bank Ltd v Kajee* [1967] 4 SA 386, 391, it states that 'the word 'may' in s 3 does not merely confer a discretion, but a power coupled with a duty'.

⁸⁸ Myburgh and Zimmermann, above n 32, 331.

⁸⁹ *Western Credit Bank Ltd v Kajee* [1967] 4 SA 386, 393.

⁹⁰ *Western Bank Ltd v Lester and Maclean* [1976] 4 SA 200.

⁹¹ Ibid 203.

⁹² Van der Merwe et al, above n 7, 145–6; John Andrew Faris, 'African Customary Law and Common Law in South Africa: Reconciling Contending Legal Systems' (2015) 10 *International Journal of African Renaissance Studies* 171, 179; *Estate Thomas v Kerr* (1903) 20 SC 354, 366.

⁹³ Van der Merwe et al, above n 7, 95, 145.

example, in the *Murcia Lands*⁹⁴ decision the Court ruled on the enforceability of a levy payable on breach of contract was set at 20 times the ordinary levy. The plaintiff argued the levy offended s 3 of the Act and Budlender AJ found that the levies imposed against the plaintiff (the breaching party) for delayed construction of a dwelling on a housing estate were penal and liable to reduction. The Court found⁹⁵ there was ‘virtually no evidence to show that the plaintiff’s failure to comply with the contract, which led to the buildings being erected late ... caused any material damage to the defendant, except that there must have been some additional noise and dust generated by the activities’. However, the Court found the defendant’s prejudice was ‘prejudice to its right to enforce concerted action for the common good, and to its interest in obtaining concerted action’.⁹⁶ In such a circumstance the court held⁹⁷ that ‘where one is not dealing with monetary prejudices, [s 3 of the Act] requires the court to make a value judgement in order to decide whether the penalty is “unduly severe to the extent that it offends against one’s sense of justice and equity”’.

Once the Court decided the amount of the levy was out of proportion to the prejudice suffered by the creditor due to the plaintiff’s breach, it considered what would constitute an equitable outcome and to do this the judge referred back to the self-evident proposition which states that ‘what is equitable is what is fair’.⁹⁸ Relying on the broad-based principles set out in *Van Staden*,⁹⁹ the judge adopted an ex post approach and made use of the best information available at the trial which included comparative data of penalties imposed at other housing estates and further data relating to the size of the total penalty imposed on the plaintiff and the income received by the defendant as a result of levies in general. In determining what was fair, the Court decided the levy imposed on the plaintiff was a penalty and should be reduced to an amount equal to eight times the ordinary levy.

7.3.3.6 Example of where a Reduced Penalty Can Still Be Advantageous

In circumstances where the stipulated sum has been found to be a penalty it is possible for a creditor to recover an amount greater than what would have been recoverable as damages for breach of contract in the absence of the stipulation. This is a correct outcome as prejudice is not assessed by the common law principles for recovery of damages for breach of contract.¹⁰⁰

By way of illustration, in *Afriscan Construction (Pty) Ltd v Umkhanyakude District Municipality*¹⁰¹ the stipulated sum payable for delayed completion of a construction contract was reduced by Van der Reyden J to an amount that exceeded legally recoverable damages for breach of contract. This case was an appeal from the award of an arbitrator in a dispute regarding late completion by the applicant (the contractor) of two civil engineering projects for the construction of a water pipeline. The purpose of the pipeline was to convey

⁹⁴ *Murcia Lands CC v Erinvale Country Estate Home Owners Association* [2004] 4 All SA 656 (High Court).

⁹⁵ Ibid 660 [20].

⁹⁶ Ibid 661 [25].

⁹⁷ Ibid 661 [27].

⁹⁸ Ibid 664 [50].

⁹⁹ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 353.

¹⁰⁰ Damages for breach of contract in South African law are assessed by reference to the same common law principles that apply in Australia and England (see Hutchison and du Bois, above n 10; Bradfield, above n 10, 641–61).

¹⁰¹ *Afriscan Construction (Pty) Ltd v Umkhanyakude District Municipality* [2005] JOL 14365. I express my thanks to Simphiwe Tshikila, Advocate of the High Court of South Africa, for providing me with a copy of the decision. See M J Maritz and S Tshikila, ‘The Extent of Enforcement of the Penalty Clause on Public Sector Construction Contracts in South Africa’ in Les Ruddock and Paul Chywoneth (eds), *COBRA 2011: Proceedings of RICS Construction and Property Conference* (Royal Institute of Chartered Surveyors, 2011) 555.

water from a reservoir and purification plant being constructed by two other contractors. The pipeline could not be used until it had been connected to the reservoir and purification plant. The applicant's work commenced on 20 November 2001 and was required to be completed by 20 July 2002. The work was delayed and completion was not achieved until 30 October 2002 with the purification plant and reservoir only became functional in phases between December 2002 and March 2003.

From the date of completion of the pipeline on 30 October 2002 to the beginning of December 2002, the first respondent, the Municipality, was unable to use the pipeline as the two contractors constructing the reservoir and purification plant had failed to bring their works to completion and Eskom (a South African electricity utility) was unable to supply electricity to the purification plant until after December 2002. By his award, the arbitrator ordered the applicant to pay the Municipality the stipulated sum of 1 748 314.80 rand for late completion of the project.

The contractor's ground of appeal was that the stipulation was a penalty and the amount payable should be reduced pursuant to s 3 of the Act.

Before the arbitrator, the evidence of the Municipality was that the tangible financial loss suffered by it equated to 168 514.56 rand for extra supervision costs incurred during the period of delay. Further evidence was also presented of 'intangible costs' arising from the fact there was delayed delivery of water to the local community, which led to unrest as well as that due to the delay in delivery of water the Municipality lost status in the eyes of the members of the community. This encouraged a substantial number of community members to withhold payment of water service charges, which impacted on cash flow. The Court found there was 'no clear cut undisputed evidence as to the exact or even approximate financial loss suffered by the first respondent'. This is not surprising as it is typically difficult for government institutions to prove loss due to delays in completion of infrastructure projects.¹⁰² The Court determined it would be equitable to reduce the amount of the stipulated sum by apportioning blame to each of the parties involved in causing the delay, namely the applicant, the two other contractors and Eskom. This resulted in a reduction of the stipulated sum by 75 per cent to arrive at a figure of 437,078.70 rand. This decision demonstrates that it is possible for the stipulated sum (ie 1 748 314.80 rand) to be found to be a penalty, but reduced to a recoverable sum (ie 437 078.70 rand) which is still greater than the amount that would otherwise be due as damages for the breach of contract (ie 168 514.56 rand). This is consistent with the proposition that reduction will be to an intermediate sum.

7.3.3.7 Reduction to Nil Amount

In certain circumstances, the Court might determine it is 'equitable' to reduce a stipulated sum to a nil amount.¹⁰³ the Court can ameliorate the effect of the stipulated sum to the extent necessary to be consistent with principle of fairness by exercising the discretion in s 3. For example, in *Western Bank Ltd v Meyer*¹⁰⁴ the

¹⁰² See generally Nicholas Seddon, *Government Contracts: Federal, State and Local* (Federation Press, 6th ed, 2018) 12–15 [1.7].

¹⁰³ *Sasol Dorpsgebiede Bpk v Herewarde Beleggings Bpk* [1971] 1 SA 128, 131. In *Afriscan Construction (Pty) Ltd v Umkhanyakude District Municipality* [2005] JOL 14365 Van der Reyden J rejected an argument that the stipulated sum be reduced to nil.

¹⁰⁴ *Western Bank Ltd v Meyer* [1973] 4 SA 697.

Court said it should only interfere (ie reduce) if ‘the penalty is unduly severe to an extent that it offends against one’s sense of justice and equity’. The exercise of the discretion to reduce the stipulated sum will decrease the amount payable by the debtor, but in doing so, the Court should ensure the creditor will nonetheless have its legitimate interests protected.

7.3.3.8 Onus of Proof

The opening words of s 3: ‘if upon the hearing of a claim for a penalty, it appears to the court that such penalty is out of proportion’ raise the issue of onus of proof. The question of who bears the onus was settled in *Smit v Bester*¹⁰⁵ where the Appellate Division of the Supreme Court concluded the debtor bears the onus of proving that the penalty is out of proportion to the prejudice suffered by the creditor and thus has to be reduced and the extent to which this has to be done.¹⁰⁶ Once the debtor has made out a prima facie case, the burden shifts to the creditor.¹⁰⁷ In that case the court placed the onus on the debtor firstly as it is implicit in the wording of s 3¹⁰⁸ referred to above, and secondly the debtor was asking the court for a concession which implied that the onus rested on it to convince the court to grant that concession by exercising the discretion to reduce in its favour.¹⁰⁹

7.3.4 Section 4: Provisions as to Penalty Stipulations Also Apply in respect of Forfeiture Stipulations

Section 4¹¹⁰ places penalty stipulations and forfeiture stipulations on the same footing in that forfeiture stipulations¹¹¹ can also be ameliorated at the court’s discretion.¹¹² The section states that a stipulation which provides that a party, upon withdrawal from an agreement under circumstances specified in that agreement, is to forfeit the right to claim restitution of her or his performance in terms of the agreement or to remain liable for her or his performance in spite of the withdrawal, is to be treated ‘as if it were a penalty stipulation’. *Western Credit Bank Ltd v Kajee*¹¹³ explained that this section can be applied to a stipulation providing for the forfeiture of instalments paid on account of the price, if the seller is entitled to and does terminate the agreement. It also applies to undertakings to pay instalments thereafter falling due. Furthermore, in *Da Mata v Otto, NO*¹¹⁴ the Appellate Division of the Supreme Court considered a clause in an instalment sale of land contract which provided under certain circumstances the seller (respondent) would be entitled to take back the land ‘together with all improvements thereof without payment of any compensation whatsoever’. The purchaser (appellant) alleged that as the stipulation provided it would lose all improvements made on the property without any compensation, it was in law a forfeiture clause that fell under the control of the Act. The court found that since s 4 makes s 1 of the Act applicable mutatis mutandis to forfeiture clauses, the performance of anything to be forfeited ‘[must] be the subject matter of a contractual obligation’.¹¹⁵ Thus in

¹⁰⁵ *Smit v Bester* [1977] 4 SA 937.

¹⁰⁶ *Ibid* 942.

¹⁰⁷ *Ibid*.

¹⁰⁸ *Ibid* 941–2.

¹⁰⁹ *Ibid* 942.

¹¹⁰ The text of s 4 of the Act is set out in Appendix A.

¹¹¹ An example of a forfeiture stipulation is one that provides: ‘Should the employee breach clause X, the employee will forfeit all commissions which may be due and not yet paid to the employee up to and including the date upon which the breach was committed’.

¹¹² Hunt, above n 10, 98.

¹¹³ *Western Credit Bank Ltd v Kajee* [1967] 4 SA 386, 390.

¹¹⁴ *Da Mata v Otto, NO* [1972] 3 SA 858, 870, 871, 878.

¹¹⁵ *Ibid* 864.

order to be subject to the provisions of the Act, the stipulation should have provided for the following:

- (a) that as required by s 4 the appellant was obliged to make improvements on the property; and
- (b) that as enjoined by s 1(1) the appellant was obliged on the breach of the contract to deliver or perform improvements for the benefit of the seller.¹¹⁶

As the contract did not require the purchaser to improve the land he was therefore not liable to forfeit performance being the subject of a contractual obligation. The court was of the opinion the stipulation was included in the contract to simplify the process of repossession of the land.¹¹⁷

PART III

7.4 South Africa v Common Law Approaches: Some Comparisons

Based on the foregoing analysis of the operation and construction of the Act, Part III provides some comparative observations of the South African treatment of stipulations payable upon breach of contract with the common law systems considered in Chapters 2, 3, 4 and 5.

The Act requires a breach of contract before its provisions can be engaged. This is the accepted position in the common law systems operating in England¹¹⁸ and Australia¹¹⁹ for the penalty doctrine. The necessity to establish a breach of contract is explained on the basis that the penalty doctrine regulates only the remedies available for breach of a party's primary obligations and not the primary obligations themselves.¹²⁰ In Australia, but not England, the penalty doctrine can be enlivened to provide relief in equity in the absence of a breach of contract¹²¹ where there has been a failure of the primary stipulation. In Australia and England, where there has been a breach of contract, the position of the creditor is considered at the date of entry into the contract. In contrast, the South African statute does not fix any particular point in time when the Court is to assess the prejudice suffered by the creditor. Prejudice can be assessed at any time, but will usually be analysed on an ex post basis at trial.¹²²

Section 1 provides a penalty can consist of the payment of money, the delivery of a thing or the performance of an obligation. In Australia and England, the common law has recognised the penalty doctrine can be engaged where there is a payment of money or transfer or forfeiture of property or shares or assets.¹²³

Section 3 permits 'a reduction of' the amount of the stipulated sum. In South Africa, if the creditor argues the stipulated sum is 'out of proportion' because it is too low when compared to the prejudice suffered by that

¹¹⁶ Ibid 871.

¹¹⁷ Ibid 872.

¹¹⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [13].

¹¹⁹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

¹²⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [13]; see also Sirko Harder, 'The Relevance of Breach to the Applicability of the Rule against Penalties' (2013) 30 *Journal of Contract Law* 52.

¹²¹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

¹²² *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352–3.

¹²³ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 217–18 [12]–[13]; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1197 [16].

party, it cannot argue for an increase.¹²⁴ On the other hand the position in Australia and England is that if the amount stipulated for liquidated damages is an underestimate then it cannot be set aside as a penalty.¹²⁵ For South African conditions, the *Afriscan* decision establishes it is quite possible for a creditor to recover more by a reduction of the stipulated sum than it would have recovered as damages in the absence of the stipulation.¹²⁶

The rationale for the penalty doctrine at common law is to consider whether the aim or purpose of the stipulated sum is punishment of the debtor. The Court considers whether the stipulated sum is out of all proportion to the interests of the creditor in performance of the contract. If the stipulated sum is out of all proportion then it will be exorbitant, extravagant and unconscionable, and an unenforceable penalty. Section 3 uses, as its touchstone, the expression 'prejudice'. If the stipulated sum is out of proportion to the prejudice suffered by the creditor then it may be reduced. It is to be observed that punishment in the common law sense and prejudice in the statutory sense are equivalents and their application leads to the same end result. The stipulated sum will either be unenforceable at common law, or reduced by statutory discretion in South Africa. In both instances, where the aim of the stipulated sum is punishment, then payment of the stipulated sum will not be enforced.

The assessment of 'prejudice' under South African law is a wide-ranging inquiry which includes losses well beyond the common law's familiar boundaries for recovery of damages for breach of contract set by the test in *Hadley v Baxendale*.¹²⁷ For South African conditions 'prejudice' suffered by the creditor encompasses more than direct or consequential loss as well as more than legitimate interests, and more than commercial or financial interests. As such it is a versatile concept of the broadest parameters. In Australia and England, if there is a breach of contract, the stipulated sum becomes payable even if there is no loss suffered.¹²⁸ The position in South Africa could be different, because a court 'may' reduce the stipulated sum. Additionally as s 3 requires any reduction to be 'equitable in the circumstances', there must be evidence whether the stipulated sum is markedly or unfairly out of proportion to the prejudice and if so, any reduction applicable could theoretically amount to a nil amount.

At common law, if the stipulated sum is found to be a penalty and unenforceable, there is a question whether that sum sets the ceiling or cap for recoverable loss when the creditor seeks to prove its actual loss and damage.¹²⁹ The preferred view is that it does operate as a cap or a ceiling because that is consistent with the utility of stipulating for liquidated damages, ie: they are used for ease of calculation of damages payable

¹²⁴ Hogg, above n 38, 398.

¹²⁵ *Diestal v Stevenson* [1906] 2 KB 345; *Cellulose Acetate Silk Co Ltd v Widnes Foundary (1925) Ltd* [1933] AC 20; *Multiplex Constructions Pty Ltd v Abgarus Pty Ltd* (1992) 33 NSWLR 504.

¹²⁶ Treitel, above n 39, 226; *Afriscan Construction (Pty) Ltd v Umkhanyakude District Municipality* [2005] JOL 14365.

¹²⁷ *Hadley v Baxendale* (1854) 9 Ex 341; 156 ER 145.

¹²⁸ *BFI Group of Companies Ltd v DCB Integration Systems Ltd* [1987] CILL 348 (12 June 1987); *Boucaut Bay Co Ltd (in liq) v Commonwealth* (1927) 40 CLR 98, 106–7; see also Brian Eggleston, *Liquidated Damages and Extensions of Time in Construction Contracts* (Wiley-Blackwell, 3rd ed, 2009) 78; Julian Bailey, *Construction Law* (Informa Law, 2nd ed, 2016) vol II, 1210 [13.173].

¹²⁹ Roger Halson, 'Remedies for Breach of Contract' in Michael Furmston (ed), *The Law of Contract* (LexisNexis, 6th ed, 2017) 1671, 1695 [8.128] argues that the preferred view is the stipulated sum provides a ceiling. The contrary opinion is advanced in Justice James Edelman, *McGregor on Damages* (Sweet and Maxwell, 20th ed, 2018) 512–13 [16.026]; Hugh Beale, 'Damages' in Hugh Beale (ed), *Chitty on Contracts* (Sweet and Maxwell, 32nd ed, 2015) vol 1, 1797, 1931 [26.202] states that the question is 'unsettled'.

upon breach of contract and give the debtor the benefit of a limit on its liability for breach of the contract. Considerations of this nature are not relevant for the statute on the basis that it permits partial enforcement of the impugned stipulation.

Drawing the threads together, **Figure 1** provides a summary comparing the South African statute with the common law.

Figure 1: Summary of the Comparison between Operation of the Penalty Doctrine in South Africa and at Common Law

	South Africa	Common Law
Is breach necessary?	✓	✓
Equitable relief against penalties	X	✓ ¹³⁰
Can the stipulation be the payment of money?	✓	✓
Can the stipulation be the forfeiture of \$/forfeiture or transfer of property?	✓	✓
Can the court reduce the stipulated sum?	✓	X ¹³¹
Is the prejudice suffered by the non-breaching party relevant?	✓	X ¹³²
Alternate remedy of unliquidated damages if stipulated sum is unenforceable	X	✓
Can the court increase the stipulated sum if it is too low?	X	X
Need to prove loss?	X	X
Need to mitigate after breach?	X	X
Is the amount of the stipulated sum the ceiling or cap to recovery?	✓	✓ ¹³³
Is stipulated sum required to be a genuine pre-estimate?	X	X
Must the stipulated sum equate to damages for breach of contract?	X	X
Is stipulated sum analysed ex post?	✓	X

This summary demonstrates a number of convergences and divergences between the differing treatments of contractual stipulations payable upon breach of contract embraced by the common law and South African statute. The most important convergence is between the South African emphasis on the prejudice suffered by the creditor because of the breach of contract. In South Africa, where the effect of the stipulation is

¹³⁰ In Australia, *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 recognises a jurisdiction in equity to relieve against penalties in the absence of a breach of contract.

¹³¹ In Australia, *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 recognises a jurisdiction in equity to relieve against penalties in the absence of a breach of contract.

¹³² In Australia and England, the relevant consideration is the legitimate interests of the non-breaching party.

¹³³ Those who favour the ceiling or cap rule include Bailey, above n 128, 1217 [13.184]–[13.185]; Halson, above n 129, 1671 [8.128]. Those who oppose the ceiling or cap rule include Nicholas Brown, 'Liquidated Damages: Is One Man's Floor Another Man's Ceiling?' (2001) 17 *Construction Law Journal* 302; Justice Edelman, above n 129, 512–13 [16.026]; John W Carter et al, 'Contractual Penalties: Resurrecting the Equitable Jurisdiction' (2013) 30 *Journal of Contract Law* 99, 116–17. Those who say the position is unsettled include Beale, above n 129, 1797, 1931–1932 [26.202].

punishment of the creditor, it can be reduced. The common law focus is on the legitimate interests (primarily financial and commercial) of the creditor in performance of the contract. At common law, if the aim of the stipulated sum is punishment of the creditor, the stipulation will not be enforced. The different treatments of contractual stipulations in the two systems intersect at this important juncture. Neither system is constrained by the limits imposed by what is recoverable as damages for breach of contract. In terms of what is recoverable, the South African statute arguably permits a higher rate of recovery for the creditor before intervention because 'prejudice' has been defined in such a broad fashion in *Van Staden*¹³⁴ to extend well beyond the common law's 'financial and commercial' interests and the calculation/analysis is done ex post when the full ramifications of breach are known and damages can be accurately concluded rather than at the ex ante stage.

This Chapter establishes that the South African statute will not enforce a contractual stipulation payable upon breach of contract where it is out of all proportion to the prejudice suffered by the creditor. This formulation is very close to the common law test in *Cavendish* and *Paciocco*. Consistent with the position at common law, South African courts will not enforce contractual stipulations that aim to punish the debtor. The fundamental difference between the two approaches is the South African power to reduce excessive stipulations. However, in Australia, *Andrews* permits partial enforcement or scaling down of stipulated sums found to be penalties in equity. In that circumstance, the level of reduction is to the level of recoverable loss and damage. Such a constraint does not apply in South Africa.

Continuing the comparative analysis, Chapter 8 analyses the significant law reform initiatives that have been proposed for Scotland where a Bill was drafted and circulated for consultation by interested stakeholders.

¹³⁴ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352.

Chapter 8

Scottish Reform Proposals for Penalty Clauses and Some Comparisons with the Common Law

8.1 Introduction

This Chapter is the second of three chapters designed to provide the comparative perspective for the thesis. The recent Scottish law reform proposal for penalty clauses has been selected for analysis because it is an extensive law reform process for the Scottish mixed legal system applying the English common law penalty doctrine. The relevance of this analysis has been enhanced because the reform initiatives have considered the historical development of the penalty doctrine analysed in chapter 2; recent changes to the common law position by the decisions in *Andrews*, *Cavendish* and *Paciocco* analysed in chapters 3, 4 and 5; the *Conventional Penalties Act 1962* (South Africa) analysed in Chapter 7; and the Draft Common Frame of Reference 2009 ('DCFR') which will be analysed in Chapter 9.

In December 1997 the Scottish Law Commission (the 'Commission') published a Discussion Paper on Penalty Clauses.¹ This was the commencement of an extensive review process of the penalty doctrine on a broad scale and not just a survey of Scottish and English approaches. Whilst this process was underway, there have been developments in the common law and in particular, the decisions in *Andrews*, *Cavendish* and *Paciocco* which have affected the proposed reform process and led to a reassessment of its present direction and potential outcome. *Andrews* was criticised in *Cavendish*² as 'a radical departure from the previous understanding of the law'. The Commission has given these decisions, in particular, further consideration in a later discussion paper³ and its final reports.⁴ *Cavendish* and *Paciocco* provide greater certainty that a sum stipulated will in the future be enforced given that the reformulated test for penalties at common law takes into account the legitimate interests of the non-breaching party in performance of the contract. The enhanced certainty brought to the common law by these decisions has, for the present halted the law reform process with the Commission deferring any further work on this reform initiative until such time as the courts have had an opportunity to apply and interpret *Cavendish*.⁵

This Chapter is divided into four Parts. Part I provides an introduction to the law reform process undertaken in Scotland. Part II analyses the draft Penalty Clauses (Scotland) Bill 2010 (Scot) (the 'Bill'). The approach adopted in the Bill maintains the theme which runs throughout this thesis with the rationale for the penalty doctrine incorporating stipulations which aim to punish are not be enforced. Part III considers criticisms of the

¹ Scottish Law Commission, *Discussion Paper on Penalty Clauses*, Discussion Paper No 103 (1997) ('1997 Discussion Paper').

² *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1207–8 [41].

³ Scottish Law Commission, *Review of Contract Law: Discussion Paper on Penalty Clauses*, Discussion Paper No 162 (2016) ('2016 Discussion Paper').

⁴ Scottish Law Commission, *Report on Penalty Clauses*, Report No 171 (1999) ('1999 Report on Penalty Clauses'); Scottish Law Commission, *Report on Review of Contract Law: Formation, Interpretation, Remedies for Breach and Penalty Clauses*, Report No 252 ('2018 Report on Review of Contract Law').

⁵ See, for example, in England: *First Personnel Services Limited v Halford's Limited* [2016] EWHC 3220 (Ch) (20 December 2016); *Vivienne Westwood Ltd v Conduit Street Developments Ltd* [2017] EWHC 350 (Ch) (27 February 2017); in Scotland: *Gray v Braid Group (Holdings) Ltd* 2017 SC 409 ('Gray').

Bill including matters raised in the 2016 Discussion Paper⁶ which took into account changes to the common law arising from the decisions in *Andrews*, *Cavendish* and *Paciocco*. Part IV concludes that the changes to the common law, brought about by *Cavendish* in particular have been significant enough to halt the reform process at present.

PART I

8.2 Characteristics of the Scottish Legal System

Scotland operates as a mixed legal system combining features of both the common law and civil law. English influence on the development of the law of contract in Scotland has been substantial, and English decisions have been relied upon extensively by the Scottish Courts. However, Scots contract law retains various features which are consistent with its civil law heritage eg: its recognition of unilateral obligations⁷ and the absence of a requirement for consideration in contract formation.⁸ In Scots law, there is no recognition of the separation between the rules of law and equity in the Australian and English sense.⁹ In the modern law of Scotland, the penalty doctrine is an aspect of the law of contract.¹⁰

Consistently with English Law, it is a requirement of the penalty doctrine operating in Scotland that there is a breach of contract.¹¹ Lord Dunedin's four propositions have,¹² until recently, applied to situations where stipulated sums have been challenged on the ground they constitute a penalty.¹³ The common law in England and Scotland changed with the UK Supreme Court decision in *Cavendish*,¹⁴ which was analysed in chapter 4.

The judgment in *Cavendish*,¹⁵ and in particular Lord Hodge (a Scot), directly considered the case on appeal from a Scots law perspective including the treatment of stipulated sum clauses and the penalty doctrine. Lord Hodge confirmed the penalty doctrine is essentially the same in England and Scotland.¹⁶ His judgment

⁶ See 2016 Discussion Paper, above n 3.

⁷ 'Scots law will enforce a unilateral undertaking that is intended to have legal effect, notwithstanding an absence of consideration. Such an undertaking may, but need not be, collateral to a separate contract, and will be subject to an objective test, ie: that which a reasonable outside observer would infer from all the circumstances': *Royal Bank of Scotland v Carlyle* [2015] UKSC 13 (11 March 2015) [35].

⁸ Elspeth Reid, 'Scotland' in Vernon Valentine Palmer (ed), *Mixed Jurisdictions Worldwide: The Third Legal Family* (Cambridge University Press, 2nd ed, 2012) 216, 254–5; Martin Hogg, *Promises and Contract Law: Comparative Perspectives* (Cambridge University Press, 2011) 276.

⁹ Reid, above n 8, 216–48.

¹⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1208–9 [42].

¹¹ *Granor Finance Ltd v Liquidator of Eastore Ltd* 1974 SLT 296.

¹² *Dunlop Pneumatic Tyre Co, Ltd v New Garage and Motor Co, Ltd* [1915] AC 79; 1997 Discussion Paper, above n 1, 10–11; 1999 Report on Penalty Clauses, above n 4; Hogg, above n 8, 400–1.

¹³ *City Inn Ltd v Shepherd Construction Ltd* [2003] BLR 468, 473 [16]. See also *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1276–7 [251]–[252], 1283–4 [283] where Lord Hodge noted that in Scots law, by contrast with English law, the Scottish Courts are authorised to modify or abate penalties imposed for non-payment over and above performance contained in bonds or other obligations for sums of money in terms of the *Debts Securities (Scotland) Act 1856* (UK), 19 & 20 Vict, c 91.

¹⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172.

¹⁵ *Ibid* 1266–85 [215]–[290]; 2016 Discussion Paper, above n 3, 2–3 [1.7].

¹⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1276–8 [251]–[254]. Lord Hodge pointed out at 1277–8 [252] that the Scottish courts have statutory power to modify or abate a penalty pursuant to the *Debts Securities (Scotland) Act 1856* (UK), 19 & 20 Vict, c 91, s 5, which gives the Scottish courts authority to modify and restrict penalties imposed for non-payment, over and above performance, contained in bonds and other obligations for

is highly persuasive, if not authoritative, in the Scottish courts. It has already been applied by the Court of Session in *Gray v Braid Group (Holdings) Ltd*.¹⁷

As the common law in Scotland and England has developed in a similar fashion, *Cavendish* is shown to have a material influence in Scotland. In particular, in *Gray*, Lords Menzies¹⁸ and Brodie¹⁹ specifically referred to the judgment of Lord Hodge in *Cavendish*, and Lord Malcolm²⁰ held the reasoning ‘can be applied to the circumstances of the present case’.

8.3 The Scottish Law Commission Discussion Papers and Reports

Law reform organisations in California, England, Ontario and Victoria (Australia) published reports which have examined, reported on and made recommendations regarding the treatment of contractual stipulations payable upon breach of contract.²¹ None of them has been as thorough or as extensive as the Scots project referring to the DCFR²² as a yardstick against which to measure its research and recommendations.²³ The DCFR has had a significant impact on the approach the Commission has taken to law reform in Scotland.²⁴ Lord Mance has said:

Whatever the future holds for the DCFR, it will be a source of law. It is available to deepen knowledge of European private law and will be a source of inspiration and reference for European and national legislators, as well as the European Court of Justice and national courts when tasked with resolving a novel or difficult question in the fields of private law covered by the DCFR.²⁵

Following a rigorous process of investigation, the Commission published the 1997 Discussion Paper, the 1999 Report on Penalty Clauses in which it proposed significant statutory reform and included the Bill as an annexure, the 2016 Discussion Paper on Penalty Clauses and the 2018 Report on Review of Contract Law. The Commission identified Lord Dunedin’s four propositions in *Dunlop* as problematic for two major reasons.

sums of money. The statutory power does not extend to a penalty in support of a primary obligation other than for payment of a sum of money. See also *Wirral Borough Council v Curry's Group Plc* 1998 SLT 463, 476 where Lord Hamilton confirmed that the statutory power to modify extends to money obligations other than bonds.

¹⁷ *Gray v Braid Group (Holdings) Ltd* 2017 SC 409, 444–6 [106]–[112].

¹⁸ *Ibid* 422–3 [28], 437–8 [83].

¹⁹ *Ibid* 444–5 [106], 445 [108].

²⁰ *Ibid* 450 [125].

²¹ California Law Revision Commission, *Recommendation and Study Relating to Liquidated Damages*, Publication No 104 (1973); Law Commission, *Penalty Clauses and Forfeiture of Monies Paid*, Working Paper No 61 (1975); Ontario Law Reform Commission, *Report on Amendment of the Law of Contract* (1987) ch 7; Law Reform Commission of Victoria, *Liquidated Damages and Penalties*, Discussion Paper No 10 (1988).

²² The Draft Common Frame of Reference (‘DCFR’) was produced by a European study group in 2009 as a draft for the codification of the whole of European contract law and related fields of law.

²³ See DCFR art III–3:712, ‘Stipulated Payment for Non-performance’, see Appendix G.

²⁴ The Scottish Law Commission has a large long-term project entitled ‘Contract Law in Light of the Draft Common Frame of Reference’ on which it has and continues to produce papers on different topics. See, eg, Scottish Law Commission, *Review of Contract Law: Discussion Paper on Interpretation of Contracts*, Discussion Paper No 147 (2011); Scottish Law Commission, *Review of Contract Law: Discussion Paper on Formation of Contract*, Discussion Paper No 154 (2012); Scottish Law Commission, *Review of Contract Law: Third Party Rights in Contract*, Discussion Paper No 157 (2014); Scottish Law Commission, *Review of Contract Law, Report on Formation of Contract: Execution of Counterpart*, Report No 231 (2013); Scottish Law Commission, *Review of Contract Law, Report on Third Party Rights*, Report No 245 (2016).

²⁵ Lorna Richardson, ‘The DCFR, Anyone?’ (2014) *The Journal of the Law Society of Scotland* (online), 20 January 2014 <<http://www.journalonline.co.uk/Magazine/59-1/1013494.aspx>>, citing Lord Jonathan Mance, ‘The Common Frame of Reference’ [2010] *Zeitschrift für Europäisches Privatrecht*, 457, 457–62. The DCFR was referred to favourably in the opinion of Lord Malcolm in *Wills v Strategic Procurement (UK) Ltd* 2016 SC 367, 371–2 [10].

In the first instance, Lord Dunedin's formulation was difficult to apply, and unrealistic in situations where it is not possible to estimate damages in advance. Further, when applied, it could lead to legitimate and reasonable agreed damages clauses being held to be unenforceable. Yet, as Lord Dunedin observed in *Dunlop*²⁶ in proposition 4(d),²⁷ it is just such cases when liquidated damages clauses are necessary and should be enforced. The theoretical conundrum is whether a stipulated sum can be found to be a genuine pre-estimate of damage in circumstances where factually a genuine pre-estimate is not possible.²⁸ An example of the problem is found in government contracts.²⁹

In *Clydebank*,³⁰ a Scottish appeal to the House of Lords, Scottish shipbuilders contracted with the Spanish government to deliver torpedo boats to the Spanish Navy during the second war for Cuban independence.³¹ In breach of the contract, the vessels were delivered late. The contract contained a stipulation requiring payment of £500 per week per boat for delayed delivery. The stipulation was challenged as a penalty on the basis it was not possible to make a genuine pre-estimate of the loss that would be suffered by the Spanish government given the military, non-commercial nature of the vessels and the use to which they would be put. The efficacy of the clause was upheld by the House of Lords.

The Earl of Halsbury LC considered proving the damages suffered by the Spanish government due to the late delivery of the vessels was a problem. He said:³² 'It is obvious on the face of it that the very thing intended to be provided against by this pactional³³ amount of damages is to avoid that kind of minute and somewhat difficult and complex system of examination which would be necessary if you were to attempt to prove the damage.'

At the time of contracting, it would not have been possible to pre-estimate the damages that might have been incurred by the Spanish government from delayed delivery of the vessels. In that circumstance, the stipulation provided the solution for the predictable difficulties of assessing damages for delay in breach of a government contract, as well as a recognition that it represented an incentive for timely performance of the contract by the shipbuilder.³⁴

In the second instance, the Commission reported the *Dunlop* formulation was a problem because a court could only find a stipulation to be unenforceable if there had been a breach of contract,³⁵ and not where one party exercised a contractual option to perform, in one way rather than another, or where a contract had been terminated early under its terms.³⁶ This criticism of the *Dunlop* formulation was not new as it had been raised in 1975 by the Law Commission (England) which had recommended in its Working Paper No 61 that

²⁶ *Dunlop Pneumatic Tyre Co, Ltd v New Garage and Motor Co, Ltd* [1915] AC 79, 87–8 at proposition 4(d).

²⁷ See Chapter 2 at [2.2.1] above.

²⁸ 1999 *Report on Penalty Clauses*, above n 4, 7 [2.9]–[2.10].

²⁹ Nicholas Seddon, *Government Contracts: Federal, State and Local* (Federation Press, 6th ed, 2018) 12–15 [1.7].

³⁰ *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 11–13.

³¹ 1895–1902.

³² *Clydebank Engineering and Shipbuilding Co Ltd v Yzquierdo y Castaneda* [1905] AC 6, 11–13.

³³ '[O]f, pertaining to, or of the nature of a pact or covenant': J A Simpson and E S C Weiner (eds), *The Oxford English Dictionary* (Clarendon Press, 2nd ed, 1989) vol XI, 47.

³⁴ 2016 *Discussion Paper*, above n 3, 9 [2.7].

³⁵ *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399; *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; see also Law Reform Commission of Victoria, above n 21, 3.

³⁶ 1999 *Report on Penalty Clauses*, above n 4, 12–14.

control over penalty clauses should be extended to cases beyond breach of contract.³⁷ It is to be noted that at the date of this Working Paper (ie: 1975), the law in England, and hence Scotland, was that breach of contract was a necessary prerequisite for operation of the penalty doctrine. For Australian conditions, this had changed with the decision in *Andrews* but any prospect this extension of the penalty doctrine in equity to relieve against penalty clauses in the absence of a breach of contract may come to represent the law in Scotland or England was ended by the *Cavendish* decision in 2016 which repudiated the *Andrews* extension to the penalty doctrine.

The Commission's 1997 Discussion Paper and the 1999 Report on Penalty Clauses concluded that the English common law penalty doctrine as applied in Scotland required reform for a number of reasons, including:

- i) the *Dunlop* formulation could lead to legitimate and reasonable stipulations being unenforceable;³⁸
- ii) the *Dunlop* formulation was difficult to apply and unrealistic where it was not possible to pre-estimate damages; and
- iii) the existing law failed to allow for any judicial control over exorbitant clauses which were the functional equivalent of penalty clauses but which were drafted so they came into operation on the happening of some event other than a breach of contract.³⁹

PART II

8.4 Penalty Clauses (Scotland) Bill 2010 (Scot)

When the Commission published the 1999 Report on Penalty Clauses it included the Bill as Annexure A to the Report.⁴⁰ In 2010, the Scottish Government distributed the Bill for consultation by stakeholders⁴¹ with the aim that this process would better inform the content of the Bill going forward. Consultees were asked to express their views on the content of the Bill and in particular, to provide commentary on the following questions:

- are the benefits to business from clarifying the law in this area significant;
- are any negative consequences foreseen from making all future penalty clauses enforceable subject to the safeguard of judicial control;
- does the way in which the Bill is framed raise any concerns; and
- what, if any, costs does the Bill impose?

The Bill proposed significant changes to Scots law. It is an important initiative on the basis it proposed the following:

³⁷ Law Commission, above n 21, 16–18, where a range of hire purchase cases are analysed.

³⁸ *1997 Discussion Paper*, above n 1, 24–32; *1999 Report on Penalty Clauses*, above n 4, 7.

³⁹ *1999 Report on Penalty Clauses*, above n 4, 7–8.

⁴⁰ The text of the draft Bill is set out in Appendix B.

⁴¹ A list of the consultees is provided in Annexure C to the *1999 Report on Penalty Clauses*, above n 4.

- i) 'manifestly excessive' stipulations will not be enforced.⁴² This is broadly consistent with the English and Australian common law approach,⁴³ and the rationale for the penalty doctrine that stipulations which aim to punish the breaching party will not be enforced;
- ii) a definition of 'penalty'⁴⁴ extending beyond the payment of money⁴⁵ and capturing 'any kind of forfeiture or an obligation to transfer'. This is consistent with the English and Australian common law approach;⁴⁶ and
- iii) providing the court with a discretion 'if it thinks fit' to modify 'manifestly excessive' penalties to make the penalty clause enforceable.⁴⁷ This is consistent with the approach adopted in most civil law systems,⁴⁸ art III–3.712 of the DCFR and other international instruments which will be considered in Chapter 9.⁴⁹ No discretion is permitted in the common law systems operating in Australia and England to reduce stipulations enlivened by a breach of contract. In Australia, since *Andrews*, equitable relief against penalties is permitted in circumstances where there has been no breach of contract, but there has been a failure of the primary stipulation. In that circumstance, the court is permitted to partially enforce or 'scale down' the stipulated sum to the extent of recoverable loss.

Following circulation of the Bill for consultation in July 2010,⁵⁰ the opinions and suggestions obtained from the process were subsequently analysed and used as part of the 2016 Discussion Paper.⁵¹

The Bill heralds a new beginning for reform of the treatment of penalty clauses in Scotland. It adopts much from civil law systems and goes further as it is more expansive than the common law in Australia and England. The Bill is a timely and highly relevant statutory law reform initiative being advocated at a time when the common law in England is undergoing significant change.

Figure 2 sets out a summary of the key features of the Bill.

⁴² See s 1(1) of the Bill in Appendix B.

⁴³ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

⁴⁴ See s 1(3) of the Bill in Appendix B.

⁴⁵ Extended in the sense that it goes beyond what is provided in DCFR art III–3.712 which deals with 'stipulated payment for non-performance' and is limited to the payment of money.

⁴⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

⁴⁷ See s 4 of the Bill in Appendix B.

⁴⁸ See Pascal Hachem, *Agreed Sums Payable upon Breach of an Obligation* (Eleven International Publishing, 2011) 30–3.

⁴⁹ See UNIDROIT Principles of International Commercial Contracts art 7.4.13 ('UPICC'); Principles of European Contract Law art 9:509 ('PECL'), all examined in Chapter 9.

⁵⁰ Scottish Government, 'Consultation on Penalty Clauses (Scotland) Bill' (Consultation Paper, Scottish Government, 8 July 2010) annex A ('Penalty Clauses (Scotland) Bill 2010').

⁵¹ *2016 Discussion Paper*, above n 3.

FIGURE 2: SUMMARY OF THE KEY FEATURES OF THE PENALTY CLAUSES (SCOTLAND) BILL 2010 (SCOT)

Definition of 'penalty'	Broad. Covers payment of money, forfeiture or an obligation to transfer (s 1(3)).
Breach of contract	Breach or early termination of the contract (s 1(3)).
No breach of contract/equity	Failure to do, or to do in a particular way, something provided for in the contract (s 1(3)).
Modification	<ul style="list-style-type: none"> • Discretion to modify stipulations that are 'manifestly excessive' (s 4(1)) to make the clause enforceable. • Penalty can be modified down but not up.
Unenforceable	Penalty clause is unenforceable if it is manifestly excessive (s 1(1)).
Liquidated damages v penalty dichotomy	No.
Ex post facto approach	All circumstances which appear relevant are to be taken into account and may include circumstances arising after the contract was entered into (s 1(4)).
Manifest excess	Yes (s 1(1)).
Can you contract out?	No (s 3).

Analysis of the operation of some key provisions in the Bill follows.

8.4.1 Section 1: 'Manifest Excess' and the Extended Definition of 'Penalty' and 'Penalty Clause'

Section 1(1) provides 'a penalty clause in a contract is unenforceable in a particular case if the penalty for which the clause provides is manifestly excessive (whether or not having regard to any loss suffered) in that case'. In the Explanatory Notes to the Bill,⁵² the words in parentheses above are said to have been included to make it clear that, in assessing whether a penalty is manifestly excessive and it is not necessary to compare the amount or value of the stipulated sum with the amount of loss suffered by the non-breaching party. This is reflective of the mechanical approach which was adopted at common law in Australia and England considered in chapter 2⁵³ on the basis that penalty clauses are often used where loss is impossible or very difficult to quantify or where damages would not be an adequate remedy. This is the situation contemplated by Lord Dunedin's proposition 4(d).

Section 1(1) presupposes contractual stipulations are in the first instance valid and enforceable. This is consistent with the approach adopted in the South African statute and in the international instruments⁵⁴ and in particular, art III-3.712 of the DCFR. The question of enforcement only arise if the clause stipulates for a 'manifestly excessive' payment. This approach is consistent with the common law in Australia and England which recognises that stipulations which are out of all proportion are not enforced.

'Penalty clause' means a clause 'in whatever form, the substance of which is that a penalty is incurred in the event of breach of, or early termination of, the contract or a failure to do, or to do in a particular way,

⁵² 1999 *Report on Penalty Clauses*, above n 4, 33.

⁵³ See Chapter 2 at [2.2.3.1].

⁵⁴ See Chapters 7 and 9.

something provided for in the contract'. The definition is in the widest terms and is consistent with the common law approach in Australia and England. It is not limited only to the payment of money, as it differs from the DCFR and other international instruments which only apply to payments of a 'specified sum' where there has been non-performance.⁵⁵

Section 1(3) provides a breach of contract is not required to engage the Bill. This is a significant divergence from the English common law position⁵⁶ presently adopted in Scotland and the DCFR, but is consistent with the Australian position in *Andrews*. The drafting in s 1(3) captures conduct where the breaching party fails to perform or fails to perform in a particular way under a contract or where there is an early termination of the contract, includes forfeiture of money and property⁵⁷ and drafting also seeks to capture those contracts which allow a party the option of choosing between different ways of performing, one or more of which attracts penal consequences: for example, provisions in a construction contract with a fixed completion date providing for payment of a bonus for early completion, and a price reduction for late completion.⁵⁸

8.4.2 Why Has the Breach Limitation Requirement Been Removed?

The Commission considered whether the breach limitation should be removed as a precondition for application of the penalty doctrine, on the basis that its retention had led to unjust results, particularly in a number of hire purchase cases.⁵⁹ An example of a Scottish decision where this unfortunate circumstance⁶⁰ arose was *Mercantile Credit Co Ltd v McLachlan*.⁶¹ McLachlan hired a car under a hire purchase agreement with a finance company. The 'hire purchase price' was £404,⁶² and a deposit of £110 was paid.

The hire purchase agreement provided:

Clause 1 ... the hirer (McLachlan) agreed to pay to the owners (financier) by way of depreciation a sum equal to two thirds of the hire purchase price (ie: £404 x 2/3 = £269), the initial payment to be applied in reduction thereof ... and to pay punctually the specified monthly instalments, one half of which shall be applied in reduction of said depreciation money PROVIDED ALWAYS that if the hiring shall be terminated by either party for any cause whatsoever then the whole of the said depreciation money still unpaid shall become due and payable by the hirer forthwith ...

Clause 4 ... the hirer may terminate the hiring by returning the goods to the owners, paying the balance of depreciation money then still unpaid and all other sums due; he is to remain liable for charges for any breach which he may have committed before the return, and for a sum equal to the estimate cost of putting the goods into good repair ...

⁵⁵ UPICC art 7.4.13; PECL art 9:509; DCFR art III-3.712, all examined in Chapter 9.

⁵⁶ In *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, the UK Supreme Court recently confirmed the importance of retaining the breach requirement. The position is the same in Australia; however, a jurisdiction has developed in equity whereby the penalty doctrine applies in circumstances where there has been no breach of contract.

⁵⁷ 1999 Report on Penalty Clauses, above n 4, 13.

⁵⁸ 2016 Discussion Paper, above n 3, 54.

⁵⁹ See Law Commission, above n 21, 12–18 for an example from an English hire purchase case; 1999 Report on Penalty Clauses, above n 4, 12–14.

⁶⁰ Described by Lord Denning as an 'absurd paradox' in *Bridge v Campbell Discount Co Ltd* [1962] AC 600, 629.

⁶¹ 1962 SLT 58.

⁶² Made up of the cash value of the car £325, plus insurance £30 (total cash price = £355) plus hire purchase charges of £49.

McLachlan terminated the agreement and the financier sued for recovery of sums due under the agreement in the name of 'depreciation money' for the amount was £116. McLachlan denied liability to pay 'depreciation money' on the basis that the amount claimed was a penalty and not a genuine pre-estimate of the financier's loss.

The court held that the 'depreciation money' claimed by the financier was not a penalty because questions of 'penalty' or 'pre-estimates of damage' arise only where damages are being claimed for a breach of contract. If McLachlan was exercising an option on condition of payment, then she was required to comply with such a condition. Thus the court reluctantly found for the financier and held that, in the circumstances, the decision 'may well put a premium on dishonesty. The hirer who honestly admits he cannot keep up payments and terminates his agreement may have to pay a penalty; whereas his less reputable neighbour, who simply goes on failing to pay the instalments until the finance company is forced to take action may escape'.⁶³ Harman LJ had expressed a similar sentiment in the English Court of Appeal decision in *Campbell Discount Co Ltd v Bridge*.⁶⁴

This 'absurd paradox'⁶⁵ could be avoided due to the broad definition of 'penalty' in s 1(3) which is not dependent on a breach of contract. Thus if the Bill were to become law, the 'depreciation money' would be found to be manifestly excessive and, pursuant to s 4, the Court would be empowered to modify the stipulated sum down to a reasonable amount to make the clause enforceable.

Additionally if the Commission considered if there was general scope for avoiding the penalty doctrine by careful contract drafting, for example, instead of providing for one method of performance with a sum stipulated as payable upon breach, the drafter could provide options for performing in different ways, some of which may attract heavy penal consequences.⁶⁶ Accordingly, the Commission decided that the breach limitation should be removed from the reform initiatives drafted into the Bill.

8.4.3 Section 4(1): Modification of the Stipulated Amount If Manifestly Excessive

Section 4(1) provides that where a court determines a sum stipulated is manifestly excessive then on application it may, if it thinks fit, modify the penalty to make the clause enforceable. The expression 'manifestly excessive' was derived from art 7 of the Council of Europe *Resolution (78)3 Relating to Penal Clauses in Civil Law* ('*Resolution (78)3*') which will be considered in Chapter 9, and is referred to in the 1997 Discussion Paper and the 1999 Report on Penalty Clauses as having informed the Commission's recommendations.⁶⁷ Article 7 of *Resolution (78)3* provides a stipulated sum may be reduced by the court

⁶³ *Mercantile Credit Co Ltd v McLachlan* 1962 SLT 58, 59.

⁶⁴ *Campbell Discount Co Ltd v Bridge* [1961] 1 QB 445, 458. The decision of the Court of Appeal was set aside by the House of Lords: see *Bridge v Campbell Discount Co Ltd* [1962] AC 600. At 635 it is noted by the House of Lords that the case was remitted to the County Court judge to assess the damages which the hire purchase company had sustained. It proved that it had spent £29.10 on repairs to the car and then sold it for £101.15. The judge found that the company failed to take reasonable steps to realise the best price for the car and that 'the sum which the vehicle might reasonably have been expected to realise when it was delivered up' was £275. He assessed the company's damages at £30 saying that: 'The major portion of their loss flows, not from the defendant's breach, but from their neglect to take reasonable steps to realise the best price for the vehicle': at 635.

⁶⁵ See *Bridge v Campbell Discount Co Ltd* [1962] AC 600, 629 (Lord Denning).

⁶⁶ *1999 Report on Penalty Clauses*, above n 4, 12–14.

⁶⁷ See Council of Europe, Committee of Ministers, *Resolution 78(3) relating to Penal Clauses in Civil Law* (20 January 1978) <https://search.coe.int/cm/Pages/result_details.aspx?ObjectID=0900001680505599>; Council of Europe,

when it is ‘manifestly excessive’.⁶⁸ It was a forerunner to the development of the DCFR and other international instruments which use the expressions ‘grossly excessive’ and ‘reduction’.⁶⁹ The expression ‘grossly’ was rejected by the Commission because it was thought to invite an element of moral judgment, whereas ‘manifestly’ suggests a more dispassionate and objective approach.⁷⁰

To determine ‘manifest excess’, s 1(4) provides that ‘all circumstances which appear relevant are to be taken into account; and such circumstances may include circumstances arising after the contract is entered into’. This is the ex post approach which has been adopted by art III–3.712 of the DCFR whereby Australia and England follow the ex ante approach provided for in Lord Dunedin’s proposition 3,⁷¹ also confirmed in *Cavendish* and *Paciocco* and representing the current law in Scotland. ‘Manifestly excessive’ is a high threshold and one that will not lightly be found. This is consistent with the approach adopted by recent international instruments including the DCFR.⁷² The discretion to modify the penalty is not one which would strike the clause down altogether; nor does it amount to a discretion to render the clause wholly unenforceable. In effect, the discretion permits the court to rewrite the stipulated sum and ‘scale it down’ to arrive at what it considers to be an enforceable amount, alternatively s 4(1) permits partial enforcement of the stipulation. That portion of the stipulated sum not ‘manifestly excessive’ will be enforced, and that portion which is a penalty because it is ‘manifestly excessive’ will not be enforced. This is, in effect, what the High Court provided in *Andrews*⁷³ for situations where there has been failure of a primary obligation and the penalty rule can be engaged in equity. However, the limitation that the stipulation is scaled down to the amount of recoverable loss is not provided in the Bill.

The question arises as to what is the appropriate level of the reduction. Must it relate to the amount of the sum that represents mathematically the amount of the ‘manifest’ part of the excess or is the reduction related to some other consideration? Thus the issue is in the exercise of the judicial reduction process, whether the amount by which the penalty sum is to be reduced is to represent the sum that equates to actual loss and damage assessed for breach of contract. Further it is noted that this is not a relevant constraint in Australia and England.⁷⁴

Explanatory Memorandum: Resolution 78(3) relating to Penal Clauses in Civil Law (20 January 1978) 20–22 <<https://rm.coe.int/09000016804d1a18>> (*Resolution 78(3) Explanatory Memorandum*), see Appendix D; see also 1997 *Discussion Paper*, above n 1, 45–7; 1999 *Report on Penalty Clauses*, above n 4, 22–4.

⁶⁸ *Resolution (78)3* had been produced with the aim of recommending a uniform application of penalty clauses for use by member states within Europe. See Appendix D.

⁶⁹ 2016 *Discussion Paper*, above n 3, 23 [3.7]. The expression ‘grossly excessive’ is used, for example, in the Contract Codes of Algeria, Bahrain, Cambodia, Egypt, Libya, Kuwait, Qatar, Syria and Yemen. See in this regard Hachem, above n 48, 127.

⁷⁰ 2016 *Discussion Paper*, above n 3, 10 [2.9].

⁷¹ See Chapter 2 at [2.2.1] above.

⁷² See DCFR art III–3.712; UPICC art 7.4.13; PECL art 9:509. Note also that this is consistent with the South African approach which permits judicial ‘reduction’ (rather than ‘modification’) of the penalty to an amount that compensates the non-breaching party for the ‘prejudice suffered by reason of the breach’. See *Conventional Penalties Act 1962* (South Africa) s 3. Note that the full text of the Bill was an appendix to the 1997 *Discussion Paper*, above n 1, 50–1.

⁷³ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

⁷⁴ However, note that in Australia following the decision in *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 if there is no breach of contract and the penalty doctrine in equity applies then the court can partially enforce the stipulation to the extent of proven loss rather than rendering it unenforceable and leaving the non-breaching party to recover what it can prove as actual loss and damage. In *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 556 [65], 579 [161] the High Court held that the amount recoverable as damages at common law was not a relevant consideration.

The Explanatory Note to the Bill⁷⁵ for s 4 provides assistance and advises modification equal to recoverable loss is 'inappropriate' for two reasons:

- i) the intent of the Bill is to remove the common law 'genuine pre-estimate' test, and replace it with a rule which provided that a penalty clause is enforceable unless it is 'manifestly excessive'. In this circumstance, there should be no reason in principle why a court should not have the power to modify a 'manifestly excessive' penalty to an amount that removes the 'manifest excess', but which is more than the actual loss suffered. This supports the position that the reduction relates to the 'manifest' component of excess of the penalty sum as what would be enforced could still be 'excessive' but not manifestly so and it would be more than the loss actually suffered. This is consistent with DCFR art III-3.712 at Comment B, which notes that the reduction is to be to an 'intermediate figure';⁷⁶
- ii) the definition of 'penalty' is extended by the Bill to instances where there has been no breach of contract. In this circumstance, damages for breach of contract do not arise. The judicial discretion to reduce manifestly excessive penalties should thus be one which operates in a way making the clause enforceable as if this were not so, then the non-breaching party could be left without a remedy.

8.4.4 Why Is the Discretion to Modify Advantageous?

The Commission reported⁷⁷ the discretion to modify stipulations which are 'manifestly excessive' is advantageous to both contracting parties because it enables the court to facilitate the enforcement of the parties' original agreement as near as possible. This is to be contrasted with Australia and England where penalty stipulations are unenforceable and not generally subject to modification.⁷⁸ The discretion to modify penalty clauses in circumstances of manifest excess provides the court with the ability to enforce contractual stipulations in a fair and flexible way and thereby facilitates the achievement of the objective of the stipulation which is to fix inter partes the amount of damages payable consequent upon breach of contract. Fairness is achieved by the reduction being limited to removal of the 'manifest' component of the excessive amount of the stipulated sum.

The capacity of the Court to exercise the discretion fairly and in a flexible manner is provided in s 4(1) and further by the power provided to the court in s 4(2) to impose conditions. The Explanatory Note to the Bill⁷⁹ provided two examples. Firstly, the non-breaching party seeking to enforce a forfeiture of property might be required to provide reasonable compensation to the breaching party for improvements made to a property and secondly, the non-breaching party seeking to enforce a stipulation might be required to allow the breaching party an opportunity to remedy the breach of contract.

It can be noted that a discretion to modify would be useful, if not essential, in those cases where no claim for damages exists such as where the stipulated sum is not payable in respect of a breach of contract, or where the sum has been agreed to precisely on the basis that damages would be difficult or impossible to

⁷⁵ 1999 Report on Penalty Clauses, above n 4, 34.

⁷⁶ See Appendix G.

⁷⁷ 1999 Report on Penalty Clauses, above n 4, 22-4.

⁷⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 permits the court to partially enforce a stipulation found to be a penalty when exercising an equitable jurisdiction in circumstances where there has been no breach.

⁷⁹ 1999 Report on Penalty Clauses, above n 4, 34.

quantify.⁸⁰

8.4.5 'Manifestly Excessive' Sum May Be Modified Down

Various legal systems use different expressions to describe excess, for example, 'manifestly disproportionate', 'grossly excessive', 'excessive', 'unreasonable' or 'oppressive'.⁸¹ 'Manifestly excessive' is the descriptor applied in s 4 where the penalty is the payment of money. In that situation, the stipulated sum may be modified (by reduction) but not increased because that is the only way 'manifestly excessive' sums can be treated.

To the extent the stipulation provides for the payment of money, modification of the stipulated sum should be a straightforward exercise. However, where the stipulation provides an obligation to transfer property or a forfeiture of a right to money or property as referred to in s 1(3), then the modification process may be more complex.⁸²

The discretion to modify a stipulation is an interference with freedom of contract which lies at the root of the whole of contract law.⁸³ Accordingly, a restrictive approach should be followed and a high threshold for excessiveness needs to be maintained otherwise expression other than 'manifestly' such as 'excessive' could be used. The word 'manifest' suggests that the level of excess needs to be 'extortionate'.⁸⁴ and on this basis the Commission⁸⁵ reported that 'manifest' suggests that 'the excessive nature of the penalty should be immediately obvious to anyone considering it and it should not be a matter of calculation.' The notion that modification is the exception is made clear by the requirement in s 4 that the stipulation must first be found to be 'manifestly excessive' and in the absence of manifest excess there will be no ground for the court to exercise the discretion to reduce.

8.4.6 Relevant Circumstances for Modification

Other than what is provided in s 1(4), there is a lack of guidelines to assist the court with the exercise of the discretion to modify 'manifestly excessive' stipulations to an enforceable level. This is consistent with European systems where most of the legislative provisions permitting modification are 'extraordinarily vague'.⁸⁶ However, s 1(4) states that 'all circumstances which appear relevant', including 'circumstances

⁸⁰ 1997 Discussion Paper, above n 1, 22–4.

⁸¹ Hachem, above n 48, 127–8.

⁸² See, eg, *Jobson v Johnson* [1989] 1 WLR 1026 where the court crafted a remedy to achieve a fair commercial result in a dispute about a share sale agreement.

⁸³ See *Printing and Numerical Registering Co v Sampson* (1875) LR 19 Eq 462, 465 (Jessel MR):

If there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts where entered into freely and voluntarily shall be held sacred and shall be enforced by the courts of justice. Therefore, you have this paramount public policy to consider — that you are not lightly to interfere with this freedom of contract.

See also Roger Brownsword, 'General Considerations' in Michael Furmston (ed), *The Law of Contract* (LexisNexis, 6th ed, 2017) 1, 28–48 [1.37]–[1.56]; *Lloyds TSB Foundation for Scotland v Lloyds Banking Group Plc* [2013] 1 WLR 366, 382 [47]; *Seven Network (Operations) Ltd v Warburton [No 2]* (2011) 206 IR 450, 454–5 [3].

⁸⁴ 1999 Report on Penalty Clauses, above n 4, 21 [6.8].

⁸⁵ *Ibid* 10 [3.8]; 2016 Discussion Paper, above n 3, 9 [2.8]; *Resolution (78)3* art 7; *Resolution (78)3 Explanatory Memorandum*, 21–2 [24]; see Appendix D.

⁸⁶ G H Treitel, *Remedies for Breach of Contract: A Comparative Account* (Clarendon Press, 1988) 226; Hachem, above n 48, 116–26.

arising after the contract is entered into', should be taken into account.⁸⁷ This suggests that when exercising the discretion to modify, the court is not limited to what amounts to recoverable loss in the common law sense of damages for breach of contract but rather the focus is on arriving at the amount of actual loss suffered by the non-breaching party thus striking the balance to arrive at a figure that is not 'manifestly excessive' but is 'enforceable' as an 'intermediate figure'.⁸⁸

8.4.7 Can an Underestimate Be Modified?

A clause will under-liquidate damages where the stipulated sum is an underestimate of damages consequent upon a breach of contract.⁸⁹ A clause of this type is described by Roger Halson as a 'hybrid',⁹⁰ as it has some of the features of a liquidated damages clause and some of a limitation clause. Like the liquidated damages clause, it aims to allow the recovery of a fixed amount and like the limitation clause, it seeks to 'limit' recovery to less than otherwise legally compensable loss. In *Tullett Prebon Group Ltd v Ghaleb El-Hajjali*,⁹¹ Nelson J confirmed the hybrid nature of the 'underliquidated' damages clause observing that 'it cannot realistically be called a penalty [or] a genuine pre-estimate of loss' and is only 'akin to a clause limiting the extent in damages of a party's liability' because it provides for a 'small agreed sum', rather than an upper limit on recovery.⁹² The Commission's Discussion Papers and Reports are silent on the topic.

In Australia and England, the common law position is that a sum stipulated, which is less than the damages payable for breach of contract, cannot be classified as an unenforceable penalty because the figure would never be capable of characterisation as 'extravagant or unconscionable'.⁹³ This also represents the law of Scotland and accordingly, at common law the sum stipulated cannot be increased. It is not open to the non-breaching party to escape from a bad bargain by seeking to defeat its own liquidated damages clause.⁹⁴ 'The court has no general jurisdiction to re-form terms of a contract because it thinks them unduly onerous on one of the parties.'⁹⁵ In the event where the Bill was enacted, a stipulated sum set at a very low amount would not attract the discretion to modify in s 4 to increase that sum because a stipulation set too low could never be considered 'manifestly excessive' whilst on the contrary, a manifestly low sum would be 'derisory'.⁹⁶

⁸⁷ 1997 Discussion Paper, above n 1, 10. Further, this is consistent with the operation of the *Conventional Penalties Act 1962* (South Africa). See Appendix A.

⁸⁸ Comment B to art 111–3.712 of the DCFR; see Appendix D.

⁸⁹ William F Fritz, 'Under Liquidated Damages as Limitation of Liability' (1954) 33 *Texas Law Review* 196; Roger Halson, *Liquidated Damages and Penalty Clauses* (Oxford University Press, 2018) 78–93 [3.10]–[3.17].

⁹⁰ Roger Halson, 'Remedies for Breach of Contract' in Michael Furmston (ed), *The Law of Contract* (LexisNexis, 6th ed, 2017) 1671 [8.129]; *Tullett Prebon Group Ltd v Ghaleb El-Hajjali* [2008] EWHC 1924 (QB) (31 July 2008) [39].

⁹¹ *Tullett Prebon Group Ltd v Ghaleb El-Hajjali* [2008] EWHC 1924 (QB) (31 July 2008)

⁹² *Ibid* [39].

⁹³ *Multiplex Constructions Pty Ltd v Abgarus Pty Ltd* (1992) 33 NSWLR 504, 519; *Cellulose Acetate Silk Co Ltd v Widnes Foundry (1925) Ltd* [1933] AC 20, 25.

⁹⁴ *Cellulose Acetate Silk Co Ltd v Widnes Foundry (1925) Ltd* [1933] AC 20; *Suisse Atlantique Societe d'Armement Maritime SA v NV Rotterdamische Kolen Centrale NV* [1967] 1 AC 361, 436; *Temloc Ltd v Errill Properties Ltd* (1987) 39 BLR 34, 38, 39–40; Halson, *Liquidated Damages and Penalty Clauses*, above n 89.

⁹⁵ *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428, 1446 (Lord Diplock).

⁹⁶ This is the expression used in the *Code Civil* [Civil Code] (France) art 1231.5 to describe a stipulated sum that is too low and can be increased.

PART III

8.5 Criticisms of the Bill

8.5.1 Uncertainty

During the consultation process, a major criticism of the Bill⁹⁷ was that, if enacted, the law would become too uncertain. The uncertainty was said to arise, for example, in cross-border situations where commercial parties with links to both jurisdictions would compare Scots and English law, and the remedies available under each before deciding on the choice of law for their contract. If a significant difference existed between English and Scots law, parties may seek to select English law on the basis that there would be a line of precedent that could be relied upon. However, given that the law in England has recently changed, and in particular for commercial contracts, this criticism is no longer as forceful as it may have been at the time it was presented in 2016. The practical effect of *Cavendish* was to make English law more certain, in that stipulated sums are far more likely to be enforced in commercial contracts. As such it can be said that the imperative for any reform in Scotland may have contracted significantly since the decision in *Cavendish*.

The Law Society of Scotland⁹⁸ made a submission to the Commission that the Bill introduced a wide and untested discretion which could render a ‘manifestly excessive’ stipulation subject to modification and lead to considerable legal uncertainty. The introduction of a discretion to modify would inject uncertainty into the law for some time until there developed a line of decisions that placed some boundaries upon the extent of the discretion. However, the real issue is whether a system providing for a discretion would produce more certain outcomes than a system that applied the test in *Cavendish*. The legitimate interests test is likely to make it very difficult for parties to avoid the consequences of stipulated sum clauses activated by a breach of contract. Furthermore, the Bill only permits modification in cases of ‘manifest excess’. The bar is set high by the use of this expression and in this circumstance, it is difficult to envisage how a new system providing for judicial discretion would lead to better outcomes than the present English common law approach represented by *Cavendish*.

8.5.2 Sophisticated Parties Can Protect Themselves

The Bill applies to all contracts irrespective of the status of the parties.⁹⁹ For example, it applies to a hire purchase contract between a consumer and trader regarding a television set, as well as to a derivatives contract between two sophisticated companies with a contract value in the hundreds of millions of pounds. In England, consumers are protected by legislation;¹⁰⁰ whereas sophisticated commercial parties generally have access to professional advice from lawyers who assist with negotiation and drafting of their contracts. This point was referred to in *Cavendish*¹⁰¹ as being ‘not entirely irrelevant’.

⁹⁷ Scottish Government, *Penalty Clauses (Scotland) Bill: Scottish Government Consultation: Summary Analysis Report* (6 January 2011) [2] <<http://www.gov.scot/Resource/Doc/254430/0110302.pdf>>.

⁹⁸ Law Society of Scotland, Response No 5 to Scottish Government, *Penalty Clauses (Scotland) Bill — Scottish Government Consultation*, September 2010, 2 [1.2(3)].

⁹⁹ Ross Gilbert Anderson, Response No 4 to Scottish Government, *Penalty Clauses (Scotland) Bill — Scottish Government Consultation*, 27 August 2010, 3 [1(1)].

¹⁰⁰ *Consumer Credit Act 1974* (UK) c 39; *Unfair Contract Terms Act 1977* (UK) c 50; *The Unfair Terms in Consumer Contracts Regulations 1999* (UK) SI 1999/2083.

¹⁰¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1205–6 [35].

The Law Society of Scotland¹⁰² made a submission to the Commission that sophisticated parties need to be able to plan their affairs by detailed contracts in the expectation they provide commercial certainty against risk. Changing the law in Scotland in the manner suggested by the Bill would therefore affect risk allocation, pricing and funding decisions.

8.5.3 Redraft the Bill Taking into Account the DCFR

The Law Society of Scotland suggested that further consideration be given to redrafting ss 1 and 4 of the Bill in terms of art III–3.712 of the DCFR¹⁰³ as this article provides certainty not present in the law in Scotland, where all penalty clauses are to be treated as valid and enforceable.

Article III–3.712 of the DCFR goes some way to providing a similar result to the Bill (ie a judicial discretion to modify penalty clauses) and treats as valid and enforceable freely negotiated terms other than those which are ‘grossly excessive’. In the 1997 Discussion Paper,¹⁰⁴ the Commission doubted if there was much difference in practice between the DCFR expression ‘grossly excessive’ and the expression used in the Bill, ‘manifestly excessive’. The importance of the point exemplified by either expression is the nature of the excess, ‘gross’ versus ‘manifest’ leaves little room to split the difference between the two expressions.

Furthermore, no other country in Europe has yet to incorporate any of the DCFR provisions into its domestic law.¹⁰⁵ The Law Society submitted that to do so in Scotland would ‘send a signal that Scotland is open for business and enthusiastic about the latest developments in international contract law.’¹⁰⁶

8.6 Ongoing Reform: 2016 Discussion Paper

A wide-ranging study¹⁰⁷ was undertaken by the Commission in its analysis and consideration of the penalty doctrine at common law, in civil law systems, as well as in recent international harmonisation instruments.¹⁰⁸ Following receipt of comments from the consultation process and after considering the recent changes to the common law in Australia¹⁰⁹ and England,¹¹⁰ the Commission decided to reopen the consultation process and continue it until the end of 2017, with a final report due for publication in 2018. The additional work was to assist the Commission to decide whether the Bill requires redrafting and whether the project should continue.

¹⁰² Law Society of Scotland, above n 98, 2 [1.2(3)].

¹⁰³ DCFR art III–3.712; see Appendix D. See also UPICC art 7.4.13 (see Appendix H); PECL art 9:509 (see Appendix F).

¹⁰⁴ *1997 Discussion Paper*, above n 1, 27.

¹⁰⁵ Richardson, above n 25, citing Mance, above n 25, 457–62. The DCFR was referred to favourably in the opinion of Lord Malcolm in *Philip Wills v Strategic Procurement (UK) Ltd* [2013] CSOH 26 (13 February 2013); the Swedish Supreme Court has between 2010 and 2013 also cited the DCFR in support of its rulings in six cases: Bo Thomaeus, *Draft Common Frame of Reference and the Supreme Court* (13 October 2014) International Law Office <<https://www.internationallawoffice.com/Newsletters/Company-Commercial/Sweden/Grde-Wesslau-Advokatbyr/Draft-Common-Frame-of-Reference-and-the-Supreme-Court>>; Mateusz Grochowski, ‘The Practical Potential of the DCFR Judgment of the Swedish Supreme Court (Hogstra Domstolen) of 3 November 2009, Case T3-08’ (2013) 9(1) *European Review of Contract Law* 96.

¹⁰⁶ Law Society of Scotland, above n 98, 9.

¹⁰⁷ *1997 Discussion Paper*, above n 1; *1999 Report on Penalty Clauses*, above n 4, which included in app A the ‘Penalty Clauses (Scotland) Bill’ (at 31–2) and Explanatory Notes (at 33–4); Scottish Government, ‘Consultation on Penalty Clauses (Scotland) Bill’, above n 50, which included at annex A ‘Penalty Clauses (Scotland) Bill [Consultation Draft]’; *2016 Discussion Paper*, above n 3.

¹⁰⁸ DCFR art III–3.712 (see Appendix G); UPICC art 7.4.13 (see Appendix H); PECL art 9:509 (see Appendix F).

¹⁰⁹ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

¹¹⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172.

The Commission¹¹¹ considered the effect of *Cavendish* on Scots law and addressed it as being a relevant factor in the decision to resubmit the Bill for further consultation. If the Bill is introduced into Scots law, adherence to the English common law will no longer apply for penalty clauses and then significant divergences will develop between the two jurisdictions.

The 2016 Discussion Paper¹¹² advanced three alternative proposals or options for action:

i) **Do Nothing Option**

The first option proposed by the Commission was to keep the common law under review as it develops while being applied and explained in light of *Cavendish*.¹¹³ By this 'bed in'¹¹⁴ process, it should become clear reasonably quickly if the decision is causing difficulty. It is suggested there is a potential for some difficulty as *Cavendish* left a number of matters in a state of uncertainty, namely the distinction between primary/secondary obligations; the extent to which that distinction may be overcome by considerations of substance over form; application of the 'legitimate interests test'; and the measurement of disproportion, ie the excessiveness, exorbitance, or unconscionability of the sum stipulated.¹¹⁵ However, two recent English decisions¹¹⁶ and one Scots decision¹¹⁷ that followed *Cavendish*, display lack of evidence of any difficulty of application.¹¹⁸

ii) **Outright Abolition Option**

The second option consistent with what was submitted to the UK Supreme Court in *Cavendish* is the proposal that the penalty rule is abolished entirely on the basis that it is an unwarranted and unnecessary interference with general freedom and sanctity of contract. On one hand, in commercial contracts the parties are generally well-equipped to protect their own interests and that autonomy should be respected, on the other hand, for consumer contracts, there is adequate protection provided by statute.¹¹⁹

The abolition argument was pursued in *Cavendish* on the grounds that 'the penalty rule should be regarded as antiquated, anomalous and unnecessary, especially in light of the growing importance of statutory regulation in the field'.¹²⁰ The argument was rejected by the UK Supreme Court on the basis that judicial abolition would not be a proper course to adopt and it is a matter for the legislature.¹²¹ The reasons advanced in *Cavendish* for retention of the penalty doctrine included its 'long standing as a principle in English law' and that 'it is common to almost all major systems of law'.¹²²

¹¹¹ 2016 Discussion Paper, above n 3, 21–42.

¹¹² Ibid 46–52.

¹¹³ For example, the 2016 Discussion Paper, above n 3, (ibid 35 [3.46]–[3.51]) refers to *Gray v Braid Group (Holdings) Ltd* 2017 SC 409.

¹¹⁴ 2016 Discussion Paper, above n 3, 46 [4.12].

¹¹⁵ Ibid 46–7; Andrew Summers, 'Unresolved Issues in the Law of Penalties' [2017] *Lloyd's Maritime and Commercial Law Quarterly* 95.

¹¹⁶ *Vivienne Westwood Ltd v Conduit Street Developments Ltd* [2017] EWHC 350 (Ch) (27 February 2017); *Richards v IP Solutions Group Ltd* [2016] EWHC 1835 (QB) (22 July 2016).

¹¹⁷ See above n 17.

¹¹⁸ For England see, eg, *First Personnel Services Limited v Halford's Limited* [2016] EWHC 3220 (Ch) (20 December 2016)

¹¹⁹ 2016 Discussion Paper, above n 3, 48–50.

¹²⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1206 [36].

¹²¹ Ibid.

¹²² Ibid 1207 [37].

iii) **Abolition and Replacement Option**

The third option is to abolish the penalty rule and replace it with a new regime. For this to occur the criticisms levelled at the 1999 Report on Penalty Clauses and the comments from the 2010 consultation process would be required to be addressed in a redrafted Bill whereas the essence of those criticisms was that the Bill added to uncertainty rather than removing it.¹²³

An alternative approach raised in the 2016 Discussion Paper¹²⁴ started with the proposition taken from art III–3.712 of the DCFR where all contractual stipulations are to be treated as valid and enforceable. If this was acknowledged in a redrafted Bill, the focus for judicial intervention and control would cease to be the stipulation itself and instead would move to its actual effect ie: is it ‘excessively penal’, or to use the expression used in chapter 6, is the stipulation unconscionable in the *Dunlop* sense. Approaching the issue in this manner would thus have the effect of crossing the boundary between legitimate encouragement of contractual performance and deterrence of non-performance into punishment of the breaching party as the judicial modification of the stipulation to remove the excessively penal elements might be the only sanction.

As a result the Commission’s provisional opinion was that the redraft of the Bill should provide the common law rule against penalties, as applied in Scotland, be abolished with the penalty clauses being treated as valid and enforceable.¹²⁵

8.7 2018 Report on Review of Contract Law

Part 5 of the 2018 Report on Review of Contract Law¹²⁶ dealt with Penalty Clauses and provided a summation of feedback received by the Commission following the further process of consultation following circulation of the 2016 Discussion Paper. The Commission reported that the clear majority of consultees favoured the option (i) do nothing option and that the penalty rule should not be abolished in whole or in part.¹²⁷ Consistently with the views of the majority of consultees, the Commission has not recommended legislative reform ahead of waiting to see how the law develops post-*Cavendish*. The Commission said¹²⁸ that its primary reasons for adopting this course of recommendation is based on the proposition that so far *Cavendish* has not created major difficulties in legal practice, and has indeed pointed the law in the correct general direction as well as the reformulated rule is capable of being used to strike down stipulations that are excessively penal in their effects.

PART IV

8.8 Conclusion

At present, the penalty doctrine operating in Scotland is the English common law represented by *Dunlop* and *Cavendish*. *Cavendish* effected change to the test to determine whether a contractual stipulation payable

¹²³ 2016 Discussion Paper, above n 3, 50 [4.26].

¹²⁴ Ibid 50–2.

¹²⁵ Ibid 51–2 [4.30]–[4.35].

¹²⁶ 2018 Report on Review of Contract Law, above n 4, 185–6 [19.1]–[19.40].

¹²⁷ Ibid 194–6 [19.34]–[19.40].

¹²⁸ Ibid 195 [19.35].

upon breach is enforceable and the *Dunlop* genuine pre-estimate of loss proposition is no longer the primary consideration for commercial contracts. The court is required to consider the legitimate interests of the non-breaching party in performance of the contract. A non-breaching party with a legitimate interest must still show that the stipulated sum sought to be enforced is not extravagant or unconscionable compared to the legitimate interests of the non-breaching party that the contract seeks to protect. *Cavendish* has already been applied by the Scottish Court of Session¹²⁹ without any expressed difficulty, and also in England, in particular, in the *Vivienne Westwood* decision.¹³⁰

Since 1997, the Commission has undertaken an extensive review of the penalty doctrine as part of a wider investigatory review of Scottish contract law and has published two Discussion Papers as well as two Reports. The Scottish Government adopted the Commission's recommendations and circulated the Bill for consultation in 2010. Following the consultation process, the Commission published the 2016 Discussion Paper¹³¹ and gave consideration to criticisms received during the consultation process and also to the potential effects that the decisions in *Andrews*, *Cavendish* and *Paciocco* might have on the Bill.

Figure 3 sets out a summary of the position in Scotland for the operation of the penalty doctrine if the Bill becomes the law.

FIGURE 3

Is breach necessary?	X
No breach (equity)	✓
Can the stipulation be the payment of money?	✓
Can the stipulation be the forfeiture of \$/forfeiture or transfer of property?	✓
Alternate remedy of unliquidated damages if stipulated sum is unenforceable	X
Can the court increase the stipulated sum?	X
Court can decrease the stipulated sum if manifestly excessive?	✓
Need to prove loss	X
Need to mitigate	X
Is the amount of the stipulated sum the ceiling to recovery?	✓
Is stipulated sum required to be a genuine pre-estimate?	X
Must the stipulated sum equate to damages for breach of contract?	X
Is stipulated sum analysed ex post?	✓

The Bill is the most extensive and well-researched statutory law reform proposal ever produced for the treatment of penalty clauses. In contrast to the English common law, it embraces an extended definition of

¹²⁹ *Gray v Braid Group (Holdings) Ltd* 2017 SC 409.

¹³⁰ *Vivienne Westwood Ltd v Conduit Street Developments Ltd* [2017] EWHC 350 (Ch) (27 February 2017).

¹³¹ 2016 Discussion Paper, above n 3.

penalty that extends beyond breach of contract. The Bill is consistent with the position that has been adopted in Australia, namely that the penalty doctrine can apply in equity in situations where there is no breach of contract and in Australia the court is permitted (whilst considering the penalty doctrine in equity where there has been no breach) to partially enforce or 'scale down' the stipulated sum.

The Bill provides for judicial discretion to reduce manifestly excessive stipulations which are not limited to the payment of money and extend to clauses which stipulate for forfeiture and obligations to transfer. The Bill also captures stipulations triggered by failure to do or not to do in a particular way something provided for in the contract. Accordingly, it covers and extends the penalty rule to situations where there has not been a breach of contract.

The discretion to reduce manifestly excessive stipulations requires a consideration of 'all circumstances that appear relevant including those that arose after the contract was entered into'. This is consistent with art III-3.712 of the DCFR and other international instruments, and have the effect of limiting the application of the penalty doctrine to stipulations. By this measure, the law becomes more certain. Judicial modification of stipulations is not permitted in Australia and England where there has been a breach of contract. It is a major stumbling block to harmonisation efforts between the divergent treatment of penalty clauses in common law and civil law systems. The Scottish reform proposal will not enforce stipulations that have the effect of punishing the breaching party because they are 'manifestly excessive'.

Chapter 9 continues the comparative analysis by examining a number of international initiatives and instruments and considers their treatment of agreed sums payable upon breach by providing some comparisons with the common law.

Chapter 9

The Treatment of Specified Sums Payable for Non-Performance in Certain International Initiatives and Instruments, Including Some Comparisons with the Common Law

9.1 Introduction

This is the final Chapter providing comparative analysis and focuses on initiatives carried out internationally where there has been a general convergence of approaches in European civil codes and soft law proposals towards a recognition of the utility and desirability of providing judicial control of disproportionate, excessive, manifestly or grossly high or unreasonable penalty stipulations.¹

Stipulations providing for payment of an agreed sum for non-performance are a frequent feature of international sales contracts.² Stipulations of this nature have been referred to as ‘Contract Clauses for an Agreed Sum Due upon Failure of Performance’³ or ‘Agreed Payment for Non-Performance’.⁴ By using these expressions the drafters of such instruments have been able to avoid referencing liquidated damages and conventional penalties (ie: penalty clauses). Liquidated damages clauses are intended to provide a genuine pre-estimate of the loss likely to be suffered by a breach of contract. They are convenient for the non-breaching party because they do away with the need to prove the loss that was actually suffered. Reinhard Zimmermann⁵ points out that conventional penalties (or penalty clauses) are more problematic as they are like liquidated damages clauses in the sense that it is not necessary for the non-breaching party to prove it has suffered loss due to the non-performance of the breaching party or to prove the extent of such loss. However, they also serve as a means of exerting pressure on the potential breaching party to comply with its obligations.

In *Cavendish*,⁶ Lords Neuberger and Sumption confirmed that the penalty doctrine is of long standing in English law dating back to 16th century England and Scotland and is common in almost all major systems of law ‘at any rate in the western world’. It has been adopted with some variants in all common law jurisdictions, including the United States.⁷ In common law systems, stipulations activated by a breach of contract are

¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1206 [37], 1252 [164].

² Ingeborg Schwenzer, Pascal Hachem and Christopher Kee, *Global Sales and Contract Law* (Oxford University Press, 2012) 633 [44.266].

³ *Report of the United Nations Commission on International Trade Law on the Work of Its Sixteenth Session*, UN GAOR, 38th sess, Supp No 17, UN Doc A/38/17 (10 August 1983) annex I (‘*Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance*’). See Appendix E.

⁴ PECL 9:509; UPICC 7.4.13; DCFR III–3.712. See Appendices F, G and H.

⁵ Reinhard Zimmermann, ‘Art 9:509: Agreed Payment for Non-Performance’ in Nils Jansen and Reinhard Zimmermann, *Commentaries on European Contract Laws* (Oxford University Press, 2018) 1529, 1540–1 [1]; Franziska Myburgh and Reinhard Zimmermann, ‘J C de Wet and the *Conventional Penalties Act 15 of 1962*’ in Jacques du Plessis and Gerhard Lubbe (eds), *A Man of Principle: The Life and Legacy of J C de Wet* (Juta, 2013) 302, 303–4; Gunther H Treitel, *Remedies for Breach of Contract: A Comparative Account* (Oxford University Press, 1988) 212–13 [167].

⁶ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1206 [37].

⁷ See, eg, E Allan Farnsworth, *Farnsworth on Contracts* (Aspen Publishers, 3rd ed, 2004) vol III, 300–23 §§ 12.18–12.18a.

treated as either enforceable liquidated damages or unenforceable penalties. In many civil law systems⁸ a different rule was derived from Roman law and exists, for example, in the civil codes of France,⁹ Germany,¹⁰ Switzerland,¹¹ Belgium,¹² and Italy.¹³ In these civil law systems, penalty clauses are treated as valid and enforceable, but they are subject to a judicial discretion to reduce when the stipulated sum is found to be 'grossly excessive'.

The initiatives and instruments examined in this chapter are of importance as they form of the 'influential' attempts to codify the law of contracts internationally.¹⁴ In each instance they have adopted 'language akin to the nomenclature of unconscionability',¹⁵ as they provide for judicial control over penalty clauses where the sum stipulated is 'manifestly excessive' or in the nature of a punishment of the breaching party. In the penalty doctrine at common law, unconscionability, in the sense that the stipulation is out of all proportion, continues to play a significant role in the determination of whether a stipulation is enforceable or a penalty.

This Chapter is divided into three parts. Part I provides a brief historical introduction to the scope and operation of the following international initiatives:

- ❖ the *Benelux Convention Relating to Penalty Clauses* (1973);
- ❖ the Council of Europe: *Resolution (78)3 Relating to Penal Clauses in Civil Law* (1978);
- ❖ the UNCITRAL 'Report on Liquidated Damages and Penalty Clauses' (1979);
- ❖ the UNCITRAL *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance* (1983); and
- ❖ the UNCITRAL *Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance* (1983);

These initiatives are all consistent in their treatment of stipulated sums ie: that excessive sums could be reduced. The output of these international initiatives and, in particular, the *Benelux Convention*, *Resolution (78)3*, the *Uniform Rules* and *Draft Convention* have ultimately not been acted upon by the member states who participated in those projects.¹⁶ The reason for this lack of action can only be explained due to a lack of imperative.

⁸ See Pascal Hachem, *Agreed Sums Payable upon Breach of an Obligation* (Eleven International Publishing, 2011) 32.

⁹ See *Code Civil* [Civil Code] (France) art 1152.

¹⁰ For non-commercial contracts, see *Bürgerliches Gesetzbuch* [Civil Code] (Germany) § 343.

¹¹ See *Schweizerisches Zivilgesetzbuch* [Swiss Civil Code] (Switzerland) art 163.3.

¹² See *Code Civil* [Civil Code] (Belgium) art 1231.

¹³ See *Codice Civile* [Civil Code] (Italy) art 1384.

¹⁴ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1206 [37].

¹⁵ Larry A Di Matteo, *Law of International Contracting* (Kluwer Law International, 2nd ed, 2009) 76.

¹⁶ The *Benelux-Overeenkomst betreffende het Boetebeding* [Benelux Convention Relating to Penalty Clauses], signed 26 November 1973, [1974] *Tractatenblad* 5 (not yet in force) ('*Benelux Convention Relating to Penalty Clauses*') was never ratified. As regards the Council of Europe, Committee of Ministers, *Resolution (78)3 Relating to Penal Clauses in Civil Law* (20 January 1978)

<https://search.coe.int/cm/Pages/result_details.aspx?ObjectID=0900001680505599> ('*Resolution (78)3*') — I have not found any instances where member states have adopted the Resolution. Luca G Castellani, 'The Contribution of UNCITRAL to the Harmonisation of International Sale of Goods Law besides the CISG' (2011) 59(3) *Annals of the Faculty of Law in Belgrade* 28, 34 notes that use of the *Uniform Rules* has not been widespread; Antonias Dimolitsa, 'Contractual Remedies: Clauses Pénales and Liquidated Damages Clauses' in L Levy and F de Ly (eds), *Interest, Auxiliary and Alternative Remedies in International Arbitration* (ICC Publication No 468, 2008) 13, 15 notes that 'national legislators did not react'.

Part II analyses ways in which the following three international instruments treat 'specified sums payable for non-performance'. Additionally each follows the approach of providing the court with a discretion to reduce 'grossly excessive' sums and to award a reasonable amount.

- ❖ The Principles of European Contract Law 2000 ('PECL');
- ❖ Draft Common Frame of Reference (Principles, Definitions and Model Rules of European Private Law) 2009 ('DCFR'); and
- ❖ UNIDROIT Principles of International Commercial Contracts 2016 ('UPICC');

Part III builds on Part II and provides comparisons of the international initiatives, as well as the PECL, DCFR and UPICC approaches to the treatment of specified sums with the common law. It aims to establish there are convergences and divergences between the various international initiatives and instruments analysed in Parts I and II as well as the common law. It concludes that these initiatives and instruments all provide for judicial reduction of grossly excessive penalty clauses whereas the common law does not enforce a stipulation if it is out of all proportion and is therefore a penalty. Thus it is at this point where there is convergence in their refusal to enforce excessive stipulations, ie those that stipulate for punishment of the breaching party. Although their treatment of excessive stipulations diverge, the main point of this Chapter is to confirm there is convergence on the significant issue of which stipulations are and are not enforced.

PART I

9.2 Brief Historical Introduction to the International Initiatives

9.2.1 *Benelux Convention Relating to Penalty Clauses (1973)*

In 1973, in an attempt at unification of domestic law across three jurisdictions, the Benelux Interparliamentary Consultative Council drafted a 'Convention Relating to Penalty Clauses' to be applied between its member states of Belgium, the Netherlands and Luxembourg. Each of these countries are civil law jurisdictions with similar national laws and all are members of the same regional trade organisation, the Benelux Economic Union.¹⁷ The Convention was concluded at The Hague on 26 November 1973, however was never ratified.¹⁸ The Convention is made up of seven articles, followed by an 'Annex' of Common

¹⁷ Ignacio Marin Garcia, 'Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to Be Solved by the Contracting Parties' (2012) 5 *European Journal of Legal Studies* 81, 96.

¹⁸ I have found there is some confusion about the *Benelux Convention* because on 26 November 1973 two Conventions were produced and they dealt with similar subject matter. First, there was the *Benelux Convention Relating to Penalty Clauses* which is relevant for present purposes. Then there was the *Benelux Convention Relating to a Uniform Law Concerning Penalty Payments*. This latter Convention came into force on 1 October 1978 as Convention No 18360 (see S A M Oostvogels, 'Treaties and Other International Agreements to Which the Netherlands Is a Party' (1975) 6 *Netherlands Yearbook of International Law* 313, 335). See Jonathan S Solorzano, 'An Uncertain Penalty: A Look at the International Community's Inability to Harmonise the Law of Liquidated Damages and Penalty Clauses' (2009) 15 *Law and Business of the Americas* 779, 787. Note that annex 2 to this article is said to be the *Benelux Convention Relating to Penalty Clauses*. This is wrong. What has been published here is the annex to the *Benelux Convention Relating to a Uniform Law Concerning Penalty Payments*. See also Barbara Pasa, 'The European Law of 'Contractual Penalties'', (2015) 3 *European Review of Private Law* 355, 371–2; 'Report of the Secretary-General: Liquidated Damages and Penalty Clauses' (1979) 10 *Yearbook of the United Nations Commission on International Trade Law*, 40, 48. See also Zimmermann, above n 5, 1539, 1546 [7].

Provisions¹⁹ consisting of Articles 1 to 4, supported by an *Explanatory Memorandum* divided into three chapters and followed by a Commentary on Articles 1 to 4.

Under Article 1 of the Convention, the contracting states agreed that they would bring their national legislation on penalty clauses into conformity with the Common Provisions (Articles 1 to 4) which were set forth in the Annex to the Convention by the date the Convention came into force. This attempt to unify domestic law, by way of uniform provisions, was not limited to domestic transactions, but applied to all contracts.

Article 1 of the Common Provisions defines a penalty clause in broad terms as ‘any clause which provides that if the breaching party fails to perform its obligation, it shall be bound to pay a sum of money or do some other thing by way of penalty or compensation.’ This confirms that there must be a breach of contract before the Convention can be engaged. Obligations that arise upon non-performance can extend beyond the payment of money and may include the forfeiture of money or the transfer or forfeiture of property.²⁰ Stipulations of this type are covered by the expression used in art 1 which states ‘or do some other thing by way of penalty or compensation’. The Commentary to art 1 provides ‘the parties are free to agree on some other kind of penalty’. This accommodates a broader application of the Convention provisions to circumstances beyond stipulations providing for the payment of money upon breach of contract.

Article 2(2) of the Common Provisions adopts the approach that the penalty sum replaces the claim for damages with the result that the non-breaching party is limited to claiming the penalty. Accordingly, the penalty sum will constitute the minimum amount of damages which the non-breaching party can recover for the breach of contract.

Article 4 the Common Provisions provides the court ‘may’ ‘if justice manifestly so requires it’²¹ mitigate the effects of the penalty clause by use of the ‘moderating power’. The Commentary to art 4 of the Common Provisions provides ‘this is the most important clause in the draft’. The language in art 4 is broad and authorises judicial reduction. The Commentary on art 4 explains that the court should exercise the power to reduce ‘with the greatest discretion as the effect of their intervention is to interfere with binding agreements’. Judicial intervention would only be warranted where ‘the sense of justice is outraged’ and the court must only

¹⁹ The English translation of the text of the Common Provisions can be found in Pedro F Silva-Ruiz, *Obligaciones Contractuales: Casas y Materiales* (Universidad de Puerto Rico, 2nd revised ed, 1993) 587–8. The text of the Common Provisions and the Commentary on the Articles is set out in Appendix C. Kay Tucker of the Monash University Law School Library and her colleague Lyonette Louis-Jacques from the University of Chicago Law School provided valuable assistance in April 2017 by locating a copy of the Council of Europe, *Penalty Clauses in Private Law: Study* (1972) which contains the draft of the statutory text (ie Common Provisions) and the Commentary on the Articles.

²⁰ It is to be noted that this wide definition of the penalty clause is consistent with the recommendations of the Scottish Law Commission in its Draft Penalty Clauses (Scotland) Bill 2010 (Scot) (see Scottish Law Commission, *Report on Penalty Clauses*, Report No 171 (1999) 31). In the Bill ‘penalty’ is defined in s 1(3) as meaning ‘a penalty of any kind whatsoever (including, without prejudice to that generality, a forfeiture or an obligation to transfer).’

²¹ *Burgerlijk Wetboek* [Civil Code] (Netherlands) arts 6.91–4 provides that penalty clauses are generally enforceable, but they are subject to a judicial discretion of modification ‘if it is evidenced that fairness so requires’. See also Scottish Law Commission, *Review of Contract Law: Discussion Paper on Penalty Clauses*, Discussion Paper No 162 (2016) 17 [2.36].

interfere with binding agreements 'if justice has obviously been violated'.²² The specified sum should only be reduced if it is unconscionable in the sense that to maintain it would be an outrage to justice. The court should not reduce²³ the penalty below what the non-breaching party would be entitled to claim under the general law.

The *Benelux Convention* is an important initiative because its Common Provisions would be engaged by a breach of contract; it applied to all types of contract; the breach which would engage the Convention was not limited to payment of money; excessive stipulations could be moderated by the court; and finally reduction could not be to a sum below that which would otherwise be recoverable as damages for breach of contract.

9.2.2 Council of Europe: *Resolution (78)3 Relating to Penal Clauses in Civil Law (1978)*

The Council of Europe²⁴ was the first international institution to achieve a certain unity in the treatment of penalty clauses on a relatively large scale. In 1978, the Council of Europe, representing 20 member states, adopted '*Resolution (78)3 Relating to Penal Clauses in Civil Law*'. The Resolution was drafted with the intention that it apply to all types of contracts,²⁵ and may have been influenced by the *Benelux Convention*.²⁶ *Resolution (78)3* was published because the Council considered 'it is necessary to provide for judicial control over penal clauses in civil law in appropriate cases where the penalty is manifestly excessive.'²⁷ The *Explanatory Memorandum to Resolution (78)3* noted that 'harmonisation of the rules relating to penalty clauses in civil law would contribute to legal certainty in international commercial relations and facilitate the application of international agreements relating to the recognition and enforcement of foreign judgments'.²⁸

Some commentators²⁹ have correctly observed that *Resolution (78)3* represents the European civil law model for penalty clauses, because it includes characteristics which provide for:

- i) the validity of penalty clauses which may have the effect of coercing a party to perform contractual duties (art 1);
- ii) the non-breaching party not being able to obtain concurrently both performance and payment of the stipulated sum unless the stipulated sum was payable for delayed performance (art 2); and
- iii) judicial review of penalty clauses on grounds of manifest excess, or on the grounds of partial

²² See Council of Europe, *Penalty Clauses in Private Law*, above n 19; Appendix C, commentary to *Benelux Convention* art 4.

²³ See commentary to art 4 in Appendix E.

²⁴ The Council of Europe was formed in 1949 pursuant to Article 4 of the *Statute of the Council for Europe*, opened for signature 5 May 1949, 8 UNTS 103 (entered into force 3 August 1949); membership is open to any European country, provided it meets specific democratic and human rights standards. As at 2017 there are 47 member states. Nearly all European states are members. As at 1978 the 20 members were Belgium, Denmark, France, Ireland, Italy, Luxembourg, the Netherlands, Norway, Sweden, United Kingdom, Greece, Turkey, Iceland, Germany, Austria, Cyprus, Switzerland, Malta, Portugal and Spain.

²⁵ See Appendix D; Council of Europe, *Explanatory Memorandum: Resolution 78(3) Relating to Penal Clauses in Civil Law* (20 January 1978) 20–22 <<https://rm.coe.int/09000016804d1a18>> ('*Explanatory Memorandum to Resolution 78(3)*'). The text of *Resolution (78)3*, its appendix and the *Explanatory Memorandum to Resolution (78)3* is set out in Appendix D.

²⁶ Zimmerman, above n 5, 1539, 1546 [7].

²⁷ See Appendix D.

²⁸ See Appendix D, *Explanatory Memorandum to Resolution (78)3*, [1]. The text of *Resolution (78)3*, and the Articles, are reprinted in annex 1 to the paper by Solorzano, above n 18, 815–16.

²⁹ Simas Vitkus, 'Penalty Clauses within Different Legal Systems' (2013) 1 *Social Transformations in Contemporary Society* 153, 158; Garcia, above n 17, 98–9.

performance (art 7).

Article 1 defines a penalty clause as ‘any clause in a contract which provides that if the breaching party fails to perform the principal obligation he shall be bound to pay a sum of money by way of penalty or compensation’.³⁰ Unlike the *Benelux Convention* art 1 is expressed to be limited to stipulations requiring the payment of money. The definition is limited in this way on the basis that the payment of money is the most common form of penal clause and ‘for reasons of clarity and simplicity’.³¹ However, the *Explanatory Memorandum* on art 1 states the parties are free to provide other remedies in the event of breach of the principal obligation and to provide for ‘something other than the payment of money’.³² This is consistent with art 1 of the *Benelux Convention*, as it accommodates a broader application of the Resolution.

Article 7 provides that the stipulated sum may be reduced by the court when it is ‘manifestly excessive’. The Commentary provides a non-exhaustive list of factors a court may wish to take into consideration to determine if the stipulated sum is ‘manifestly excessive’.³³ These factors extend well beyond commercial and financial matters and include:

- ❖ comparison of the stipulated sum with the actual damages suffered;³⁴
- ❖ the legitimate interests of the parties including the non-breaching party’s non-pecuniary interests;³⁵
- ❖ the category of the contract and the circumstances under which it was concluded;
- ❖ the relative social and economic positions of the parties;
- ❖ whether the contract was a standard form contract; and
- ❖ whether the breach was in good faith.³⁶

Furthermore, art 7 provides that the stipulated sum may be still reduced when the principal obligation has been only partly performed. However, consistently with the approach adopted by the *Benelux Convention* the stipulated sum cannot be reduced below the amount of damages recoverable for failure to perform the obligation.

The Council of Europe recommended member states consider *Resolution (78)3* when preparing new legislation, and the extent to which the Resolution could be applied, subject to any necessary modifications, to other clauses having the same aim or effect as penalty clauses.³⁷ There is no evidence that any member state of the Council of Europe adopted the recommendation referred to above.

³⁰ It is to be noted that art 1 of *Resolution (78)3* is not identical to art 1 of the Common Provisions of the *Benelux Convention* and is more limited because it only applies to stipulations requiring a payment of money upon breach.

³¹ See Appendix D, *Explanatory Memorandum to Resolution (78)3*, [11].

³² See Appendix D, *Explanatory Memorandum to Resolution (78)3*, [13]–[14].

³³ See Appendix D, *Explanatory Memorandum to Resolution (78)3*, [26].

³⁴ This is consistent with the common law *Dunlop* approach.

³⁵ This is consistent with the common law legitimate interests approach.

³⁶ See Appendix D, *Explanatory Memorandum to Resolution (78)3*, [26]; see also the discussion in Scottish Law Commission, *Review of Contract Law: Discussion Paper on Penalty Clauses*, above n 21, 62–71 [5.37]–[5.62].

³⁷ The writer has not been able to find any instance where a member state of the Council of Europe has adopted *Resolution (78)3* as part of its law.

9.2.3 UNCITRAL Report on Liquidated Damages and Penalty Clauses (1979)

The United Nations Commission on International Trade Law ('UNCITRAL') was established by the United Nations General Assembly on 17 December 1966.³⁸ It plays an important role in developing the legal framework for the facilitation of the progressive harmonisation and modernisation of the law of international trade and investment.³⁹

In 1979, the Secretary-General of UNCITRAL published a 'Report on Liquidated Damages and Penalty Clauses'⁴⁰ ('the Report') as part of its program of work studying international contract practices. The report was limited to consideration of the use of such provisions in international commercial contracts, and accordingly, has no relevance to consumer contracts. The Report concluded that legislative intervention was necessary to harmonise the divergent positions that operated in civil law and common law systems for the treatment of liquidated damages and penalty clauses. The preferred means to achieve harmonisation was the drafting of a model law containing *Uniform Rules* to be adopted by the relevant member states of UNCITRAL.

Upon consideration of the report, UNCITRAL required its Working Group on International Contract Practices to consider the feasibility of formulating *Uniform Rules* on liquidated damages and penalty clauses referable to a wide range of international trade contracts. The UNCITRAL analysis of the feasibility of completing the task established that the distinction between the common law refusal to enforce clauses that sought to coerce performance (ie: penalty clauses) and the civilian law tradition of enforcement of such provisions had been diminished.⁴¹ The report⁴² makes the point that penal clauses in civil law systems which seek to coerce performance are sometimes invalidated because of public policy concerns, for example, where they offend good morals, are contrary to good faith or give rise to unjust enrichment. In that sense, all penal clauses which are purely coercive and provide for private penalties will be invalid as being contrary to public policy. In common law systems, a liquidated damages sum may exceed the amount of damages payable for breach of contract. In circumstances where the breaching party realises this position prior to breach, that stipulation is likely to coerce performance. It may also be the case where the amount of damages likely to be awarded is uncertain. However, in the absence of a liquidated damages clause, a party may be tempted to breach the contract on the prospect of a low damages award. Where the primary object of a stipulation is to limit liability by fixing a sum payable on breach of contract at an amount below that of recoverable damages, both the common law and civil law systems will give effect to such a provision.

Following meetings between representatives of member states (including Australia and the United Kingdom),

³⁸ *Establishment of the United Nations Commission on International Trade Law*, GA Res 2205, 21st sess, 1497th plen mtg, UN Doc A/RES/2205(XXI) (17 December 1966).

³⁹ United Nations Commission on International Trade Law, 'A Guide to UNCITRAL: Basic Facts about the United Nations Commission on International Trade Law' (United Nations Commission on International Trade Law, January 2013) 1.

⁴⁰ 'Report of the Secretary-General: Liquidated Damages and Penalty Clauses', above n 18, 48 [58]. At the same time UNCITRAL was working on this problem it also had a committee working on the drafting of the *Convention on Contracts for the International Sale of Goods*, opened for signature 11 April 1980, 1489 UNTS 3 (entered into force 1 January 1988) (otherwise referred to as the 'CISG' or the 'Vienna Convention').

⁴¹ Alexander Komarov, 'The Limitation of Contract Damages in Domestic Legal Systems and International Instruments' in Djakhongir Saidov and Ralph Cunningham (eds), *Contract Damages: Domestic and International Perspectives* (Hart Publishing, 2008) 245, 262–3.

⁴² 'Report of the Secretary General: Liquidated Damages and Penalty Clauses', above n 18, 42.

during the period from 1979 to 1983, UNCITRAL produced a range of reports⁴³ dealing with the treatment of agreed sums. Extensive research was undertaken, including consideration of the outcomes of the *Benelux Convention and Resolution (78)3* together with the results obtained from a survey undertaken by UNCITRAL in 1979 of the use of a representative selection of general conditions of contract and various international trade contracts.⁴⁴ The survey was conducted to inter alia determine the nature and extent of the use of liquidated damages and penalty clauses in international commercial contracts. The results of this empirical research was the catalyst for development of an agreed set of *Uniform Rules* and a draft Convention (based on the *CISG*). This empirical data established that out of the 167 forms of general conditions and contracts analysed, 79 contained liquidated damages clauses.

9.2.3.1 UNCITRAL Texts on Liquidated Damages and Penalty Clauses:

9.2.3.1.1 *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance (1983)*

9.2.3.1.2 *United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance (1983)*

On 29 June 1983, UNCITRAL published the *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance* ('*Uniform Rules*') together with a *Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance* ('*Draft Convention*').⁴⁵

The *Uniform Rules* recognised there were a wide range of international trade contracts containing

⁴³ Ibid; 'Report of the Working Group on International Contract Practices on the Work of Its First Session (Vienna, 24–28 September 1979)' (1980) 11 *Yearbook of the United Nations Commission on International Trade Law* 39; 'Report of the Working Group on International Contract Practices on the Work of Its Second Session (New York, 13–17 April 1981)' (1981) 12 *Yearbook of the United Nations Commission on International Trade Law* 25; 'Working Paper Submitted to the Working Group on International Contract Practices at Its Second Session (New York, 13–17 April 1981)' (1981) 12 *Yearbook of the United Nations Commission on International Trade Law* 30; 'Report of the Secretary-General: Liquidated Damages and Penalty Clauses (II)' (1981) 12 *Yearbook of the United Nations Commission on International Trade Law* 30; 'Report of the Secretary-General: Analysis of Expert Opinions, and of Replies to the Secretariat Questionnaire on Liquidated Damages and Penalty Clauses' (1981) 12 *Yearbook of the United Nations Commission on International Trade Law* 44; 'Alternative Methods for the Final Adoption of Conventions Emanating from the Work of the Commission' (1981) 12 *Yearbook of the United Nations Commission on International Trade Law* 263; United Nations Commission on International Trade Law, *Text of Draft Uniform Rules on Liquidated Damages and Penalty Clauses Together with a Commentary Thereon: Report of the Secretary-General*, 15th sess, UN Doc A/CN.9/218 (11 November 1981); United Nations Commission on International Trade Law, *Draft Uniform Rules on Liquidated Damages and Penalty Clauses: Analysis of the Responses of Governments and International Organizations: Note by the Secretary-General*, 15th sess, UN Doc A/CN.9/219 (28 May 1982); United Nations Commission on International Trade Law, *Draft Uniform Rules on Liquidated Damages and Penalty Clauses: Analysis of the Responses of Governments and International Organizations: Note by the Secretary-General: Addendum*, 15th sess, UN Doc A/CN.9/219/Add.1 (23 June 1982); Commission des Nations Unites pour le Droit Commercial International [United Nations Commission on International Trade Law], *Projet de Regles Uniformes Relatives aux Dommages-Interets Liberatoires et aux Clauses Penales: Analyse des Réponses des Gouvernements et des Organisations Internationales: Note du Secrétaire Général: Rectificatif* [Draft Uniform Rules on Liquidated Damages and Penalty Clauses: Analysis of the Responses of Governments and International Organizations: Note by the Secretary General: Corrigendum], 15th sess, UN Doc A/CN.9/219/Add.1/Corr.1 (23 June 1982) (available in French only); United Nations Commission on International Trade Law, *Revised Text of Draft Uniform Rules on Liquidated Damages and Penalty Clauses: Report of the Secretary General*, 16th sess, UN Doc A/CN.9/235 (31 March 1983); 'Summary Records of the 255th to 261st Meetings, Fifteenth Session (New York, 26 July–6 August 1982)' (1983) 14 *Yearbook of the United Nations Commission on International Trade Law* 202; *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance*, UN Doc A/38/17; *Report of the United Nations Commission on International Trade Law on the Work of Its Sixteenth Session*, UN GAOR, 38th sess, Supp No 17, UN Doc A/38/17 (10 August 1983) annex II ('*Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance*').

⁴⁴ 'Report of the Secretary-General: Liquidated Damages and Penalty Clauses', above n 18.

⁴⁵ The text of the *Uniform Rules* and the draft Convention are set out in Appendix E.

stipulations requiring the breaching party to pay an agreed sum. It was further recognised that the validity and enforcement of those provisions was often uncertain due to disparities in the treatment of such stipulations in common law and civil law systems. UNCITRAL considered this uncertainty constituted an obstacle to the flow of international trade, and that uncertainty could be eliminated by a set of legal rules that harmonised the treatment of such provisions.

On 19 December 1983, the General Assembly recommended that member states 'give serious consideration' to the *Uniform Rules* and, where appropriate, implement them in the form of either a model law or convention.⁴⁶ The *Uniform Rules* seek to harmonise the treatment, in particular as to validity and application, of clauses which stipulate for payment of a specified sum of money as damages ie: expressed as 'agreed sums' or as a penalty in the event of the failure by a party to perform its contractual obligations in an international commercial transaction.⁴⁷ Unlike *Benelux Convention* art 1, and *Resolution (78)3* art 1 as expanded upon in its *Explanatory Memorandum*, art 6 of the *Uniform Rules* is limited to a contractual stipulation requiring the payment of money consequent upon breach.

Article 8 of the *Uniform Rules* provides that 'the agreed sum shall not be reduced' unless it is 'substantially disproportionate in relation to the loss' suffered by the non-breaching party. This language is different to that used in the *Benelux Convention* (art 4: 'manifest') and *Resolution (78)3* (art 7: 'manifestly excessive'). The use of the different expression 'substantially disproportionate' to describe the agreed sum is of little consequence, as each of the relevant expressions make the same point that reduction may be permitted in circumstances of excess. Each of the international initiatives discussed in this Part require that the stipulation be manifestly or substantially disproportionate before it may be reduced. All of the initiatives are consistent in this regard and there is no justification for any cavilling whether there is any subtle difference in, or shade of meaning, in the expressions used.

Despite the United Nations recommendation regarding acceptance and enactment in one form or another, the member states did little to adopt the *Uniform Rules* as a model law or convention.⁴⁸ Luca G Castellani has commented that the use of the *Uniform Rules* in practice has not been widespread, but that they represent an important intellectual achievement on the basis of provision of a viable compromise between notions of liquidated damages which are acceptable in many jurisdictions and of penalty clauses which may find more difficulty in being recognised by courts.⁴⁹ He states that by the linking of judicial intervention to cases where the agreed sum 'is substantially disproportionate in relation to the loss that has been suffered'⁵⁰ is consistent with the trend towards mitigation of excessive stipulations present particularly in civil law systems. Castellani's argument that the *Uniform Rules* put forward a 'viable compromise' is questionable given that common law systems do not permit the courts to exercise a discretion to reduce or moderate

⁴⁶ See *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance*, 38th sess, 101st plen mtg, UN Doc A/RES/38/135 (19 December 1983). As well as the *Uniform Rules*, UNCITRAL also produced a draft Convention the contents of which was modelled on the *CISG*.

⁴⁷ Castellani, above n 16, 34.

⁴⁸ Solorzano, above n 18, 813. I have not been able to find any instance where the *Uniform Rules* have been adopted.

⁴⁹ Castellani, above n 16, 34. I assume the reference to 'courts' is to courts in common law systems which do not enforce penalty clauses.

⁵⁰ *Ibid.*

agreed sums where there has been a breach of contract. On this basis there is a 'wide gulf'⁵¹ between the common law and civil law systems.

9.2.4 Summary

Figure 4 is a summary of the important aspects of the international initiatives examined in Part I.

FIGURE 4

	<i>Benelux Convention Relating to penalty Clauses (1973)</i>	<i>Council of Europe: Resolution (78)3 Relating to Penal Clauses in Civil Law (1978)</i>	<i>UNCITRAL: Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance (1982)</i>
Applicable to all contracts	✓	✓	Only applies to international contracts as defined
Breach of contract	✓	✓	✓
Payment of money	✓	✓	✓
Matters beyond the payment of money	✓	✓ ⁵²	X
Reduction if stipulation is manifestly excessive	✓ Article 4 Court can mitigate the effect of the penalty clause if justice manifestly so requires	✓ Article 7 Note: non-exhaustive list of factors a court may consider: commentary to art 7	✓ Article 8 Reduction is permitted if the agreed sum is substantially disproportionate in relation to the loss
List of factors relevant to exercise of discretion to reduce	X	✓	X ⁵³

Article 6 of the *Uniform Rules* does not adopt the wide definition of 'penalty clause' provided, for example, in art 1 of the *Benelux Convention*. However, the *Explanatory Memorandum* to art 1 of *Resolution (78)3* provides that the parties are free to agree that the breaching party is bound to do something other than paying a sum of money. Accordingly, both of these initiatives provide for a wide definition of a penalty clause. For all of the initiatives there is convergence in that they apply to clauses stipulating for the payment of money, and that it is necessary for there to be a breach of contract as well as each provides a judicial discretion to reduce. The threshold for reduction was high because the stipulation must be excessive. This represents a protection of principles of party autonomy, freedom of contract and also reinforces contractual certainty.

The extent to which these principles are protected by the initiatives is emphasised in the Commentary to art

⁵¹ Farnsworth, above n 7, 302 n 5; Garcia, above n 17, 98.

⁵² The *Explanatory Memorandum* to art 1 of *Resolution (78)3* states 'the Article only mentions payment of a sum of money as this is undoubtedly the most common form of penalty. The parties are of course free to agree that if the promisee fails to perform the principal obligation he shall be bound to do something other than paying a sum of money': *Explanatory Memorandum to Resolution (78)3*, [14] set out in Annexure D.

⁵³ There is no commentary provided by UNCITRAL with the *Uniform Rules*. However, in the work done by UNCITRAL prior to publication of the *Uniform Rules* it produced a report which listed a variety of factors civil law courts had taken into account for the purposes of reduction in previous decisions. These factors would be of assistance to the court. See 'Report of the Secretary-General: Liquidated Damages and Penalty Clauses', above n 18, 43.

4 of the *Benelux Convention* which provides that the court should exercise the power to reduce 'with the greatest discretion' because the effect of intervention is 'to interfere with binding agreements'. Accordingly, intervention would only be appropriate if 'the sense of justice is outraged'. Further, the 'court must only interfere with binding agreements if justice has obviously been violated'. To like effect the *Explanatory Memorandum to Resolution (78)3* in its commentary on art 7 provides that the court should 'exercise its power with much discretion' and that judicial intervention is to be of an 'exceptional character'.⁵⁴ The fact that the loss actually sustained is less than the sum stipulated is not of itself sufficient reason for the penalty to be reduced. The *Uniform Rules* do not provide any commentary referable to the reduction power; however, the words used in art 8 provide that reduction is not to occur unless there is 'substantial disproportion' between the stipulation and the loss suffered by the non-breaching party. All of the initiatives operate consistently and position the reduction power as an exceptional one to be used sparingly.

After the abovementioned international initiatives were completed, a number of further instruments were drafted in Europe, aimed at harmonising the law of obligations, including the law of contract across the legal systems of Europe. The three international instruments examined each approached the treatment of agreed sums payable for non-performance in the same way in that they provide for judicial reduction of excessive sums. Those instruments are analysed in Part II.

PART II

9.3 Treatment of Specified Sums Payable for Non-Performance in Three International Instruments

9.3.1 Introduction

There has been a general convergence of approaches in international instruments which contain proposals which recognise the utility and desirability of providing for judicial control of disproportionately excessive, manifestly or grossly high, or unreasonable stipulations of specified sums payable upon breach.⁵⁵ That convergence has been to the effect that provisions of this nature are treated in a manner consistent with many civil law systems; namely, they permit judicial reduction. This Part analyses how specified sums payable for non-performance are treated in the following international instruments:

- ❖ The Principles of European Contract Law 2000 ('PECL') at art 9:509 (agreed payment for non-performance);⁵⁶ and
- ❖ The Draft Common Frame of Reference (Principles, Definitions and Model Rules of European Private Law) 2009 ('DCFR') at art III-3:712 (stipulated payment for non-performance);⁵⁷ and
- ❖ The UNIDROIT Principles of International Commercial Contracts 2016 ('UPICC') at art 7.4.13 (agreed

⁵⁴ See the *Explanatory Memorandum* to art 7 of Resolution (78)3 set out in Appendix D.

⁵⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1252 [164]; Scottish Law Commission, *Report on Penalty Clauses*, above n 20, 2 [1.8].

⁵⁶ The text of PECL art 9:509, Comments and Illustrations is set out in Appendix F.

⁵⁷ The text of DCFR art III-3:712, Comments and Illustrations is set out in Appendix G. It is to be noted that the DCFR is published in what are called ten 'Books'. In reality each 'Book' is a chapter of the whole document. Book III deals with 'Obligations and corresponding rights'. The method of citation is 'Article III-3:712', which means art 3:712 in Book III.

payment for non-performance).⁵⁸

These instruments were prepared with the benefit of the prior ground-breaking work undertaken to draft the *Benelux Convention, Resolution (78)3*, and the *Uniform Rules* analysed in Part I above.

9.3.2 Principles of European Contract Law 2000

The PECL is the product of years of comparative analysis and international cooperation amongst European legal scholars. It was drafted by the Commission on European Contract Law set up by Ole Lando⁵⁹ and it was intended to be a set of soft law principles which explained and harmonised the rules and principles of the law of contract regarded as common to most legal systems of the member states of the European Union.⁶⁰ It is in the nature of a restatement, composed of 17 chapters and based on the concept of a uniform European contract law system.⁶¹ It is explained as being ‘a set of general rules which are designed to provide maximum flexibility and thus accommodate future development in legal thinking in the field of contract law.’⁶² Additionally it offers an authoritative point of reference for the interpretation and development of a national legal system in Europe.⁶³

The production of the PECL is described as ‘one of the most interesting, most widely acclaimed, and most influential projects on the way toward the harmonisation of European contract law’.⁶⁴ Nils Jansen and Reinhard Zimmermann⁶⁵ observe that the PECL is a ‘non-legislative codification’: ‘a text in the form of a codification which, however, attains its authority, if any, not by legislative command ... but as a result of its persuasiveness and recognition in legal discourse ... As such, it has become the model for many similar subsequent projects’.

Article 1 of PECL provides that the Principles are meant to serve as general principles of contract law in the European Union. They apply where parties so agree and may be applied as an elaboration of the *lex mercatoria*⁶⁶ or where the parties have not made a choice of law or where the applicable local law does not offer a solution. Additionally art 9:509 of the PECL provides that a specified sum may be reduced to a

⁵⁸ The text of UPICC art 7.4.13, Official Comments and Illustrations is set out in Appendix H.

⁵⁹ The Commission is often referred to in the literature as the ‘Lando Commission’.

⁶⁰ As at 2018 there are 28 European Union member countries.

⁶¹ See Guillermo Palao Moreno, ‘Some Private International Law Issues’ in Javier Plaza Penades and Luz M Martinez Velencoso (eds), *European Perspectives on the Common European Sales Law* (Springer, 2015) 17, 17–18 where he discusses the Common European Sales Law and notes it is closely linked to the development of a ‘European Contract Law’. See also European Commission, ‘Green Paper from the Commission: On Policy Options for Progress towards a European Contract Law for Consumers and Businesses’ (Green Paper No COM (2010) 348 final, European Commission, 1 July 2010).

⁶² Ole Lando and Hugh Beale (eds), *The Commission on European Contract Law, Principles of European Contract Law: Parts I and II* (Kluwer Law Intl, 2000) xxvii.

⁶³ Horst Eidenmuller et al, ‘The Common Frame of Reference for European Private Law — Policy Choices and Codification Problems’ (2008) 28 *Oxford Journal of Legal Studies* 659, 661.

⁶⁴ Nils Jansen and Reinhard Zimmermann, ‘General Introduction: European Contract Laws: Foundations, Commentaries, Synthesis’ in Nils Jansen and Reinhard Zimmermann (eds), *Commentaries on European Contract Laws* (Oxford University Press, 2018) 1, 5 [9].

⁶⁵ Ibid.

⁶⁶ Schwenger, Hachem and Kee, above n 2, 49–50 [3.73]–[3.74] explain that the *lex mercatoria* is a body of law that originally developed in medieval times completely independently of sovereign control and which was based on pragmatism and the universal realities of trade. The understanding of *lex mercatoria* has evolved over time. In its modern incarnation, it is said to be found in the uniform projects, such as UPICC and PECL.

reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance.⁶⁷ This provision is limited to stipulations which provide for the payment of money upon breach.

9.3.3 Draft Common Frame of Reference 2009

The DCFR is the result of a collaboration between the Study Group on a European Civil Code and the Research Group on Existing EC Private Law ('Acquis Group'). The authors have drawn upon common approaches throughout Europe to draft the DCFR being the follow up instrument to the PECL. The DCFR is a soft law draft for the codification of the whole of the European law of obligations and related fields of law and it is an academic text split into ten books produced with the intention that it could be used by European institutions. The scope of the DCFR is more extensive than the PECL as it includes European measures of a consumer protection nature⁶⁸ as well as covering specific contracts and the rights and obligations arising from them, unjust enrichment, acquisition and loss of ownership of goods, and proprietary security rights in movable assets and trusts.

Article III–3:712 of the DCFR is contained in Book III, 'Obligations and Corresponding Rights', and provides that a specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance.⁶⁹ Consistently with the PECL, the provision is limited to stipulations that provide for the payment of money upon breach.

9.3.4 UNIDROIT Principles of International Commercial Contracts 2016

In 1994, the Governing Council of UNIDROIT stated that the objective of the UPICC was to establish a balanced set of rules designed for use throughout the world irrespective of the legal traditions and the economic and political conditions of the countries in which they are to be applied.⁷⁰ The Preamble states that the UPICC may be applied when contracting parties have agreed that their disputes shall be settled according to the 'general principles of law, the *lex mercatoria* or the like' or where the parties have simply failed to make any provision for an applicable law.⁷¹ The UPICC was drafted with the intention of assisting harmonisation of legal principles of contract law for international commercial contracts. It is now in its fourth edition.⁷²

Article 7.4.13 of the UPICC provides that a specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from non-performance.⁷³ Consistently with the PECL and the DCFR, the provision is limited to stipulations for the payment of money upon breach.

The UPICC was drafted simultaneously with the PECL. Both instruments were prepared in a similar manner, they pursue similar aims and have been drafted in a similar style. However, there are two major differences

⁶⁷ The text of PECL art 9:509 and the Comments and Illustrations are set out in Appendix F.

⁶⁸ Laura McGregor, 'Report on the Draft Common Frame of Reference' (Report, Scottish Government, 26 September 2008).

⁶⁹ The text of DCFR art III–3:712 and the Comments and Illustrations are set out in Appendix G.

⁷⁰ See International Institute for the Unification of Private Law, *UNIDROIT Principles of International Commercial Contracts* (2016) xxix.

⁷¹ *Ibid* 1–7.

⁷² Earlier editions were published in 1994, 2004 and 2010.

⁷³ The text of UPICC art 7.4.13 together with the Official Comments and Illustrations are set out in Appendix H.

between the instruments. Firstly the aim of the UPICC is global rather than European harmonisation of contract law and secondly the UPICC specifically deals with international commercial contracts whereas the PECL is a formulation of principles of contract law in general.⁷⁴

9.3.5 Common Themes in PECL, DCFR and UPICC

The rules laid down by the three instruments for the treatment of agreed sums are virtually identical and do not reveal any difference in substance save for some terminological differences.⁷⁵ Each of the Articles is expressed in language consistent with the treatment of agreed sums payable upon non-performance in many civil law systems, *Resolution (78)3* and the *Uniform Rules*. None of the instruments go as far as the *Benelux Convention* to extend the definition of a penalty clause to obligations requiring the doing of 'some other thing by way of penalty or compensation' however each is limited to the payment of money consequent upon breach and followed by 'Comments' to assist with interpretation and implementation.⁷⁶ The instruments explain the background and reasons for the adoption of the relevant Article and its potential application. Some of the Comments are followed by 'Illustrations' which provide hypothetical fact scenarios designed to provide guidance how the Article might operate in practice.⁷⁷ The drafters of the UPICC, for example, regarded the Comments and Illustrations as an 'integral part of the UPICC'.⁷⁸

9.3.5.1 Validity

Each of the Articles acknowledges the validity of a stipulation providing for payment of a specified sum for non-performance. The consequence of non-performance is that the non-breaching party is entitled to receive the specified sum irrespective of the harm/loss actually suffered by it.⁷⁹ DCFR art III-3:712 at Comment A provides that 'there is nothing wrong with the parties agreeing on a penalty for non-performance, provided that they are fully aware of what they are doing and it does not operate unfairly'.⁸⁰

One of the reasons contracting parties stipulate a sum as payable for non-performance is to avoid the difficulty, delay or expense involved in proving actual loss and damage consequent upon breach of contract. Such a clause may also incentivise the potential breaching party to perform as performance could be less costly than paying the specified sum.⁸¹

⁷⁴ Jansen and Zimmermann, above n 64, 5 [10].

⁷⁵ For example, the use of expressions such as 'aggrieved party', 'creditor', 'harm', 'loss', 'agreement', 'contract', 'contract or other judicial act'.

⁷⁶ Michael Joachim Bonell, 'The UNIDROIT Principles of International Commercial Contracts: Why? What? How?' (1995) 69 *Tulane Law Review* 1121, 1128.

⁷⁷ Stefan Vogenauer, 'Introduction' in Stefan Vogenauer (ed), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)* (Oxford University Press, 2nd ed, 2015) 1, 15–16.

⁷⁸ International Institute for the Unification of Private Law, above n 70, 457.

⁷⁹ See Comment 2, and Benedicte Fauvarque-Cosson and Denis Mazeaud (eds), *European Contract Law: Materials for a Common Frame of Reference — Terminology, Guiding Principles, Model Rules* (Sellier, 2008) 286.

⁸⁰ The relevant Articles in the PECL and UPICC do not include this Comment.

⁸¹ See generally Richard Manly, 'The Benefits of Clauses That Liquidate, Stipulate, Pre-Estimate or Agree Damages' (2012) 28 *Building and Construction Law* 246.

9.3.5.2 Non-Performance: Breach of Contract⁸²

The Articles only apply if the non-breaching party establishes there has been non-performance of the contract and that the specified sum is payable for such non-performance.’ This means that a breach of contract ie: non-performance is a precondition to the enlivening of the judicial discretion to reduce.⁸³

The remedies available for non-performance depend upon whether the non-performance is:

- excused;
- not excused; or
- results from the other party’s behaviour.⁸⁴

A non-performance that is excused does not give the non-breaching party the right to claim damages or performance. A non-performance is excused when the breaching party proves that it is due to an impediment beyond its control and that it could not reasonably have been expected to take it into account at the time of the conclusion of the contract, or to have avoided or overcome the impediment or its consequences.⁸⁵ A non-performance which is not excused may give the aggrieved party the right to claim performance, to claim damages, to withhold performance, to reduce performance or to terminate the contract. A non-performance resulting from the breaching party’s behaviour will be excused if it was beyond his or her control or could not have been expected.⁸⁶

9.3.5.3 Harm/Loss

The UPICC uses the expression ‘harm’ whereas the PECL and DCFR use the expression ‘loss’. There is nothing in the Comments to explain whether it was intended there was to be any distinction between these different expressions. However, some guidance can be obtained from UPICC art 7.4.2 (Full Compensation)⁸⁷ and in particular Comment 2 which provides that

[i]n specifying the harm for which damages are recoverable, paragraph (1) of this Article, following the rule laid down in Article 74 of the *C/SG*,⁸⁸ states that the aggrieved party is entitled to compensation in respect

⁸² Article 7.1.1 of the UPICC defines ‘non-performance’ as a failure by the breaching party to perform any of its obligations under the contract, including defective or late performance. Article 1:301 of the PECL defines ‘non-performance’ as any failure to perform an obligation under the contract, whether or not excused (see art 8:108 (Excuse to an Impediment)) and includes delayed performance, defective performance and a failure to operate in order to give full effect to the contract. In the DCFR ‘non-performance’ is defined in art III–1:01 as ‘any failure to perform the obligation, whether or not excused, and includes delayed performance and any of the performance which is not in accordance with the terms regulating the obligation’.

⁸³ Examples of arbitral awards or disputes where UPICC was applicable and where the question of validity of agreed payment for non-performance has been considered can be found in Michael Bonell (ed), ‘The UNIDROIT Principles in Practice: Caselaw and Bibliography on the UNIDROIT Principles of International Commercial Contracts (Transnational Publishers, 2002) 409 (abstract of Award No A-1795/51, Camera Arbitrale Nazionale ed Internazionale di Milano, 1 December 1996), 443 (abstract of Award No 8261, ICC International Court of Arbitration, 27 September 1996), 483 (Award No 229/1996, International Arbitration Court of the Chamber of Commerce and Industry of the Russian Federation, 5 June 1997).

⁸⁴ See PECL art 8:108; UPICC art 7.1.1; DCFR art III–3.104.

⁸⁵ See PECL art 8:10(1); UPICC arts 7.1.1–3, 7.1.7; DCFR art III–3.104.

⁸⁶ DCFR art III–3.104 (Excuse due to Impediment); UPICC arts 7.1.2 (Interference by the other party), 7.1.7 (Force Majeure); PECL art 8.108 (Excuse due to an Impediment).

⁸⁷ Article 7.4.2 (Full Compensation) of UPICC states:

(1) The aggrieved party is entitled to full compensation for harm sustained as a result of non-performance. Such harm includes both any loss which it suffered and any gain of which it was deprived, taking into account any gain to the aggrieved party resulting from its avoidance of cost or harm.

(2) Such harm may be non-pecuniary and includes, for instance, physical suffering or emotional distress.

⁸⁸ Article 74 of the *C/SG* states:

not only of loss which it has suffered, but also of any gain of which it has been deprived as a consequence of the non-performance. The notion of loss suffered must be understood in the wide sense.

PECL art 9:501 (Right to Damages) provides that the non-breaching party is entitled to damages for loss which includes non-pecuniary loss and future loss. DCFR art III–3.701 (Right to Damages) provides that loss for which damages are recoverable includes future loss. ‘Loss’ is defined to include economic loss ie: loss of income or profit, burdens incurred and a reduction in the value of property and non-economic loss ie: pain and suffering and impairment of quality of life.

The instruments use the following expressions:

- i) harm for which damages are recoverable for loss suffered;
- ii) damages for loss; and
- iii) loss for which damages are recoverable.

There is no substantial difference between the expressions ‘harm’ and ‘loss’ where used in the various instruments as they are expressions intended to have wider meaning.

9.3.6 Factors to Determine Whether a Specified Sum Is Grossly Excessive

When deciding whether a specified sum is ‘grossly excessive’, the court must compare that sum against the harm or loss in money terms resulting from the non-performance and ‘to other circumstances’. This means ‘actual’ harm or loss which need not be ‘foreseeable’ at the time the parties entered into the contract.⁸⁹ It is not sufficient merely for the non-breaching party to demonstrate that the specified sum is in an amount greater than the monetary amount which represents the value of the harm or loss which has resulted from the breach. The disparity between the figures must be so substantial that it qualifies as ‘grossly excessive’. PECL art 9:509 Comment B, and DCFR art III–3:712 Comment B, both proffer the following indicia:

- the disparity between the specified sum and the actual loss suffered by the non-breaching party is gross;
- the stipulation is abusive in effect; and
- the stipulated sum substantially exceeds the actual loss.

UPICC art 7.4.13 Comment 3 states that a sum is likely to be grossly excessive if ‘it would clearly be so to any reasonable person.’ Because of the use of the words ‘clearly’ and ‘any’ in Comment 3, if there is a doubt in the mind of a reasonable person, then the specified sum is unlikely to be regarded as ‘grossly excessive’ and it will be enforced.⁹⁰ The court should have the widest discretion to assess the facts and circumstances of each case. The common theme running through the Comments and the instruments is the avoidance of punishment. Penalty clauses which aim to punish may not be enforced but may be reduced.

Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.

⁸⁹ Ewan McKendrick, ‘Article 7.4.13’ in Stefan Vogenauer (ed), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)* (Oxford University Press, 2nd ed, 2015) 1025, 1030 [18].

⁹⁰ Ibid 1030 [17]; UPICC art 7.4.13 at Comment 3.

Before a stipulated sum may be reduced the court must first find its level of disproportion to be 'grossly excessive'. This is confirmed by each Article where it is stated that the sum is not to be reduced 'unless' it is excessive.⁹¹ A grossly excessive specified sum may be reduced to a reasonable amount meaning that there is little incentive in the first place for contracting parties to err on the side of caution when negotiating the amount of the specified sum payable in the event of non-performance.⁹² The stipulation will never be found to be totally unenforceable but merely subject to judicial reduction and it is the starting point for the court when it deliberates on the extent to which the specified sum is excessive and may be reduced. It is evident that disproportion is a highly significant consideration under each of the Articles in that they all provide that 'regard should, in particular, be had to the relationship between the sum agreed and the harm or loss actually sustained'.

9.3.6.1 'Other Circumstances'

Each of the Articles uses the expression 'other circumstances'. It is neither defined nor explained in the Comments and it is an expression of wide import. McKendrick⁹³ suggests the expression may mean that courts can have regard to equality of bargaining power and the extent to which the parties were legally advised. In this regard, the factors a court may take into account may also include those listed in the *Explanatory Memorandum* to art 7 of *Resolution (78)3* referred to above.⁹⁴ Further guidance can be obtained from the UNCITRAL report discussed above which listed a variety of factors courts in civil law systems had taken into account in deciding whether to reduce⁹⁵ as the instruments use such an open-ended expression matters beyond mere disproportion would be relevant and can be considered by the court to determine otherwise would result in making the expression redundant.

9.3.6.2 Specified Sum: Reduction If Grossly Excessive

Pascal Hachem observes that in developing the relevant criteria to measure gross excess, a 'restrictive approach'⁹⁶ is required as there is a high threshold before the fact of excess can be established. The level of excess must be 'gross'. The courts are circumspect about reducing specified sums freely agreed by the parties and reduction has to be the exception rather than the rule because agreed sums are not to be reduced or modified 'unless' they are excessive. The instruments are each drafted to protect the bargain of the parties and provide commercial certainty. Accordingly, unless gross excess exists the specified sum clause is likely to be enforced.

This restrictive approach applies due to the language used in the various instruments; for example, 'grossly excessive',⁹⁷ 'substantially disproportionate',⁹⁸ and 'manifestly excessive'.⁹⁹ The various instruments provide little guidance as to how the relevant yardstick is to operate. This is consistent with the drafting style used for

⁹¹ Schwenger, Hachem and Kee, above n 2, 638 [44.285].

⁹² McKendrick, above n 89, 1030 [16]; see also Gabriel A Moens, Lisa Cohn and Darren Peacock, 'A New Approach to International Commercial Contracts: The UNIDROIT Principles of International Commercial Contracts — The Australian Experience' (2000) 5 *International Trade and Business Law Annual* 219, 248–51.

⁹³ McKendrick, above n 89, 1031.

⁹⁴ See Appendix D.

⁹⁵ 'Report of the Secretary-General: Liquidated Damages and Penalty Clauses', above n 18, 43.

⁹⁶ Hachem, above n 8, 127.

⁹⁷ PECL art 9:509; UPICC art 7.4.13; DCFR art III–3.712.

⁹⁸ *Uniform Rules* art 8.

⁹⁹ *Resolution (78)3* art 7.

civil law instruments which are characterised by ‘a high level of abstraction and constitute a framework of general principles’ leaving it to the courts to determine definitions and guidelines.¹⁰⁰ Each of the Articles envisages a comparison between the agreed sum and something else,¹⁰¹ ie: the agreed sum must be assessed in relation to the loss resulting from the non-performance meaning that the loss actually is suffered by the non-breaching party rather than constrained legally recoverable loss.¹⁰² Also, it is necessary to take into account, for example, all the circumstances of the case such as whether there has been part performance, the seriousness of the non-performance, as well as the position of the breaching party.¹⁰³

UNCITRAL¹⁰⁴ reports that most of the civil law systems that permit reduction do not specify the criteria to be applied in determining whether a penalty is grossly or manifestly excessive. This is consistent with the use of the expression ‘other circumstances’ which gives the court unfettered discretion. In its report published in 1979,¹⁰⁵ UNCITRAL provides a listing of the following main criteria ascertained from its research and applied by civil law courts when carrying out the reduction process:

- ❖ whether the obligation has been partly performed by the breaching party before breach;
- ❖ whether the penalty is disproportionately high, or excessive or manifestly excessive;
- ❖ whether the penalty is unreasonable or iniquitous;
- ❖ the extent to which part performance has benefited the non-breaching party;
- ❖ the extent of the disproportion between the amount of the penalty, and either the value of the actual loss suffered, or the amount recoverable as damages for the loss (this criterion has been widely applied);
- ❖ the good or bad faith of the breaching party, or the degree of its fault, in committing the breach of contract;
- ❖ culpable conduct on the part of the non-breaching party, such as a failure to take action to mitigate its loss, which might have contributed to the loss;
- ❖ the extent to which the breaching party has been enriched by its own breach of contract;
- ❖ the financial state of the breaching party, and the effect that payment of the penalty would have on that state; and
- ❖ all legitimate interests of the non-breaching party in the payment of the penalty.

These factors fall within the expression ‘other circumstances’. They are many-faceted, of the broadest import, include legitimate interests, are not confined to commercial or financial interests, and are not constrained by the limits applicable to damages for breach of contract.

¹⁰⁰ Myburgh and Zimmermann, above n 5, 309. Kay Tucker of the Monash University Law School Library provided valuable assistance in January 2019 by locating a copy of this book chapter from the Yale University Library.

¹⁰¹ Treitel, above n 5, 224 [177].

¹⁰² See PECL art 9:509 Comment G; DCFR art III–3.712 Comment C; UPICC art 7.4.13 Comment 3; Hachem, above n 8, 129–30. This is also consistent with the way in which s 3 of the *Conventional Penalties Act 1962* (South Africa) operates.

¹⁰³ Hachem, above n 8, 128–32.

¹⁰⁴ ‘Report of the Secretary-General: Liquidated Damages and Penalty Clauses’, above n 18, 43.

¹⁰⁵ *Ibid.*

The expression 'specified sum' is used in each of the Articles to refer to the amount to be paid consequent upon breach 'irrespective of [its] actual harm'¹⁰⁶ or 'irrespective of [its] actual loss'.¹⁰⁷ The 'specified sum' in each instance may be reduced to a reasonable amount where it is 'grossly excessive' in relation to the 'harm'¹⁰⁸ or the 'loss'¹⁰⁹ resulting from the non-performance and to 'other circumstances'. Each of the instruments recognises that specified sum clauses have a compensatory function and evaluate the 'loss' or 'harm' in a prospective way ie: an ex post analysis consistent with the well-established benefits of the use of such provisions¹¹⁰ which facilitate the task of the non-breaching party in not having to prove damages. In exercising the reduction discretion the courts thus need to recognise that the stipulated sum clause can have various functions eg: limitation of liability and pre-estimation of loss. The courts also need to determine whether the function of the clause is compensatory or 'grossly excessive' in relation to the harm/loss resulting from the non-performance.

A question upon which little guidance is provided relates to exactly when the assessment of whether the specified sum is grossly excessive is to be carried out. As the calculation that is required is of the actual loss suffered by the non-breaching party, the relevant point in time when it is to be calculated cannot be ex ante when the parties entered into the contract. The relevant time is therefore ex post, either when the agreed sum became due to be paid or when the legal proceeding is heard before a court.¹¹¹

9.3.7 Level of Reduction

Reduction of the agreed sum is not mandatory due to the presence of the use of the expression in each of the Articles 'notwithstanding any agreement to the contrary' in each of the Articles. Each instrument permits the parties to exclude application of any of the Articles or to derogate from or vary their effects¹¹² and each article provides for reduction to 'a reasonable amount' leaving a wide discretion to the court.

An important consideration is whether the amount of the 'reasonable sum' to which the specified sum may be reduced must necessarily be equal to the amount of the money value of the actual harm or loss which the non-breaching party has suffered or whether it can be higher than that sum. If a specified sum is 'grossly excessive' the court 'may' reduce the sum where emphasis in all articles is on the word 'may'. The amount of the reasonable sum may be a figure higher than the amount of the actual harm or loss as all Articles merely state that the specified sum 'may be reduced' but they do not state that the specified sum is to be ignored, disregarded or accorded no status, which would apply if the non-breaching party is to be confined automatically to recovery of an amount equal to its legally recoverable loss or damage.¹¹³

Zimmermann¹¹⁴ observes that reduction to a reasonable amount is less helpful than it sounds due to reduction to such a level is an indicator that the stipulated sum may be reduced to a level which, while harsh,

¹⁰⁶ UPICC art 7.4.13.

¹⁰⁷ PECL art 9:509; DCFR art III-3.7.12.

¹⁰⁸ UPICC art 7.4.13.

¹⁰⁹ PECL art 9:509; DCFR art III-3.7.12.

¹¹⁰ Manly, above n 81.

¹¹¹ Hachem, above n 8, 132-3.

¹¹² This is provided for in UPICC art 1.5 (Exclusion or Modification by Parties). Similar provisions exist in PECL art 1:102(2) (Freedom of Contract) and DCFR art II-1:103 (Binding Effect).

¹¹³ McKendrick, above n 89, 1031 [20].

¹¹⁴ Zimmermann, above n 5, 1552 [19].

is no longer manifestly unfair. UPICC art 7.4.13 at Comment 3 provides that ‘the agreed sum may only be reduced, but not entirely disregarded’. The respective Articles in PECL and DCFR do not contain this Comment. Each instrument permits the court to reduce ‘grossly excessive’ specified sums ie: that portion of the specified sum representing the amount of the gross excess. However, each of PECL art 9:509 and DCFR art III–3.712 at Comment B states that the court has to fix an ‘intermediate figure’¹¹⁵ which is consistent with an attempt to achieve an outcome maintaining the sanctity of the contract and curbing abuse. This outcome permits the non-breaching party to obtain a remedy of the kind provided for in the contract ie: payment of the specified sum but in a judicially reduced amount. Furthermore permitting the court to arrive at an ‘intermediate figure’ means that the strict mathematical exercise often adopted in common law systems is not appropriate.

It is evident that disproportion is a highly significant consideration in all of the Articles as they all state that ‘regard should in particular be had to the relationship between the sum agreed and the harm or loss actually sustained’.

9.3.8 Specified Sum Disproportionately Low

Where the parties agree to a stipulation that fixes a disproportionately low amount ie: one which is clearly inadequate to compensate for the harm or loss resulting from the non-performance, each of the instruments provides that such a clause may be regarded as an exemption clause and consequently ineffective if it would be grossly unfair to permit the breaching party to rely on it.¹¹⁶

PART III

9.4 Conclusion

This Chapter analyses how a number of important international initiatives and instruments have treated specified sums payable for non-performance. Before moving to an examination of the comparison between the common law and the various initiatives and instruments, it is useful to briefly summarise some of the key differences between the approaches that have been adopted by the three international instruments examined in Part II.

Figure 5 summarises how the three international instruments treat specified sums payable for non-performance, and demonstrates an approach which is predominantly consistent.

¹¹⁵ See PECL art 9:509; DCFR art III–3.712 Comment B: ‘the court ... should respect the intention of the parties to deter default and therefore should not reduce the award to the actual loss. The court has to fix an intermediate figure’. There is no similarly worded Comment in the UPICC.

¹¹⁶ See UPICC art 7.1.6 at Comment 4; PECL art 8:109; DCFR art III–3:105(2) at Comment B; see Michael Joachim Bonnell, *An International Restatement of Contract Law: The UNIDROIT Principles of International Commercial Contracts* (Transnational Publishers, 3rd ed, 2005) 162–3.

FIGURE 5

	PECL	DCFR	UPICC
Liquidated damages v penalty dichotomy	X	X	X
Necessity to prove some loss or harm	X	X	X
Only applies to payment of money	✓	✓	✓
Stipulated sum is a ceiling to the amount of reasonable compensation	✓	✓	✓
Is mitigation relevant?	✓	✓	✓
Ex post facto analysis	✓	✓	✓
Reasonable sum recoverable	✓	✓	✓
Breach necessary	✓	✓	✓
Applicable to non-breach	X	X	X
Loss	✓	X	X
Harm	X	✓	✓
Discretion to reduce grossly excessive sums	✓	✓	✓
Reduction to an intermediate figure	✓	✓	X
For reduction 'other circumstances' are relevant	✓	✓	✓

Reduction applies to stipulations activated by a breach of contract. Such stipulations must be excessive before judicial intervention is justified. The differences in wording adopted by the instruments is not significant.

A tension exists between how common law systems and many civil law systems treat specified sums payable for breach of contract. In common law systems, specified sums ie: liquidated damages found to be penal are unenforceable. A stipulated sum is a penalty if it is found to be out of all proportion to the legitimate interests of the non-breaching party in contractual performance.¹¹⁷ The alternative remedy of a suit for recovery of unliquidated damages is available at common law. In many civil law systems penalty clauses are treated as valid, and in general, enforced subject to a judicial discretion to reduce or modify for 'gross excess' or 'manifest excess'. At common law in Australia, in situations where there has been no breach of contract equity may intervene, and the stipulated sum may be 'partially enforced' but only to the extent necessary to satisfy the prejudice suffered by the non-breaching party.¹¹⁸ This is usually equal to the amount of damages recoverable for breach of contract.

Part I considers the international initiatives developed in Europe in the 1970s, aimed at unifying national laws and their treatment of specified sums. These initiatives include the *Benelux Convention* (1973), and

¹¹⁷ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

¹¹⁸ *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

Resolution (78)3 (1978). UNCITRAL carried out a research project and based on empirical evidence produced the *Uniform Rules* in 1993. **Figure 4**¹¹⁹ summarises the salient features of these international initiatives. In each instance, they had been drafted consistently by providing for judicial reduction¹²⁰ where the excess needs to be gross before reduction can be sanctioned by the court. This is to be compared with the common law rationale for the penalty doctrine advanced in Chapter 2 ie: that stipulations which seek to punish the breaching party will not be enforced on the basis that they are extravagant, exorbitant and unconscionable in their operation. Furthermore stipulations are not enforced as their aim is to punish. The international initiatives and instruments examined in this chapter converge with the common law to the extent that their treatment of stipulations means that where there is gross excess there will be reduction or non-enforcement (at common law) thus excessive stipulations are not enforced.

The relevance and importance of the international initiatives and instruments considered in Parts I and II has been confirmed by the UK Supreme Court which referred positively to them in the recent judgment in *Cavendish*.¹²¹ There, the Court observed that the penalty rule 'is included in influential attempts to codify the law of contracts internationally, including the UNIDROIT Principles of International Commercial Contracts (2010) [sic] (Article 7.4.13), and the UNCITRAL *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance* (Article 6)'.¹²² The Court also referred to Article 7 of *Resolution (78)3* and PECL art 9:509.¹²³

Part II analyses the treatment of agreed sums in three international instruments ie: the DCFR, PECL and UPICC. The treatment of agreed sums in these instruments is consistent with¹²⁴ the *Benelux Convention*, *Resolution (78)3*, and the *Uniform Rules*. They all feature a discretion to reduce the specified sum to a reasonable amount in circumstances where it is found to be 'grossly excessive' or 'manifestly excessive'. Each instrument permits the reduction to apply only to stipulations requiring the payment of money upon breach of contract. The discretion to reduce does not extend to enforcing stipulations that provide for the forfeiture of money or the transfer or forfeiture of property or a failure of the primary stipulation.

The treatment of specified sum clauses provided by the DCFR, PECL and UPICC differs in a number of respects to the common law. Firstly in each of the instruments, penalty clauses are prima facie valid and enforceable. The common law dichotomy between the enforceable liquidated damages clause and unenforceable penalty clause does not apply. Secondly in the international instruments the courts have a discretion to modify grossly excessive penalty clauses which does not exist in common law systems where there has been a breach of contract. At common law, the remedy, where a clause is found to be penal and unenforceable, is recovery of unliquidated damages. Thirdly in common law systems the penalty doctrine applies beyond specified sums payable upon breach of contract to include forfeiture and transfer of property and there is no equivalent provision in any of the international instruments. Furthermore, Australian law recognises a jurisdiction which can provide relief in equity against penalties where there has been no breach

¹¹⁹ See above Figure 4 at [9.2.4].

¹²⁰ See 'Report of the Secretary-General: Liquidated Damages and Penalty Clauses', above n 18, 42.

¹²¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1206–7 [37]–[38], 1252 [164], 1280 [265].

¹²² Ibid 1206 [37].

¹²³ Ibid 1252 [164].

¹²⁴ See Schwenger, Hachem and Kee, above n 2, 634.

of contract, but rather a failure of a primary stipulation.¹²⁵ In such a circumstance the remedy is scaling down to the level of recoverable loss. This jurisdiction is not recognised by any of the international instruments.

The international instruments all refer to ‘actual harm’ or ‘actual loss’ calculated ex post. As Part II explains, there is no substantial difference between these expressions. The instruments take into account interests beyond the legitimate financial and commercial interests of the non-breaching party in contractual performance on the basis that it is ‘actual’ harm/loss being considered ex post. There is nothing in the international instruments which limits recovery to damages for breach of contract and this does not differ to the common law position for commercial contracts where the pre-estimated amount calculated by an ex ante approach, as at the date of entry into the contract and payable as a result of a breach of contract is no longer the predominant factor to weigh in the balance in deciding whether the stipulated sum is liquidated damages or a penalty. The common law now requires a consideration of the ‘legitimate interests’ of the non-breaching party in performance of the contract and those interests need to be ‘out of all proportion’ to the stipulation. In common law systems those interests are not limited to the amount of damages recoverable for breach of contract.¹²⁶ However, in Australia they are limited to commercial and financial interests, whereas in England they may be broader.¹²⁷

At common law, there is a debate as to whether the stipulated sum is a ‘ceiling’ or cap on the amount that can be recovered in the event the stipulation is found to be unenforceable and the non-breaching party is left to pursue a claim for unliquidated damages.¹²⁸ This consideration does not arise under any of the international instruments because the excessive stipulation may be reduced by the court, rather than rendered unenforceable. The international instruments are consistent in that they permit reduction in circumstances where the specified sum is found to be ‘grossly excessive’ having regard to the actual harm or loss suffered by the non-breaching party. However, PECL art 9:509 Comment B and DCFR art III–3.712 each provide that the reduced amount is to be to ‘an intermediate figure’. At common law, the time at which a liquidated damages clause is to be assessed for whether it is a penalty is the date of entry into the contract ie: an ex ante approach. The international instruments all provide that the relevant time is after breach ie: an ex post facto analysis. This is because the instruments focus on ‘actual loss’ or ‘actual harm’.

As part of the comparative element of the thesis, this Chapter argues that the underlying theme in the various international initiatives and instruments examined in both Parts I and II is that judicial reduction will only apply in circumstances where there has been gross excess in the amount of the stipulation. Gross excess is in the nature of contract sanctioned punishment which the law will not tolerate. To this extent, the international initiatives and instruments operate in a manner consistent with the common law and only the

¹²⁵ See *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd* (2014) 45 VR 79, 98–101 [43]–[54]; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

¹²⁶ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

¹²⁷ For Australia see *ibid* 547 [29], 581 [166], 583 [172], 584 [176], 613 [272]. For England see *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1276 [249].

¹²⁸ See the discussion in Roger Halson, ‘Remedies for Breach of Contract’ in Michael Furmston (ed), *The Law of Contract* (LexisNexis, 6th ed, 2017) 1671, 1820 [8.128]; Doug Jones, ‘Can Prevention Be Cured by Time Bars?’ (2009) 26 *International Construction Law Review* 57, 59–60; Justice James Edelman, *McGregor on Damages* (Sweet and Maxwell, 20th ed, 2018) 512–13 [16.026]; Hugh Beale, ‘Damages’ in Hugh Beale (ed), *Chitty on Contracts* (Sweet and Maxwell, 32nd ed, 2015) [26.001], [26.202].

outcomes differ. What is consistent is that the international instruments will only operate to reduce in extreme or exceptional circumstances and at common law the High Court determined that setting aside a stipulation on the grounds of penalty is a 'high hurdle'.¹²⁹

This concludes the comparative aspect of the thesis analyses the statutory regime in South Africa, the law reform initiative in Scotland, and the international initiatives and instruments.

¹²⁹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 553 [53].

Chapter 10

Conclusion: Liquidated Damages and Penalties: Comparison of the Common Law and Certain International Approaches

10.1 Introduction

This thesis is divided into four sections. The first section comprises Chapters 2, 3, 4 and 5 which in the first instance analyse the common law penalty doctrine represented by the *Dunlop* formulation and in the second instance evaluate the major changes to the law brought about by *Andrews*, *Cavendish* and *Paciocco*. The second section comprises Chapter 6 which examines an unsuccessful argument advanced in *Cavendish* that the penalty doctrine should be limited to confining *Dunlop* unconscionability to circumstances of procedural misconduct involving duress, undue influence or misrepresentation. For this reason it is argued that 'unconscionability' in the *Dunlop* sense is a freestanding narrow concept which focuses on the extravagance of the stipulated sum but different to unconscionability in equity and in particular substantive unconscionability which focuses on the conduct of the stronger party. The third section comprises the international material evaluated in Chapters 7, 8 and 9 thus providing the comparative aspect of the thesis, and notes how this material adopts a different approach to the treatment of penalty stipulations compared to the common law approach by providing for judicial reduction of excessive sums whilst not recognising the dichotomy between enforceable liquidated damages and unenforceable penalties. The different approaches which are evaluated are shown to converge in sharing a common rationale that stipulations with the aim or purpose of punishment are not enforced and further that agreed remedies will not lightly be found to be unenforceable or subject to reduction. The fourth and final section comprises this chapter, the purpose of which is to draw the threads together.

This thesis supports a number of findings and conclusions including the true rationale for the penalty doctrine is that stipulations which have the aim or purpose of punishment are not enforced. The extension to the penalty doctrine arising from *Andrews* has not proven in practice to be a major development. *Cavendish* and *Paciocco* provide a legitimate interests test for complex contracts which makes the law more certain in the sense that stipulated payment clauses are more likely to be enforced. Accordingly their use by contracting parties to protect particular interests will increase. Chapter 5 contends that the court will need to impose limits on the legitimate interests which the law will protect. As *Dunlop* continues to apply to 'straightforward clauses' it is necessary to distinguish between simple clauses and complex contracts as different tests apply. Chapter 5 supports a process whereby the court determines the question of characterisation which can have an effect on pleadings and expert evidence.

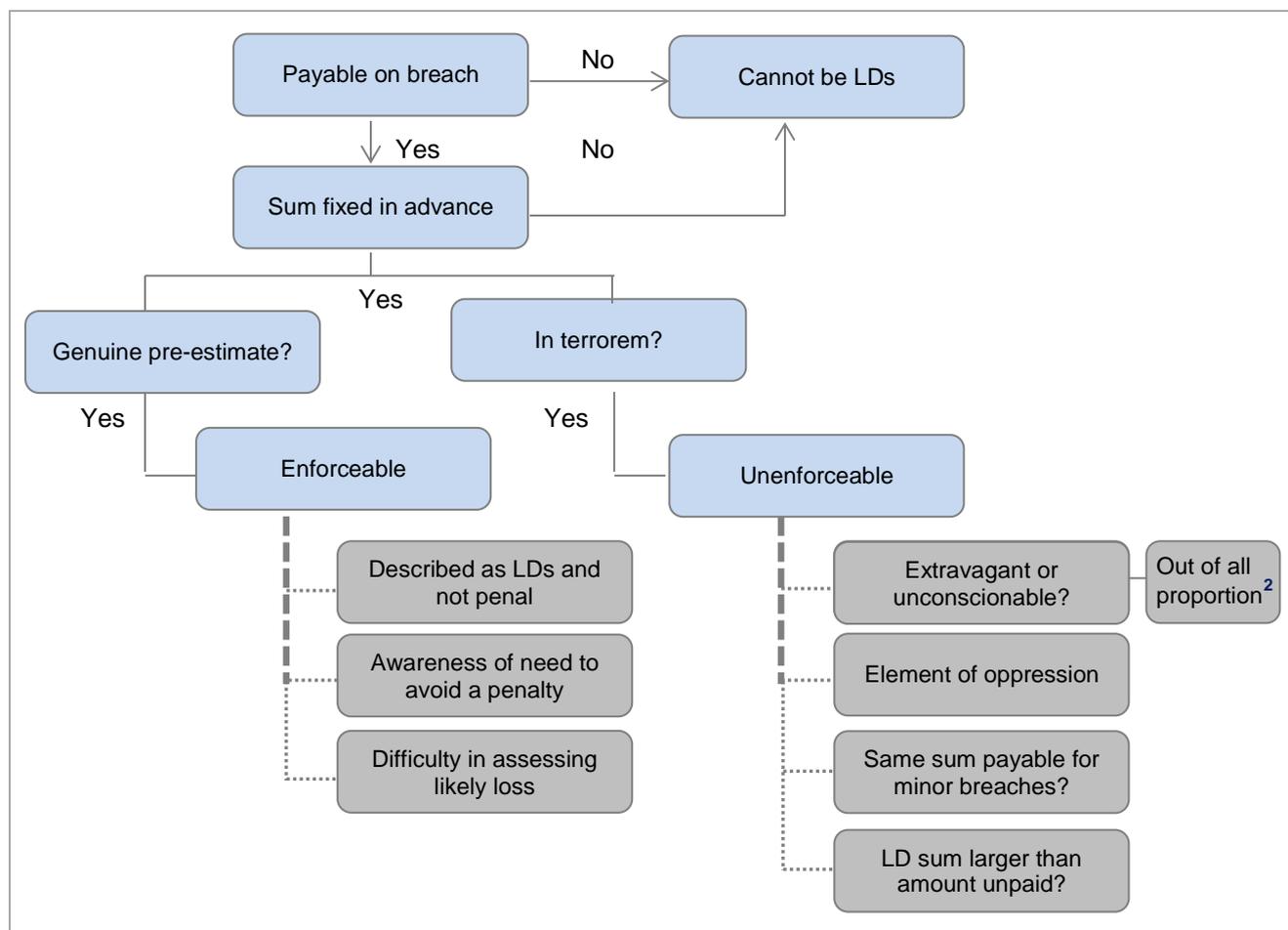
10.2 *Andrews* Test Will Rarely Apply

For nearly a century, Lord Dunedin's four propositions represented the settled position at common law which was applied by judges in a formulaic manner to determine whether an impugned stipulation was enforceable liquidated damages or an unenforceable penalty.

The *Dunlop* formulation as explained in detail in *Paciocco* is set out in Chapter 2 and is conveniently

summarised in diagrammatic fashion in **Figure 6**.¹

Figure 6: Diagrammatic representation of the *Dunlop* formulation



The law in Australia and England recognises that at common law the penalty doctrine is not engaged unless there is a breach of contract. *Andrews* enlivens a jurisdiction in equity which had otherwise 'withered on the vine' to grant relief in circumstances where there is failure of a primary stipulation. In *Andrews*, the court determined the important breach limitation that applies to the penalty doctrine is no longer a prerequisite in equity. However as noted in Chapter 3 *Andrews* was severely criticised by academics. The *Andrews* extension to the penalty doctrine was rejected outright by Lords Neuberger and Sumption in *Cavendish* and a number of the Lords commented that such a change to the law could only be achieved by legislative reform. French CJ in *Paciocco* seems to have agreed. The practical effect of *Andrews* is that the equitable jurisdiction is rarely engaged but, if it is then the remedy is scaling down of the stipulated sum to the level of unliquidated damages, which is equivalent to the result which applies in a breach situation when the stipulation is found to be a penalty.

Chapter 3 contends that the decision in the *Cedar Meats* appeal may have been differently decided if the appellant had pursued a ground of appeal questioning the trial judge's finding that the stipulation in question was a penalty. The point was not taken for the purposes of the appeal and could not be examined by the

¹ See Patricia Wade, 'Outside the Penalty Box: The Latest on Liquidated Damages' (2009) 4 *Construction Law International* 11, 13.

² *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656.

Court of Appeal. However based on what was said about the penalty doctrine and its limited application it is arguable the court would have found on the appeal that the stipulation was enforceable and not a penalty. This is due to the finding that in cases involving commercial organisations of equal bargaining power courts should be prepared to allow a substantially larger degree of latitude than would be appropriate in a standard form contract. This would appear to be the approach which was adopted in *Cavendish*.

10.3 *Cavendish and Paciocco* and Legitimate Interests

Cavendish provided further incremental development to the penalty doctrine and correctly observed that Lord Dunedin's four propositions had been applied as a code or a set of rules. The distinction between rules, principles and standards is advanced in Chapter 2. *Cavendish* explains that Lord Dunedin's four propositions were incorrectly elevated to the status of rules and applied in a fashion which was too rigid and straight-jacketed as they are a set of principles intended to provide guidance and applied only in straightforward cases where the penalty doctrine in its 'standard application' is engaged. The formulaic way in which Lord Dunedin's four propositions were applied for nearly a century caused the Lords to reconsider the speeches in *Dunlop*, which led to the realisation that the real focus of the judgment is not to be found in Lord Dunedin's speech, but rather in consideration of the interests of *Dunlop* itself which were said to be protected by the stipulation. Lord Atkinson considered that when a stipulation payable upon breach is impugned it is necessary to inquire whether the legitimate interests of the non-breaching party in performance of the contract are protected by that stipulation. A non-breaching party with a legitimate interest must still establish that the stipulated sum sought to be enforced is not extravagant or unconscionable when compared to the legitimate interests of that party. The legitimate interests test is therefore not new, but rather can be found to be embedded in the speeches in *Dunlop* but had been overlooked due to the prominence given to Lord Dunedin's four propositions. The effect of the legitimate interests test is that the court adopts the approach which compares an impugned stipulation with the legitimate interests of the non-breaching party in its observance rather than with the loss suffered by the non-breaching party.

Cavendish confirms that clauses providing for the payment of money upon breach³ operates, for example, to capture liquidated damages clauses in most standard form construction contracts. The contract in *Cavendish* is of the more complex variety and the stipulations in question require forfeiture of money and enforcement of a call option. Stipulations of this complexity do not fit within what the UK Supreme Court referred to as 'straightforward clauses' and they will be subject to the legitimate interests test. As the bar to enforcement is set high, enforcement of the stipulation rather than reduction is likely to be the norm. In Australia and England due in particular to *Cavendish* and *Paciocco* enforcement of stipulated sums is now more certain than it was when the *Dunlop* formulation represented the law. However, that does not mean the penalty doctrine has no role to play in the law of contract as impugned stipulations are still found to offend the penalty doctrine.⁴

The modern penalty doctrine represented by the legitimate interests test has a practical limitation; the test

³ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 224 CLR 656, 662 [10].

⁴ *Gray v Braid Group (Holdings) Ltd* 2017 SC 409; *Richards v IP Solutions Group Ltd* [2016] EWHC 1835 (QB) (22 July 2016); *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (27 February 2017).

only applies to commercial contracts. Lords Neuberger and Sumption⁵ stated that Lord Dunedin's four propositions are not determinative, but can be 'perfectly adequate' to 'straightforward'⁶ damages clauses. Thus the difficulty is in determining exactly what this meant and furthermore the judges in *Cavendish* provided limited guidance. Following *Cavendish* and *Paciocco* there is presently no line of decisions providing guidance as to the boundaries of legitimate interests that courts may regard as relevant however, to date the cases have established those circumstances where legitimate interests in performance rather than agreed damages will arise include the following:

- i) where the non-breaching party faces serious difficulty in proving loss due to the breach of contract;
- ii) where the non-breaching party would face serious difficulties in detecting whether there has been a breach of the contract;
- iii) where the non-breaching party would not be able to obtain substitute goods, property or services which would make damages an inadequate remedy;
- iv) where loss will be suffered by a third party instead of or in addition to the non-breaching party;
- v) where the non-breaching party risks insolvency if it has to wait for damages from the breaching party;
- vi) where the non-breaching party has an exceptional interest in ensuring that the breaching party performs such that the court would award an account of profits; and
- vii) generally in circumstances where deliverance is an essential element of a lawful scheme.

Some further limited guidance is found in *Paciocco* as to the identification and valuation of legitimate interests. Two approaches are evident, firstly⁷ Nettle J (in dissent) follows a narrow approach concentrating on the interests protected by the bargain, and secondly the majority prefer an expansive approach which considers the subjective interests of the non-breaching party. The expansive approach will continue to be applied as that is what is required when the legitimate interests test is applied. This is unsatisfactory as it permits the non-breaching party to recover damages to its interests for matters not necessarily the subject of the bargain.⁸

10.3.1 Suggested Limits to Legitimate Interests

Chapter 5 contends that later decisions provide guidance defining which legitimate interests are relevant, however the court still needs to provide some boundaries. The concern arises from the outcome of *Cavendish* which was to deprive Mr Makdessi of over \$100 million. This decision appears harsh and in the circumstances the financial result is to be seen as a worst case scenario. This raises the issue of the limits or boundaries being placed on the legitimate interests test. This thesis provides some suggestions about this issue and suggests control measures which include consideration of the proportionality between what the parties can permissibly apportion between themselves in stipulations and what can be awarded as a remedy for breach of contract. Any unsatisfactory imbalance may be addressed in the ways provided in chapter 5 which include:

⁵ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172.

⁶ *Ibid.*

⁷ Chapter 5 at [5.2.5.1].

⁸ In this regard see chapter 5 at the final paragraph of [5.2.8.2] where examples are provided from *ParkingEye Ltd v Beavis* [2016] AC 1172, and *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

- i) a comparison between the stipulated sum and the actual loss and damage suffered by the non-breaching party which is then to be compared with legally recoverable loss. The court needs to determine the acceptable levels of disproportion;
- ii) narrowing or specifying the acceptable and unacceptable 'legitimate interests'. These could be limited to commercial or financial interests only;
- iii) confining 'legitimate interests' to a series of exceptional circumstances the court prescribes;
- iv) limiting recoverable legitimate interests having regard to the purpose of the contract; and
- v) applying Nettle J's narrow approach which would limit recovery to only the interests protected by the bargain.

Factors (iv) and (v) will provide the required degree of limitation or boundary to legitimate interests as they more closely align with the proper compensatory principles and reflect an appropriate limit to the acceptable degree of proportionality between the stipulated sum and recoverable loss.

The rationale for the penalty doctrine outlined in Chapters 2 and 5 advocates that stipulated sums payable upon breach which aim to punish or have the purpose of punishment of the breaching party, are not enforced. That is consistent with the principle advanced in *Cavendish*⁹ that 'the innocent party can have no proper interest in simply punishing the defaulter', as punishment, more properly, relates to breaches of public duties and not private duties.¹⁰ This rationale is founded in 19th century Scottish cases and the principles have been passed down and adopted in decisions in Australia and England. The rationale was extracted from *Andrews*, but in particular from *Cavendish* and *Paciocco*. This rationale is consistent through the *Conventional Penalties Act 1962* analysed in Chapter 7, the Penalty Clauses (Scotland) Bill 2010 (Scot) analysed in Chapter 8, and the international instruments and initiatives analysed in Chapter 9. Furthermore this rationale prevents contracting parties using courts and the law to punish a contractual counterparty for its own benefit.

10.3.2 Future Conduct of Litigation: Question of Characterisation

Chapter 5 contends that due to the simple-complex distinction which is explained in Chapter 4, procedural difficulties arise for litigation practitioners, and it suggests a process for the management of this issue by use of the Rules of Civil Procedure,¹¹ which ensure compliance with the overarching objective requirement of the *Civil Procedure Act 2010* (Vic). Chapter 5 argues it is now essential that application be made to the Court requesting the preliminary determination of the question of characterisation required by the simple-complex distinction.¹² This is important for three reasons, firstly, determination of this question is crucial as different tests apply and different results based on the same facts can occur depending on which test is used and this

⁹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1204–5 [32]. See also *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 547–8 [32] (Kiefel J), 605–6 [253] (Keane J) who both appear to rely upon Lords Neuberger and Sumption's statement to support the prevention of punishment as a freestanding policy justification for the penalty doctrine.

¹⁰ Nicholas Tiverios, 'Doctrinal Approaches to the Law of Penalties: A Post-*Andrews* Intention-Based Defence of Relief against Fixed Contractual Penalties' in Simone Degeling, Justice James Edelman and James Goudkamp (eds), *Contract in Commercial Law* (Thomson Reuters, 2016) 457, 468–9.

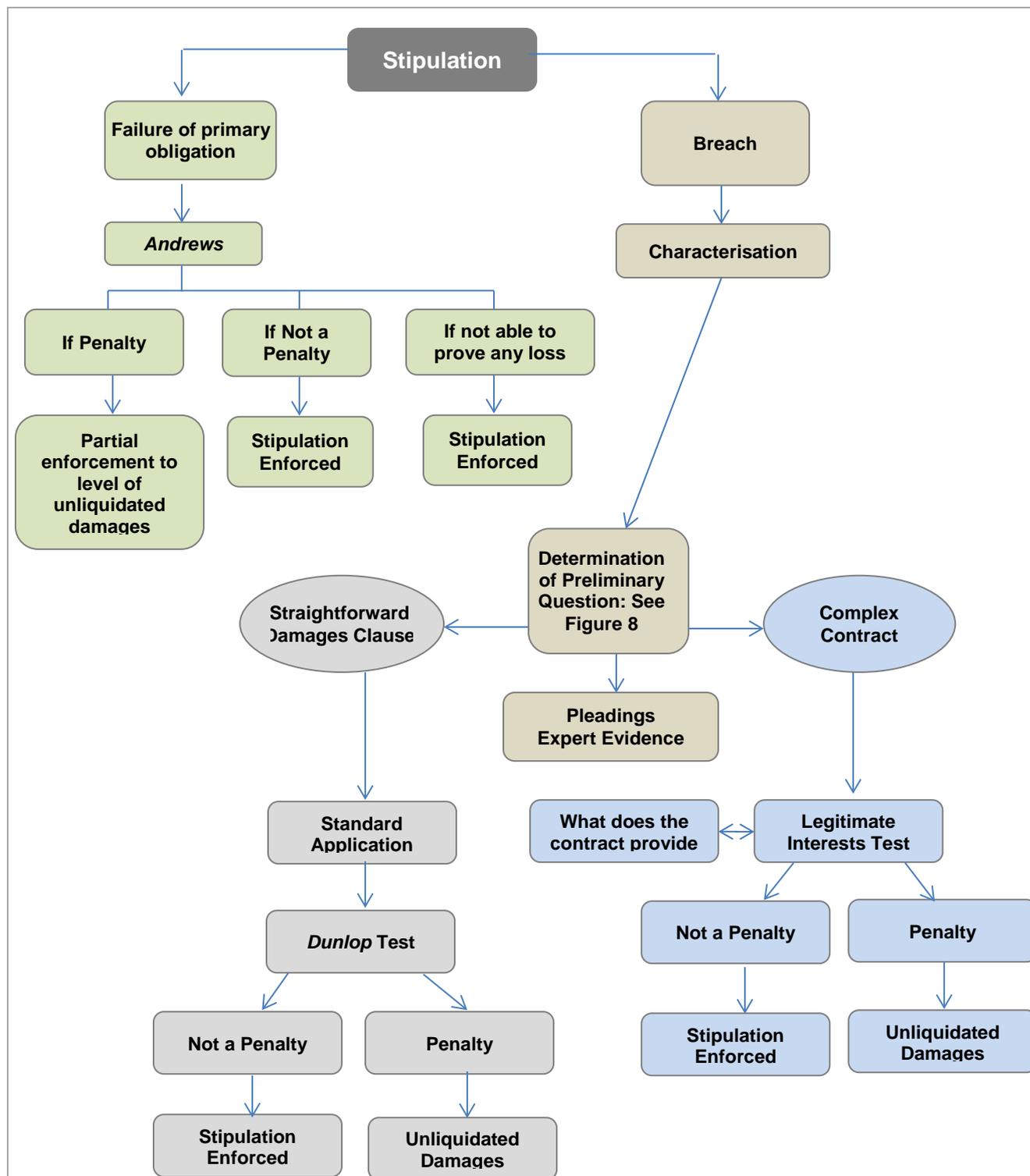
¹¹ See chapter 5 at [5.2.8.4].

¹² See chapter 2 at [4.6.6].

was demonstrated by the two examples provided in Chapter 5.¹³ Secondly the answer to the question of characterisation raises issues that need to be attended to expeditiously including the pleadings and finally the expert evidence to be presented.

Figure 7 is a characterisation flowchart which demonstrates diagrammatically the steps involved in the process post-*Paciocco*.

FIGURE 7: CHARACTERISATION FLOWCHART



¹³ See Chapter 4 at [4.6.6.1].

Figure 7 demonstrates the complexity of the issue and in **Figure 8** there is a summary of the issues that will arise when the court determines the question of characterisation.

FIGURE 8: PRELIMINARY QUESTION OF CHARACTERISATION: SUMMARY OF RELEVANT ISSUES

1. Trial of preliminary question which determines whether the stipulation-contract is simple or complex.
2. If simple, then *Dunlop* formulation applies.
3. If complex, then legitimate interests test applies.
4. The answer to the question of characterisation has an effect on:
 - i) the length, scope and complexity of the pleadings;
 - ii) expert evidence;
 - a) common questions/assumptions preventing *Paciocco* scenario of 'ships passing in the night';
 - b) analysis of alternative heads of claim;
 - iii) conclave of experts

The legitimate interests test raises the of increased use of liquidated damages clauses as principals increase the range of losses they seek to have include into the make-up of the stipulated sum.¹⁴ Powerful contracting parties usually the principal or developer in a construction project are more inclined to insist upon liquidated damages clauses in their contracts for a number of reasons,¹⁵ firstly consistent with the expansive approach explained in chapter 5¹⁶ the legitimate interests test expands the scope of stipulated sums to include wider interests, rather than being confined to compensation for loss eg: reputational, wider commercial, business or financial, intangible and unquantifiable interests¹⁷ and secondly the scope of stipulated sums is not limited to concepts of causation, remoteness or the measure of damages for breach of contract.

10.4 Unconscionability in the *Dunlop* Sense and Substantive Unconscionability

Chapter 6 contends that unconscionability in the *Dunlop* sense is a concept focusing on the punitive nature of the amount of the stipulated sum. If the stipulated sum is found to be exorbitant or excessive in the sense that it is out of all proportion to the non-breaching party's loss consequent upon a breach of contract then it is unconscionable in the *Dunlop* sense and thus not enforceable. This concept overlaps with the concept of substantive unconscionability in equity, which focuses on the situation where the stronger party insists on strict enforcement of its legal rights in circumstances where to do so is contrary to equity and good conscience due to the hardship caused to the weaker party by such enforcement. The court must examine specific acts of wrongful conduct and hence the question of whether the impugned conduct is unconscionable is subjective.

¹⁴ Petrina Macpherson and Tom Kearney, 'Beyond Bank Fees: What Does *Paciocco v ANZ* Mean for Liquidated Damages Provisions in Construction Contracts?' (2016) 28 *Australian Construction Law Bulletin* 233, 235.

¹⁵ Larissa Welms and John Naughton, 'The 'Interest' Based Penalty Tests in *Paciocco* and *Cavendish/ParkingEye* and the Law of Penalties and Damages in Australia and the United Kingdom' (2018) 44 *University of Western Australia Law Review* 157, 166.

¹⁶ See chapter 5 at [5.2.5.1.2].

¹⁷ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 579 [161].

It is argued that there are four differences or limitations applicable to the two concepts. Firstly, there are different circumstances justifying court intervention; to make a finding of unconscionable conduct the court requires proof the stronger party, by its conduct, took unfair advantage of the weaker party during contract negotiations. Such considerations do not apply to the penalty doctrine. The second limitation is timing; to make a finding of unconscionable conduct the court examines the conduct of the stronger party during the period of contract formation whereas the inquiry for the penalty doctrine focuses on the status of the stipulation at the time of entry into the contract. The third differentiating factor is that each concept is subject to different remedies. For unconscionability rescission of the whole of the contract is the usual remedy whereas, when a court finds that a stipulation is a penalty it is only the clause which is unenforceable, and the contract otherwise remains enforceable between the parties. The remedy available to the non-breaching party is recovery of unliquidated damages and where the penalty doctrine in equity applies the remedy is scaling down of the stipulated sum to the level of recoverable loss and the contract remains enforceable. The final point of difference relates to contractual certainty which can be clouded where equitable principles are used to resolve commercial disputes.

In *Cavendish* the court rejected the suggestion that *Dunlop* unconscionability should be confined to procedural misconduct involving the vitiating factors. It is contended in this chapter that confinement of the penalty doctrine to circumstances of unconscionability involving procedural misconduct is not sustainable due to the difficulty in crafting an appropriate test to which governs a concept which suffers from profound vagueness.

10.5 The International Approaches

By way of comparative analysis chapters 7, 8 and 9 analyse the treatment of penalty clauses in a number of international jurisdictions and make comparisons with the common law.

10.5.1 Conventional Penalties Act 1962 Focuses on Prejudice

Chapter 7 provides an exposition of the historical treatment of penalty clauses in the mixed legal system which operates in South Africa. In 1934 the Privy Council determined the common law of England was the applicable law for South Africa¹⁸ which was not well received and efforts were made to enshrine Roman-Dutch legal principles which treat penalty clauses as valid and enforceable but subject to reduction if excessive. This occurred with the enactment of the *Conventional Penalties Act 1962* which only engages with stipulations activated by a breach of contract, and focus on whether the stipulated sum exceeds the prejudice suffered by creditor. Prejudice is interpreted extremely widely,¹⁹ and measured at the time of trial ie: an ex post approach.

The South African statute has operated since 1962 and provides that penalty clauses can be reduced where the stipulated sum is out of all proportion to the prejudice suffered by the creditor due to the breach. There is a line of decisions which provide guidance about what can be taken into account to measure prejudice. The leading decision is *Van Staden*²⁰ and it provides that 'everything that can reasonably be considered to hurt or

¹⁸ *Pearl Assurance Co Ltd v Government of the Union of South Africa* [1934] AC 570.

¹⁹ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349.

²⁰ *Ibid* 352.

harm' is relevant and includes actual direct proprietary loss, money expended in connection with the contract or the subject matter of the contract, financial loss due to reliance on funds due under the contract, impairment of reputation, impairment of personal dignity, substantial inconvenience, frustration of holiday plans and loss of sentimental value. It is to be observed that the factors regarded as relevant to reduction are very broad and in assessing prejudice a South African court may consider further factors such as the prior conduct of the parties, their relationship, their respective bargaining positions, when they entered into the contract, the nature of the business of the creditor, the reasons for the breach, whether an apology or amends has been offered and the effect on the creditor if the court does reduce. The courts are not quick in finding that stipulations offend the statute and in this respect the statute resembles the common law approach post-*Cavendish* and *Paciocco*. The major factor which distinguishes the statute from the common law approach which operates in Australia and England is the judicial discretion to reduce excessive sums. Chapter 7 explains that 'prejudice' is a broader concept than legitimate interests which means that what South Africa recognises as recoverable and protected by the stipulation will proceed beyond the common law.

Some important lessons which can be learnt from the South African model include firstly the impugned stipulation can be for the payment of money, forfeiture of money, forfeiture or transfer of property and in this respect, it is consistent with the common law approach in Australia and England. Secondly, South Africa uses a different approach as it legislated for a system consistent with the practice of Roman-Dutch law and as such does not recognise the dichotomy between liquidated damages and penalties applicable in common law systems, and proceeds on the basis that prima facie penalty clauses are valid and enforceable. Before a court can exercise the discretion to reduce there must be a finding of manifest excess, and the touchstone or trigger for the exercise of this discretion is the prejudice the stipulation inflicts on the debtor. It is to be appreciated that the factors which the court takes into account in each instance may well be similar in the two systems. The closest thing common law systems have to the South African system is the practice in equity sanctioned by *Andrews*, where Australian courts are empowered in the event of the failure of a primary stipulation to scale down the impugned stipulation to the level of recoverable loss. In South Africa, a breach of contract is a necessary limiting requirement to activate the statute and this is the accepted position in the common law systems operating in England²¹ and Australia.²² The necessity to establish a breach of contract is explained on the basis that the penalty doctrine regulates only the remedies available for breach of a party's primary obligations and not the primary obligations themselves.²³ In Australia and England, where there has been a breach of contract, the position of the creditor is considered at the date of entry into the contract and in contrast, the South African statute does not fix any particular point in time when the Court is to assess the prejudice suffered by the creditor. Prejudice can be assessed at any time, but will usually be analysed on an ex post basis at trial.²⁴

For South African conditions 'prejudice' suffered by the creditor will encompass more than direct or consequential loss, or legitimate interests, or commercial or financial interests. As such it is a versatile

²¹ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [13].

²² *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

²³ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1196 [13]; see also Sirko Harder, 'The Relevance of Breach to the Applicability of the Rule against Penalties' (2013) 30 *Journal of Contract Law* 52.

²⁴ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352–3.

concept of the broadest parameters. In Australia and England, if there is a breach of contract, the stipulated sum becomes payable even if there is no loss suffered²⁵ however the position in South Africa could be different, as a court 'may' reduce the stipulated sum. Additionally as s 3 requires any reduction to be 'equitable in the circumstances', there must be evidence whether the stipulated sum is markedly or unfairly out of proportion to the prejudice and, if so, any reduction applicable could theoretically amount to a nil amount.

A number of convergences and divergences between the differing treatments of contractual stipulations payable upon breach of contract embraced by the common law and the statute are demonstrated in **Figure 1**, Chapter 7. The most important convergence is between the South African emphasis on the prejudice suffered by the creditor due to of the breach of contract. In South Africa, where the effect of the stipulation is punishment of the creditor, it can be reduced. The common law focus is on the legitimate interests, primarily financial and commercial, of the creditor in performance of the contract. At common law, if the aim of the stipulated sum is punishment of the creditor, the stipulation is not enforced. The different treatments of contractual stipulations in the two systems intersect at this important juncture. Neither system is constrained by the limits imposed by what is recoverable as damages for breach of contract. In terms of what is recoverable, the South African statute arguably permits a higher rate of recovery for the creditor before intervention²⁶ and this will extend beyond the common law's 'financial and commercial' interests and the calculation/analysis is done ex post when the full ramifications of breach are known and damages can be accurately concluded rather than at the ex ante stage.

10.5.2 Scotland and the Reform Process

Chapter 8 analyses the law reform initiative pursued by the Scottish Law Commission, which produced the Draft Penalty Clauses (Scotland) Bill 2010. The Commission undertook an extensive review of the penalty doctrine as part of a wider investigatory review of Scottish contract law and has published two Discussion Papers and two Reports. The Scottish Government adopted the Commission's recommendations and circulated the Bill for consultation in 2010. Following the consultation process, the Commission published the 2016 Discussion Paper²⁷ which gave consideration to criticisms received during the consultation process as well as to potential effects the decisions in *Andrews*, *Cavendish* and *Paciocco* may have on the Bill. The Bill provides for a judicial discretion to reduce a manifestly excessive stipulation which is not limited to the payment of money and extends to clauses which stipulate for forfeiture and obligations to transfer. The Bill also captures stipulations triggered by failure to do or not to do in a particular way something provided for in the contract. Accordingly, it covers and extends the penalty rule to situations where there has not been a breach of contract.

The discretion to reduce manifestly excessive stipulations requires a consideration of 'all circumstances that appear relevant including those which arose after the contract was entered into'. This is consistent with art

²⁵ *BFI Group of Companies Ltd v DCB Integration Systems Ltd* [1987] CILL 348 (12 June 1987); *Boucaut Bay Co Ltd (in liq) v Commonwealth* (1927) 40 CLR 98, 106–7; see also Brian Eggleston, *Liquidated Damages and Extensions of Time in Construction Contracts* (Wiley-Blackwell, 3rd ed, 2009) 78; Julian Bailey, *Construction Law* (Informa Law, 2nd ed, 2016) vol II, 1210 [13.173].

²⁶ *Van Staden v Central South African Lands and Mines* [1969] 4 SA 349, 352.

²⁷ Scottish Law Commission, *Review of Contract Law: Discussion Paper on Penalty Clauses*, Discussion Paper No 162 (2016).

III–3.712 of the DCFR and other international instruments, which have the effect of limiting the application of the penalty doctrine. By this measure, the law becomes more certain; judicial modification of stipulations is not permitted in Australia and England where there is a breach of contract and it is a major stumbling block to harmonisation efforts between the divergent treatment of penalty clauses in common law systems and those systems that permit reduction. The Scottish reform proposal does not enforce stipulations which have the effect of punishing the breaching party as they are ‘manifestly excessive’. **Figure 2** in Chapter 8 provides a convenient summary of the key features of the draft Bill.

The reform process has been put on hold for the time being due to the wish of the Commission to observe how *Cavendish* is applied and ‘bedded down’ and determine whether there are difficulties with its application. The Commission is concerned that enactment of the Bill will lead to legal uncertainty, in particular due to the introduction of the discretion to reduce. The effect of *Cavendish* is to increase legal certainty for contracting parties and the practical effect of the decision is increased certainty that stipulations will be enforced. Provided this is established by the analysis of future decisions the election to proceed to statutory reform of the penalty doctrine in Scotland will recede and the existing common law may well be retained to regulate stipulations impugned on the basis that their aim is punishment.

10.5.3 International Initiatives and Instruments

Chapter 9 provides a wide-ranging analysis of five international initiatives that seek to harmonise the treatment of agreed sums payable upon breach of contract. They each provide that the penalty clause is valid and enforceable and the court has a discretion to reduce excessive stipulations by applying an ex post approach. These initiatives have not been embraced by the legal systems of the contributors and have therefore had little effect, however that is not to say they have not informed the drafting of the three international instruments, ie: DCFR, PECL and UPICC. The former two instruments are the output of extensive research projects conducted in Europe, whereas the third instrument is not widely used at all and certainly not in Australia. It is a mechanism to assist parties in drafting contracts.

Part I of Chapter 9 considers the international initiatives developed in Europe in the 1970s, aiming at unifying national laws and their treatment of specified sums. These initiatives include the *Benelux Convention* (1973), the Council of Europe *Resolution (78)3* (1978) and the *Uniform Rules* in 1993. **Figure 4**²⁸ in Chapter 9 summarises the salient features of these international initiatives. In each instance, they were drafted consistently by providing for judicial reduction²⁹ where the excess is gross. This is to be compared with the common law rationale for the penalty doctrine advanced in Chapter 2 ie: that stipulations which seek to punish the breaching party will not be enforced on the basis that they are extravagant, exorbitant and unconscionable in their operation. Furthermore stipulations will not be enforced if their aim is to punish. The relevance and importance of the international initiatives and instruments is confirmed by the UK Supreme Court in *Cavendish*³⁰ where the Court observed that the penalty rule ‘is included in influential attempts to codify the law of contracts internationally, including the UNIDROIT Principles of International Commercial

²⁸ See above Figure 4 at [9.2.4].

²⁹ See ‘Report of the Secretary-General: Liquidated Damages and Penalty Clauses’ (1979) 10 *Yearbook of the United Nations Commission on International Trade Law* 40, 42.

³⁰ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1206–7 [37]–[38], 1252 [164], 1280 [265].

Contracts (2010) [sic] (Article 7.4.13), and the UNCITRAL *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance* (Article 6).³¹ The Court also referred to Article 7 of *Resolution (78)3* and PECL art 9:509.³²

Part II of chapter 9 analyses the treatment of agreed sums in three international instruments ie: the DCFR, PECL and UPICC which is consistent with³³ the *Benelux Convention, Resolution (78)3*, and the *Uniform Rules* as they all feature a discretion to reduce the specified sum to a reasonable amount in circumstances where it is found to be 'grossly excessive' or 'manifestly excessive'. Each instrument permits the reduction to apply only to stipulations requiring the payment of money upon breach of contract and the discretion to reduce does not extend to enforcing stipulations which provide for the forfeiture of money or the transfer or forfeiture of property or a failure of the primary stipulation. The treatment of specified sum clauses provided by the DCFR, PECL and UPICC differs in a number of respects to the common law and these are summarised in **Figure 5** in chapter 9. Firstly, in each of the instruments, penalty clauses are prima facie valid and enforceable. The common law dichotomy between the enforceable liquidated damages clause and unenforceable penalty clause does not apply. Secondly, in the international instruments, the courts have a discretion where there has been a breach of contract to modify grossly excessive penalty clauses which does not exist in common law systems which permits recovery of unliquidated damages. Thirdly, in common law systems, the penalty doctrine applies beyond specified sums payable upon breach of contract to include forfeiture and transfer of property but there is no equivalent provision in any of the international instruments. Furthermore, Australian law recognises a jurisdiction which provides relief in equity against penalties where there has been no breach of contract, but rather a failure of a primary stipulation.³⁴ In such a circumstance the remedy is scaling down to the level of recoverable loss. This jurisdiction is not recognised by any of the international instruments.

The international instruments all refer to 'actual harm' or 'actual loss' calculated ex post. As Part II of chapter 9 explains, there is no substantial difference between these expressions. The instruments take into account interests beyond the legitimate financial and commercial interests of the non-breaching party in contractual performance on the basis that it is 'actual' harm/loss being considered ex post. There is nothing in the international instruments limiting recovery to damages for breach of contract and this is no different to the common law position for commercial contracts where the pre-estimated amount calculated by an ex ante approach, as at the date of entry into the contract and payable as a result of a breach of contract, is no longer the predominant factor to weigh in the balance in deciding whether the stipulated sum is liquidated damages or a penalty. The common law now requires consideration of the 'legitimate interests' of the non-breaching party in performance of the contract and those interests need to be 'out of all proportion' to the stipulation where those interests are not limited to the amount of damages recoverable for breach of contract³⁵ however, in Australia they are limited to commercial and financial interests, whereas in England

³¹ Ibid 1206 [37].

³² Ibid 1252 [164].

³³ See Ingeborg Schwenzer, Pascal Hachem and Christopher Kee, *Global Sales and Contract Law* (Oxford University Press, 2012) 634.

³⁴ See *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205; *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd* (2014) 45 VR 79, 98–101 [43]–[54]; *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

³⁵ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525.

they may be broader.³⁶

The international instruments are consistent in that they permit reduction in circumstances where the specified sum is found to be ‘grossly excessive’ having regard to the actual harm or loss suffered by the non-breaching party. However, PECL art 9:509 Comment B and DCFR art III–3.712 each provide that the reduced amount is to be to ‘an intermediate figure’. At common law, the time at which a liquidated damages clause is to be assessed as a penalty is the date of entry into the contract ie: an ex ante approach whereas the international instruments all provide that the relevant time is after breach ie: an ex post analysis. This is because the instruments focus on ‘actual loss’ or ‘actual harm’.

As part of the comparative element of this thesis it is argued that the underlying theme in the various international initiatives and instruments examined in both Parts I and II chapter 9 is that judicial reduction will only apply in circumstances where there has been gross excess in the amount of the stipulation. Gross excess is in the nature of contract-sanctioned punishment which the law will not tolerate. To this extent, the international initiatives and instruments operate in a manner consistent with the common law and only the outcomes differ. What is consistent is that the international instruments will only operate to reduce in extreme or exceptional circumstances whilst at common law the High Court has determined that setting aside a stipulation on the grounds of penalty is a ‘high hurdle’.³⁷

10.5.4 Conclusion

It can be observed by comparing **Figures 1 to 5** in chapters 7, 8 and 9 that there is a degree of consistency in the treatment of penalty clauses in the various systems analysed in this thesis. For ease of reference **Figure 9** provides a comparative summary of the common law and those various systems which verifies that proposition.

Figure 9: Comparative Summary of Common Law, and Certain International Instruments

	Australia: Common Law	Australia: Equity	England	South Africa	Scotland	PECL	UNIDROIT 2016	DCFR
Statute	X	X	X	✓	Bill	X	X	X
Common Law	✓	✓	✓	✓	✓	X	X	X
Mixed Jurisdiction	X	X	X	✓	✓	X	X	X
Breach/No Breach								
Payment of Money	✓	✓	✓	✓	✓	✓	✓	✓
Forfeiture of Money/Forfeiture of Transfer of Property	✓	✓	✓	✓	✓	X	X	X
Unenforceable/ Alternative Remedy	✓	X	✓	X	X	X	X	X

³⁶ For Australia see *ibid* 547 [29], 581 [166], 583 [172], 584 [176], 613 [272]. For England see *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1276 [249].

³⁷ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 553 [53].

of Unliquidated Damages								
Gross Excess/Manifest Excess Out of All Proportion	✓	✓	✓	✓	✓	✓	✓	✓
Judicial Reduction/Modification	X	✓	X	✓	✓	✓	✓	✓
Commercial/Legitimate Interest	✓	X	✓	✓	X	X	X	X

10.6 Statutory Reform Has Little to Offer

In *Cavendish*,³⁸ Lords Neuberger and Sumption endorse the view that the *Andrews* extension to the penalty doctrine ought not be extended by the judges, but rather it is best left to the legislature. Further, Lord Hodge³⁹ when considering whether English law should be extended in a manner consistent with *Andrews* was of the opinion that if the penalty doctrine is to be extended to situations that do not entail a breach of contract, then such an innovation requires legislation. Finally, in *Paciocco*,⁴⁰ French CJ alludes to the prospect of statutory law reform of the penalty doctrine. However since these suggestions were made, there is no evidence that the legislature or law reform bodies in England or Australia have expressed any recent interest in reform of the penalty doctrine by statutory means. In England, reform had been advocated by the Law Commission in its 1975 report,⁴¹ and also in Australia with the 1988 report of the Law Reform Commission of Victoria (Australia).⁴² The Law Commission proposed an expansion of the courts' powers to review stipulations as penalties whether or not they came into operation by breach. The proposal was not implemented due to the difficulty in regulating the power to reduce in a way set clear and certain boundaries and did not mandate the prospect to review every stipulation requiring the payment of money.⁴³

In *Paciocco*,⁴⁴ French CJ states that *Andrews* and *Dunlop* provide the governing principles regarding application of the penalty doctrine and this confirms application of the doctrine to circumstances other than breach. French CJ⁴⁵ observes 'more than one account of its construction and more than one view of whether it should be abrogated or extended or subsumed by legislative reform is reasonably open.' French CJ therefore suggests statutory reform even though application of the doctrine is extended by *Andrews*. This suggestion has some difficulties which were recognised long ago by the Earl of Halsbury LC in *Clydebank*⁴⁶ where he considered the problem which codification of the doctrine presents. He said:⁴⁷ 'it is impossible to lay down any abstract rule as to what it may or it may not be extravagant or unconscionable to insist upon without reference to the particular facts and circumstances which are established in the individual case'. The difficulty foreshadowed in *Clydebank* of providing statutory regulation of the penalty doctrine that is broad

³⁸ *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1274 [241].

³⁹ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 540–1 [10].

⁴⁰ *Ibid.*

⁴¹ Law Commission, *Penalty Clauses and Forfeiture of Monies Paid*, Working Paper No 61 (1975) 16 [22].

⁴² Law Reform Commission of Victoria, *Liquidated Damages and Penalties*, Discussion Paper No 10 (1988).

⁴³ Law Commission, above n 51, 16 [22].

⁴⁴ *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525, 537–8 [5].

⁴⁵ *Ibid* 540–1 [10].

⁴⁶ *Clydebank Engineering and Ship Building Co Ltd v Yzquierdo y Castaneda* [1905] AC 6.

⁴⁷ *Ibid* 10; see also *Cavendish Square Holding BV v Makdessi* [2016] AC 1172, 1285 [293].

enough to cover the field and specific enough to apply in every circumstance demonstrates the problematic nature of the vague suggestion about statutory reform measures.

It is to be remembered that the Scottish Law Commission recommends the retention of judicial control over penalties⁴⁸ with this recommendation concluding that 'judicial control over contractual penalties should apply whatever form the penalty takes'.⁴⁹ However, since *Cavendish* and *Paciocco*, the Commission has placed its reform agenda for penalty clauses on hold. In light of the decision in *Andrews* and *Paciocco*, it is difficult to understand why French CJ suggests statutory reform, as he provides no reasoning to support the suggestion. Statutory reform may overcome any possible confusion that exists regarding the rules of application of the penalty doctrine; however, any reform measure would be required to take account of the scope of operation of the doctrine and determine the appropriate test to apply. Any statutory reform which does no more than reiterate the current principles discernible from *Andrews*, *Cavendish* and *Paciocco* offers little value and subject to the drafting of such legislative reform may operate to restrict operation of the doctrine. In such a circumstance, the present judicial control over the doctrine is preferable.

10.7 Concluding Remark

This chapter evaluates the main arguments presented in this thesis which assist with a better understanding of the operation and future direction of the penalty doctrine particularly in Australia. These arguments support the contention that the common law's incremental development, as demonstrated by the decisions in *Andrews*, *Cavendish* and *Paciocco*, is the preferred course for the future development of the penalty doctrine in Australia rather than statutory control. This thesis provides suggestions for ways in which legitimate interests may be limited and also recommends the pursuit of determination of a preliminary question in reliance on rules of court to obtain guidance on the question of characterisation which thereafter assists with the management of pleadings and expert evidence.

⁴⁸ Scottish Law Commission, *Report on Penalty Clauses*, Report No 171 (1999) 28.

⁴⁹ *Ibid* 16.

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APPENDIX A

Conventional Penalties Act 1962 (South Africa)

To provide for the enforceability of penalty stipulations, including stipulations based on pre-estimates of damages, and forfeiture clauses.

Section 1: Stipulations for penalties in case of breach of contract to be enforceable

- (1) A stipulation, hereinafter referred to as a penalty stipulation, whereby it is provided that any person shall, in respect of an act or omission in conflict with a contractual obligation, be liable to pay a sum of money or to deliver or perform anything for the benefit of any other person, hereinafter referred to as a creditor, either by way of a penalty or as liquidated damages, shall, subject to the provisions of this Act, be capable of being enforced in any competent court.
- (2) Any sum of money for the payment of which or anything for the delivery or performance of which a person may so become liable, is in this Act referred to as a penalty.

Section 2: Prohibition on cumulation of remedies and limitation on recovery of penalties in respect of defects or delay

- (1) A creditor shall not be entitled to recover in respect of an act or omission which is the subject of a penalty stipulation, both the penalty and damages, or, except where the relevant contract expressly so provides, to recover damages in lieu of the penalty.
- (2) A person who accepts or is obliged to accept defective or non-timeous performance shall not be entitled to recover a penalty in respect of the defect or delay, unless the penalty was expressly stipulated for in respect of that defect or delay.

Section 3: Reduction of excessive penalty

If upon the hearing of a claim for a penalty, it appears to the court that such penalty is out of proportion to the prejudice suffered by the creditor by reason of the act or omission in respect of which the penalty was stipulated, the court may reduce the penalty to such extent as it may consider equitable in the circumstances: Provided that in determining the extent of such prejudice the court shall take into consideration not only the creditor's proprietary interest, but every other rightful interest which may be affected by the act or omission in question.

Section 4: Provisions as to penalty stipulations also apply in respect of forfeiture

A stipulation whereby it is provided that upon withdrawal from an agreement by a party thereto under circumstances specified therein, any other party thereto shall forfeit the right to claim restitution of anything performed by him in terms of the agreement, or shall, notwithstanding the withdrawal, remain liable for the performance of anything thereunder, shall have effect to the extent and subject to the conditions prescribed in sections *one* to *three*, inclusive, as if it were a penalty stipulation.

APPENDIX B

Penalty Clauses (Scotland) Bill 2010 (Scot)

An Act of the Scottish Parliament to make new provision as respects the enforceability of penalty clauses in contracts and in unilateral voluntary obligations; and for connected purposes.

1. Enforceability of penalty clauses

- (1) A penalty clause in a contract is unenforceable in a particular case if the penalty for which the clause provides is manifestly excessive (whether or not having regard to any loss suffered) in that case.
- (2) Any rule of law under which such a clause is unenforceable if it is not founded in a pre-estimate of damages ceases to have effect.
- (3) In subsection (1) —
‘penalty’ means a penalty of any kind (including, in particular, a forfeiture or an obligation to transfer); and
‘penalty clause’ —
 - a) does not include a clause of irritancy of a lease of land; but
 - b) means any other clause, in whatever form, the substance of which is that a penalty is incurred in the event of —
 - i) breach of, or early termination of, the contract; or
 - ii) failure to do, or to do in a particular way, something provided for in the contract.
- (4) In determining, for the purposes of subsection (1), whether a penalty is manifestly excessive all circumstances which appear relevant are to be taken into account; and such circumstances may include circumstances arising after the contract is entered into.

2. Onus of proof

The onus of proving that a penalty is manifestly excessive lies on the party so contending.

3. Purported evasion

Where a term of a contract would (but for this section) have the effect of excluding or restricting the application of a provision of this Act in respect of that or any other contract, the term is void.

4. Power to modify a penalty

- (1) Where a court determines that a penalty provided for in a contract is manifestly excessive in a particular case then on application it may, if it thinks fit, modify the penalty in that case so as to

make the penalty clause enforceable in the case.

- (2) In subsection (1), modifying a penalty includes imposing a condition as respects the penalty.
- (3) Subsection (1) applies to a tribunal or arbiter as it applies to a court (provided that the tribunal or arbiter has power to adjudicate on the enforceability of the penalty).

5. Application of Act to unilateral voluntary obligations

This Act applies to unilateral voluntary obligations as it applies to contracts.

6. Short title, commencement and application

- (1) This Act may be cited as the *Penalty Clauses (Scotland) Act 2010*.
- (2) This Act comes into force at the end of the period of three months beginning with Royal Assent.
- (3) This Act applies only as respects a penalty clause agreed to on or after the date on which the Act comes into force.

APPENDIX C

Benelux-Overeenkomst betreffende het Boetebeding [Benelux Convention Relating to Penalty Clauses], signed 26 November 1973, [1974] *Tractatenblad* 5 (not yet in force)

Common Provisions:

- Article 1** A penalty clause is any clause which provides that if the promisor fails to perform his obligation he shall be bound to pay a sum of money or do some other thing by way of penalty or compensation.
- Article 2**
- (1) The promisee may not claim concurrently performance of the penalty clause and of the obligation to which it is annexed.
 - (2) The thing due under the penalty clause shall take the place of statutory damages.
 - (3) The promisee may not claim performance of the penalty clause unless the failure to perform the obligation to which it is annexed is imputable to the promisor.
- Article 3** Notice to perform or other previous declaration is required for the enforcement of a penalty clause whenever this would be necessary in order to obtain statutory damages.
- Article 4** The court may, on the application of the promisor, if justice manifestly so requires, mitigate the effects of the penalty clause without, however, reducing the penalty below the amount of the statutory damages. Any stipulation excluding this provision shall be void.

Commentary on Articles 1 to 4 of the *Benelux Convention* (1973)

Article 1 The advantage of the proposed wording is that it does away with the distinction between clauses which fix in advance the amount of damages payable where failure to perform is imputable to the promisor (Article 1185 BW) and those intended to act as an incentive to performance of the obligation (Articles 1340 et seq BW). This distinction had come to appear inapposite, since in practice these two reasons for stipulating penalty clauses are closely connected and in many cases indistinguishable (cf Explanatory Memorandum to the new Netherlands draft civil code, Article 6.1.8.16).

The concept underlying the draft represents more of a break with tradition in Belgian and Luxembourg law for, as mentioned in the general part of the report, the penalty clause can no longer be regarded solely as an agreement on damages.

Another point is clarified by the draft: although Articles 1152 and 1285 BW only mention the payment of a certain sum, the wording used in Articles 1226 Cc and 1340 BW is broad enough to permit the assumption that though as a rule the penalty clause relates to a sum of money, the parties are free to agree on some other kind of penalty (PB Clause pénale, n.17). The suggested wording settles all doubt on the point and the combination of Articles 1152 and 1226 Cc and 1285 and 1340 BW in the present draft restores harmony to the text.

It should be observed that the suggested text does not relate to what are called improper penalty clauses, where the promisor is not bound by a principal obligation. These are better classified as straightforward conditional obligations. A penalty clause, which is an accessory provision, can only exist when the promisor is bound by a principal obligation.

Article 2 This Article introduces no substantive changes in the existing law. The rules are not mandatory and may allow of exception either by an express clause or by implication which may, where necessary, be inferred from the gist of the transaction. The new draft Netherlands Civil Code expressly refers to this non-mandatory character by a stated exception repeated in all three paragraphs of Article 6.1.8.17. It seemed unnecessary to state expressly that this Article is non-mandatory, in the present text, because in principle all the rules embodied in the general part of the law of obligations in the Civil Codes of the three countries are non-mandatory, unless otherwise expressly stated - as, for example, in Article 4 of this draft.

Paragraph 1 This provision is intended to replace Article 1229, paragraph 2 Cc and Article 1343, paragraph 2, BW. If the parties are silent on the point, it may ordinarily be assumed that they did not intend the promisee to be able to claim concurrent performance of the principal obligation and the penalty clause. However, the parties often decide otherwise, particularly when stipulating a penalty for delay only, which is the case referred to in the provisions cited from the existing Codes.

Paragraph 2 The parties stipulate a penalty clause usually because they wish to avoid all

discussion of the amount of damages. But they may very properly reserve to the promisee who has been prejudiced by the failure to perform the contract the choice between enforcing the penalty clause and the application of the general law, or even the right to claim both.

Paragraph 3 The promisor should be released from liability on a penalty clause in exactly the same circumstances as he is under the general law where no penalty clause exists. The promisor will therefore be excused from performance of the penalty clause on the same grounds as those on which he would be relieved from his liability under the general law. Here it should be noted that under Belgian and Luxembourg law time for payment granted by the court (Article 1244 Cc) does not relieve the promisor of his liability.

Even if there is no penalty clause, the parties are free to extend or restrict the type of event which can excuse non-performance by the promisor; they may even agree that the promisor shall be liable in damages without having the right to plead force majeure in any circumstances and parties who stipulate a penalty clause may do the same.

The paragraph under discussion is intended to perform one of the functions at present fulfilled by Article 1230 Cc (1344 BW). By requiring that the promisor should be in default this Article makes it impossible to rely on a penalty clause if the promisor is relieved of liability by force majeure, since this situation precludes the possibility of default. The other function of Article 1230 Cc (1344 BW), which requires that notice to perform must be given is replaced by Article 3 of the present draft.

Article 3 If the penalty is to be payable, Articles 1230 Cc and 1344 BW require that the promisor be in default. With some exceptions, the promisor is not in default until he has received notice to perform. A promisee who intends to rely on a penalty clause must therefore give the promisor notice to perform whenever this would be necessary in order to sue for damages under the general law. Though this rule is not repeated expressly in the new draft Netherlands Civil Code, this was not because those responsible for the text wished the rule abolished, but because they felt that an express provision of this sort would be superfluous. Although the argument that the penalty stipulated by the parties takes the place of statutory damages and is therefore in principle governed by the same rules is defensible, it nevertheless seems prudent to state the rule expressly, particularly as it already appears in the existing codes.

The phrase 'or other previous declaration' recalls the wording now found in the existing law of the three countries in Article 1139 Cc (1274 BW): 'by formal notice to perform or other equivalent instrument'. The main reason for including it, however, is that the new draft Netherlands Civil Code introduces a number of new procedures in this context, so that a mere reference to notice to perform would perhaps no longer be sufficient. As at present, a

promisee who wishes to rely on non-performance will normally have to make certain communications to the promisor, their contents varying with the circumstances and the remedy desired (damages for delay, ordinary damages or rescission). The expression 'notice to perform' would accordingly be too narrow. (see Articles 6.1.8.7, 6.1.8.11-12 and 6.5.4.6, and the commentary thereon). The wording suggested is widely drawn and ensures that a promisee who wishes to rely on a penalty clause will have to act in the same way as if he wished to obtain damages under the general law.

Article 4

This is the most important clause in the draft. For the reasons justifying its introduction see the general part of the report.

If the courts' moderating power was not to be reduced to a meaningless formula all clauses purporting to exclude it had to be forbidden. The relevant provision is therefore mandatory.

The courts should of course exercise this power with the greatest discretion, as the effect of their intervention is to interfere with binding agreements. Accordingly, they will intervene only to correct the position in cases where the sense of justice is outraged. The words 'if justice manifestly so requires' show that the court must only interfere with binding agreements if justice has obviously been violated.

The same wording ('indien de billijkheid dit klaarblijkelijk eist'), 'if justice manifestly so requires', is to be found in the corresponding Article of the new draft Netherlands Civil Code (6.1.8.18). Other Codes use similar expressions, such as Article 1384 of the Italian Civil Code: 'La penale puo essere diminuita equamente dal giudice ... ovvero se l'ammontare della penale è manifestamente eccessivo ...'

It was not considered desirable that the courts should be able, by using their moderating power, to reduce penalties below what the promisee would be entitled to claim under the general law.

APPENDIX D

Council of Europe — Committee of Ministers

Resolution (78)3

Relating to Penal Clauses in Civil Law

(adopted by the Committee of Ministers on 20 January 1978)
at the 281st meeting of the Ministers' Deputies)

The Committee of Ministers,

Considering that the aim of the Council of Europe is to achieve greater unity between its members, in particular by the adoption of common rules in the field of law;

Considering that it is necessary to provide for judicial control over penal clauses in civil law in appropriate cases where the penalty is manifestly excessive;

Considering that penal clauses applicable on breach of contract constitute the most typical and frequent form of penal clauses and that it is therefore desirable to provide common rules for such clauses,

Recommends governments of the member states:

1. To take the principles concerning penal clauses in civil law contained in the Appendix to this Resolution into consideration when preparing new legislation on this subject;
2. To consider the extent to which the principles set out in the Appendix can be applied, subject to any necessary modifications, to other clauses which have the same aim or effect as penal clauses;
3. To make this Resolution and its Appendix and the Explanatory Memorandum available to the appropriate authorities and other interested bodies in their countries.

Appendix to *Resolution (78)3*

Article 1 A penal clause is, for the purposes of this Resolution, any clause in a contract which provides that if the promisor fails to perform the principal obligation he shall be bound to pay a sum of money by way of penalty or compensation.

Article 2 The promisee may not obtain concurrently performance of the principal obligation, as specified in the contract, and payment of the sum stipulated in the penal clause unless that sum was stipulated for delayed performance. Any stipulation to the contrary shall be void.

Article 3 A penal clause shall not of itself prevent the promisee from obtaining specific performance of the principal obligations instead of the sum due under that clause.

Article 4 The sum stipulated shall not be due unless the promisor is liable for the failure to perform the principal obligation.

Article 5 The promisee cannot obtain damages in respect of the failure to perform the principal obligation instead of, or in addition to, the sum stipulated.

Article 6 Despite any stipulation to the contrary, the promisee cannot obtain a sum in excess of either the sum stipulated under the penal clause or the damages payable for the failure to perform the principal obligation whichever is the larger.

Article 7 The sum stipulated may be reduced by the court when it is manifestly excessive. In particular, reduction may be made when the principal obligation has been performed in part. The sum may not be reduced below the damages payable for failure to perform the obligation. Any stipulation contrary to the provisions of this Article shall be void.

Article 8 The provisions of the preceding Articles shall be without prejudice to rules relating to any particular type of contract owing to its special nature.

Appendix C

Explanatory Memorandum to *Resolution (78)3*

Introduction

1. The legal system of all Council of Europe member states contain rules relating to penal clauses in civil law. Such clauses are also very frequently used in practice and appear in many forms. Considering that a study of this question was of international interest the European Committee on Legal Co-operation (**CCJ**) proposed that it should be included in the legal programme of the Council of Europe. The CCJ observed in particular that the harmonisation of the rules in this field would both contribute to legal certainty in international commercial relations and facilitate the application of international agreements relating to the recognition and enforcement of foreign judgments.
2. At the request of the CCJ, the International Institute for the Unification of Private Law (UNIDROIT) first prepared a study setting out the existing legislation on penalty clauses in member states and a number of national and international drafts. The study also contained a recapitulation of the various problems which would be involved in harmonising the relevant but often divergent rules.
3. In 1974 the Committee of Ministers, on the proposal of the CCJ, decided to set up a Committee of Experts with the task of drawing up an international instrument on penalty clauses which might take the form of a convention providing for a uniform law.
4. Between 1974 and 1976 the Committee of Experts held four meetings in the course of which it decided that a resolution containing recommendations to member states of the Committee of Ministers, rather than a convention, would be the most appropriate instrument in this field and drew up the text of such a draft resolution. It also prepared the text of the explanatory memorandum relating to the draft Resolution.
5. At the outset the Committee of Experts discussed the legal position relating to penalty clauses in member states taking into account developments in the law subsequent to the completion of the UNIDROIT study. It appeared that several member states were in the process of reviewing their laws in this field or had recently adopted new legislation. The Committee also paid particular attention to the *Benelux Convention* on Penalty Clauses which was signed at the Hague on 26 November 1973 but has not yet entered into force.
6. One of the fundamental questions which the Committee had to tackle was the definition of a 'penal clause'. It was observed that the survey of the current laws of member states showed that, generally speaking, the notion of penal clause had two different characteristics, namely:
 - a) the penal clause *stricto sensu* whose main purpose was to act as a threat to induce the promisor to perform his obligation and punish him if he fails to do so; and
 - b) a clause which contained a genuine pre-assessment of damages owed by a promisor who fails to perform his obligation (or to use another term, liquidated damages).
7. It was further observed that the treatment of these two aspects of the penal clause, insofar as they

could be distinguished, varied considerably from one member state to another. The view was expressed that it was almost impossible to draw a clear distinction in many cases between the two aspects and that the same clause might often have a dual purpose.

8. In this context the difficulty arose that in a small number of member states a penal clause *stricto sensu* was either void or would not be enforced by the courts, eg: on the grounds that it was contrary to morality or public policy, while the laws of all other member states allowed such clauses. On the other hand, there was general agreement that, if the penal clause provided for a genuine pre-assessment of damages it should in principle be enforced.
9. The Committee did not find it useful to draw up rules aiming at a harmonisation of the laws of member states which applied to liquidate damages alone. Neither would it, in the Committee's opinion, serve any purpose to draw up such rules which made it possible to set aside all penal clauses *stricto sensu*. The rules proposed by the Committee are therefore based on the idea that sums due under penal clauses *stricto sensu* are also normally recoverable.
10. The Committee was fully aware that a change of the law with regard to the enforcement of penal clauses *stricto sensu* might create considerable difficulty in some member states which do not at present enforce such clauses. It took note in particular of the work of the English Law Commission on the subject of penalty clauses and forfeiture of monies paid in the course of which account was being taken of the Committee's work. The Committee was informed that the trend of this work which was still in progress showed a preference for maintaining, on the whole, the present law with regard to penalty clauses and liquidated damages. The Committee expressed its understanding of the difficult position of the United Kingdom experts and regretted that it had not proved possible fully to reconcile the different approaches to the question which reflect divergent approaches to damages for breach of contract, of which the present subject is only a subordinate part, and to the role of the judiciary in this context. In this connection, it should also be stressed that under the terms of the Resolution, member states are merely invited to take these rules into consideration when preparing new legislation in this field.

General consideration

11. The most common form of a penal clause providing for the payment of a sum of money by one party to a contract to the other in the event of the former's failure to perform his obligation under the contract. For reasons of clarity and simplicity the rules set out in the Appendix to the Resolution have expressly been drafted with this situation in mind. It is, however, clear that there are many other clauses which may have the same effect or aim. Thus, for example, a clause providing for forfeiture of money paid as a deposit or a clause providing for a loss of bonus for early performance after a certain time limit may have the same effect as a clause providing for the payment of a penalty for breach of contract. Under paragraph 2 of the operative part of the Resolution member states are therefore invited to consider the application of the provisions to other clauses with the same aim or effect. Similarly member states may wish to consider whether the rules should be applicable to penal clauses stipulated in connection with juristic acts other than contracts.
12. The legal systems of all member states provide special rules for penal clauses in connection with certain types of contracts. In order to take account of these situations a provision relating to such rules

has been included as Article 8.

Commentary on the specific provisions in the Appendix to the draft Resolution

Article 1

13. This article is based on Article 1 of the common provisions annexed to the *Benelux Convention*.¹ It recognises that the purpose of the penal clause may be to provide either for a pre-assessment of damages or for a true penalty irrespective of loss. This means that it is not necessary for the purpose of the provisions to distinguish between the two categories. In some countries such a distinction forms an integral part of the law and is made without undue difficulty. However, in other countries whose law has developed along different lines and which form the majority of those represented on the Committee, the distinction would be difficult to draw because it is considered that the reason for inserting a penal clause in a contract may be both a wish to facilitate the assessment of compensation and to provide an incentive for the promisor to perform. It should also be observed that the rules concerning judicial control set out in Article 7 apply to all penal clauses, as defined by Article 1, and the significance of the distinction will therefore be reduced.
14. For the reasons given above in paragraph 11 the Article only mentions payment of a sum of money as this is undoubtedly the most common form of penalty. The parties are of course, free to agree that if the promisee fails to perform the principal obligation he shall be bound to do something other than paying a sum of money.

Article 2

15. It is obvious that the penalty is not due if performance of the principal obligation as specified in the contract has been obtained. Article 2 means that the promisee who has not yet obtained performance cannot obtain from the court judgment for both such performance and the penalty.
16. An exception is, however, made for the case where that sum has been stipulated to ensure that the obligation is performed in time. It has also been considered whether or not, in addition to delay, an express exception should also be made for the situation where performance has either been defective or partial. It appears, however, that, under the law of some member states, a defective or partial performance would not constitute performance. Under the law of other member states a partial or defective performance might be considered as a form of delayed performance. Moreover, the laws of certain member states do not generally entitle the promisee to obtain specific performance to remedy a defect in the performance of the principal obligation. A reference to partial or defective performance in the text of the Article has therefore not seemed necessary or desirable. In view of the meaning given to the concepts of 'performance' or 'delay' in their laws member states may provide expressly that the rule relating to delayed performance applies to partial or defective performance also.
17. The provisions of this Article should be mandatory regardless of whether the penal clause provides for liquidated damages or for a true penalty. In the former case there is no room for compensation if the obligation has actually been performed in conformity with the contract. Similarly, it would be unreasonable to allow the promisee to claim at the same time both the stipulated penalty and

¹ A penalty clause is any clause which provides that if the promisor fails to perform his obligation he shall be bound to pay a sum of money or do some other thing by way of penalty or compensation.

performance of the principal obligation.

Article 3

18. The Article makes it clear that the mere existence of a penalty clause in a contract is not to be interpreted as meaning that the parties have selected the penalty as the sole remedy for failure to perform the obligation. Accordingly, the promisee may, unless the parties have agreed otherwise, always make a choice between asking for performance and claiming the sum stipulated in the penal clause. If the promisee does not have this choice, he would be forced to choose the penalty which amounts to giving the promisor a right to choose payment of the penalty rather than performance of his obligation. It would then be a matter of alternative obligations or of an option to rescind and not of a penal clause. In this case the provisions of the present resolution should not be applicable. This is the significance of the words 'of itself'.

Article 4

19. The penal clause is normally not a warranty clause but only designed as a sanction for non-performance of the obligation in circumstances where the promisor is liable for the failure to perform. This rule should not however be mandatory and the parties are therefore free to agree that the penalty agreed upon should be due irrespective of the reasons for the failure to perform.
20. The liability of the promisor under the penal clause should be governed by the general rule applicable to contracts under the law of each member state.

Article 5

21. The provisions of this Article govern the relation between the penal clause and damages. According to Article 5 the promisee is not entitled to damages instead of or in addition to the sum stipulated in the clause. In other words, he may not normally choose between the penal clause and damages as the clause has been agreed upon by the parties in order to provide a specific sanction for non-performance. This rule should not, however, be mandatory and the parties can, if they wish, agree that the sum due under the penal clauses shall set a minimum for the damages.

Article 6

22. This Article is based on the idea that it is reasonable to impose an upper limit on the sum which the promisee can obtain if the promisor fails to perform his obligation. This limit is determined by either the sum stipulated in the penal clause or by the damages payable for failure to perform, whichever sum is the larger. As this rule is mandatory it also applies to the situation where the parties have availed themselves of the possibility of setting aside the non-mandatory provisions of Article 5.

Article 7

23. The most important function of the penal clause is to avoid the need to have recourse to judicial proceedings in order to obtain an assessment of damages for failure to perform the obligation. Much expense and difficulty is otherwise often caused in particular by the necessity of producing proof of the loss for which damages are to be paid. The logical consequence of this would obviously be to enforce all penal clauses but this would in some cases lead to results which would be difficult to accept. The legal systems of member states have therefore devised various means to enable the courts to

exercise a certain control over penal clauses although the circumstances under which this control can be exercised differ considerably from one state to another. Because of the importance of this question, it is one of the essential aims of the present Resolution to contribute toward a harmonisation of the laws of member states on this point. It should, however, be recalled that one of the major divergencies between these laws at present arises from the fact that under the law of certain member states (Belgium and the United Kingdom) the courts do not have any general power to refuse to enforce a genuine liquidated damages clause but only to set aside a clause which is found to impose a true penalty. The courts in such states have only the choice of awarding the stipulated sum or damages provided by law, and cannot award a sum which is neither of these as would be the result of increasing or decreasing the stipulated sum. While this approach deserves full understanding it cannot fruitfully be reconciled with the approach of the legal systems in the majority of member states which confer a wider power on the courts with regard to penal clauses. In the choice between the two approaches preference has therefore been given to the majority view.

24. Article 7 lays down the criteria which the courts should apply when exercising their power of judicial review with a view to reducing the sum stipulated in the penal clause. The main purpose of the clause (ie: to discourage litigation) would be lost if the court could set it aside too easily and the court should therefore exercise its power with much discretion. In order to indicate the exceptional character of judicial intervention, a number of formulae have been discussed. In addition to the term proposed namely 'manifestly excessive' other terms such as 'exorbitant', 'unconscionable' (in French 'abusive'), 'unreasonable' were considered. However, the term 'exorbitant' was felt to restrict too narrowly the power of judicial review; the term 'unconscionable' was considered insufficiently precise within the context of judicial review of penal clauses; the term 'unreasonable' in English was found when used in this connection to have no acceptable equivalent in French legal terminology. The Committee therefore finally decided in favour of the term 'manifestly excessive' which is in fact already used in the existing legislation of some member states.
25. While Article 7 lays down the general principle, it only expressly refers to one situation where it may be particularly justified to reduce the sum stipulated in the penal clause, namely where the obligation has been performed in part. It is evident that it would in many cases be excessive to require a promisor to pay the full penalty although the promisee has in addition obtained the benefit of partial performance. In this connection, it may be observed that the laws of some member states (see eg: the recent amendment of Article 1152 of the French Civil Code) confer a wider power on the courts to reduce penalties in this particular situation and allow reduction to take place even if the penalty is not 'manifestly excessive'.
26. It is left to each legal system to determine under what precise circumstances the sum concerned should be considered to be manifestly excessive. It is, however, suggested that, in a given case the courts may have regard to a number of factors such as:
- i) damage pre-estimated by the parties at the time of contracting and the damage actually suffered by the promisee;
 - ii) the legitimate interests of the parties including the promisee's non-pecuniary interests;
 - iii) the category of the contract and the circumstances under which it was concluded in particular the relative social and economic position of the parties at the conclusion or the fact that the

- contract was a standard form contract;
- iv) the reason for the failure to perform the obligation in particular the good or bad faith of the promisor.
27. This list of criteria to be taken into account should not be regarded as exhaustive, nor does it indicate any order of priority. When applying this criteria, regard must also be had to the general law of contracts in the member state concerned which may exclude or limit the possibility of using a particular criterion. It is clear, however, that the most important case is that when the stipulated sum is clearly disproportionate to the loss suffered by the promisee. Nevertheless the mere fact that the loss actually sustained is less than the sum stipulated by the parties at the time of making the contract shall not be sufficient reason for the reduction of the penalty.
28. The Article does not include any rules concerning evidence and in particular as regards the burden of proof. These questions are linked to the general rules of civil procedure and evidence in each member state and it would not be possible or desirable to attempt to harmonise them in the present context. It would, however, appear that most legal systems would place the burden of proof on the person who claims that the clause should be modified or set aside. Article 7 does not deal with the question of whether or not the court should have a power to reduce ex officio or of its own motion the sum stipulated in the penal clause, for example, in the situation where the promisor fails to take part in the proceedings. National systems should therefore be free to make provision for such an ex officio reduction in appropriate cases. There is, however, no suggestion that national systems which do not at present recognise such a power should change their law in this respect.
29. It was thought necessary to impose a limit on the power of reduction of the court and a provision to this effect has therefore been inserted in Article 7. According to this provision the sum may not be reduced below the damages payable for failure to perform the obligation.
30. The rules in Article 7 concerning judicial control should be mandatory. The protection of the parties which the provisions are designed to ensure would otherwise rapidly become ineffective in practice as standard form contracts would undoubtedly tend to include a clause excluding them from such control.

Article 8

31. As stated in paragraph 12 above the legal systems of all member states provide special rules for penal clauses in connection with certain types of contracts, eg: hire purchase. Usually these rules are intended to protect persons in a weak contracting position.
32. It is neither possible nor desirable to attempt to deal with all these special situations in a resolution relating to penal clauses in general. It is therefore not suggested that the present rules should interfere with such special rules which already exist or may become necessary in relation to particular types of contract, including standard contracts. A provision indicating this has therefore been included in Article 8. In this connection note has also been taken of the work of the CCJ and the Committee of Experts on the Legal Protection of Consumers which resulted in the adoption by the Committee of Ministers in November 1976 of Resolution (76) 41 on unfair terms in consumer contracts and an appropriate method of control.
33. The Articles appended to the Resolution do not (as for example Article 3 of the Common Provisions

annexed to the *Benelux Convention*) provide any provisions concerning notice to perform or other requirements before the penal clause can be enforced. These matters relate closely to the law of civil procedure of each member state and it would go beyond the practical limits of the present Resolution to attempt to harmonise these often very divergent rules within this context.

APPENDIX E

Texts on Liquidated Damages and Penalty Clauses

- A. ***Report of the United Nations Commission on International Trade Law on the Work of Its Sixteenth Session, UN GAOR, 38th sess, Supp No 17, UN Doc A/38/17 (10 August 1983) annex I ('Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance')***.
- B. ***Report of the United Nations Commission on International Trade Law on the Work of Its Sixteenth Session, UN GAOR, 38th sess, Supp No 17, UN Doc A/38/17 (10 August 1983) annex II ('Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance')***.
- A. ***Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance, UN Doc A/38/17, annex I.***

PART ONE: SCOPE OF APPLICATION

Article 1 These Rules apply to international contracts in which the parties have agreed that, upon a failure of performance by one party (the obligor), the other party (the obligee) is entitled to an agreed sum from the obligor, whether as a penalty or as compensation.

Article 2 For the purposes of these Rules:

- a) A contract shall be considered international if, at the time of the conclusion of the contract, the parties have their places of business in different States;
- b) the fact that the parties have their places of business in different States is to be disregarded whenever this fact does not appear either from the contract or from any dealings between, or from information disclosed by, the parties at any time before the conclusion of the contract;
- c) Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of these Rules.

Article 3 For the purposes of these Rules:

- a) If a party has more than one place of business, his place of business is that which has the closest relationship to the contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract;

- b) If a party does not have a place of business, reference, is to be made to his habitual residence.

Article 4 These Rules do not apply to contracts concerning goods, other property or services which are to be supplied for the personal, family or household purposes of a party, unless the other party, at any time before or at the conclusion of the contract, neither knew nor ought to have known that the contract was concluded for such purposes.

PART TWO: SUBSTANTIVE PROVISIONS

Article 5 The obligee is not entitled to the agreed sum if the obligor is not liable for the failure of performance.

- Article 6**
- (1) If the contract provides that the obligee is entitled to the agreed sum upon delay in performance, he is entitled to both performance of the obligation and the agreed sum.
 - (2) If the contract provides that the obligee is entitled to the agreed sum upon a failure of performance other than delay, he is entitled either to performance or to the agreed sum. If, however, the agreed sum cannot reasonably be regarded as compensation for that failure of performance, the obligee is entitled to both performance of the obligation and the agreed sum.

Article 7 If the obligee is entitled to the agreed sum, he may not claim damages to the extent of the loss covered by the agreed sum. Nevertheless, he may claim damages to the extent of the loss not covered by the agreed sum if the loss substantially exceeds the agreed sum.

Article 8 The agreed sum shall not be reduced by a court or arbitral tribunal unless the agreed sum is substantially disproportionate in relation to the loss that has been suffered by the obligee.

Article 9 The parties may derogate from or vary the effect of Articles 5, 6 and 7 of these Rules.

B. *Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance, UN Doc A/38/17, annex II*

Article I (Vienna Sales Convention, art 1)

Each Contracting State shall apply the Uniform Rules on Contract Clauses for an Agreed Sum due upon a Failure of Performance (hereinafter referred to as the Uniform Rules') contained in the Annexure to this Convention to the contracts described in Article 1 of the Uniform Rules:

- a) When at the time of the conclusion of the contract, the parties have their places of business, as described in Articles 2 and 3 of the Uniform Rules, in different Contracting States; or
- b) When the rules of private international law lead to the application of the law of a contracting State.

Article II (Vienna Sales Convention, art 90)

The Uniform Rules do not prevail over any international agreement which has already been or may be entered into and which contains provisions concerning the matters governed by the Uniform Rules, provided that the parties to the contract have their places of business in States parties to such agreement.

Article III (Vienna Sales Convention, art 95)

Any State may declare at the time of signature, ratification, acceptance, approval or accession that it will not be bound by subparagraph (b) of Article I.

Article IV (Vienna Sales Convention, art 96)

A Contracting State whose legislation requires contracts to be concluded in or evidenced by writing may at any time make a declaration that it will apply the Uniform Rules only to a contract concluded in or evidenced by writing where any party has his place of business in that State.

Article V (ULIS, art. V)

Any State may declare at the time of signature, ratification, acceptance, approval or accession to this Convention that it will apply the Uniform Rules only to a contract in which the parties to the contract have agreed that the Uniform Rules be applied thereto.

Article VI (Vienna Sales Convention, art. 94)

- (1) Two or more Contracting States which have the same or closely related legal rules on matters governed by the Uniform Rules may at any time declare that the Uniform Rules are not to apply to a contract where the parties thereto have their places of business in those States. Such declarations may be made jointly or by reciprocal unilateral declarations.
- (2) A Contracting State which has the same or closely related legal rules on matters governed by the Uniform Rules as one or more non-contracting States may at any time declare that the Uniform Rules are not to apply to contracts where the parties have their places of business in those States.

- (3) If a State which is the object of a declaration under the preceding paragraph subsequently becomes a Contracting State, the declaration made will, as from the date on which this Convention enters into force in respect of the new Contracting State, have the effect of a declaration made under paragraph (1), provided that the new contracting State joins in such declaration or makes a reciprocal unilateral declaration.

Article VII (Vienna Sales Convention, art 28)

If, in accordance with the provisions of the Uniform Rules the obligee is entitled to performance of an obligation, a court is not bound to enter a judgment for specific performance unless the court would do so in respect of similar contracts not governed by the Uniform Rules.

Article VIII (Vienna Sales Convention, art 89)

The Secretary-General of the United Nations is hereby designated as the depository for this Convention.

Article IX (Vienna Sales Convention, art 91)

- (1) This Convention is open for signature by all States at the Headquarters of the United Nations in New York until ...
- (2) This Convention is subject to ratification, acceptance or approval by the Signatory States.
- (3) This Convention is open for accession by all States which are not Signatory States as from the date it is open for signature.

APPENDIX F

Article 9:509 of the PECL (agreed payment for non-performance) provides:

- (1) Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of its actual loss.
- (2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and other circumstances.

Comment

A. Stipulation as to agreed payment binding

It is common for the parties to a contract to specify a sum to be paid for non-performance, with a view to avoiding the difficulty, delay and expense involved in proving the amount of loss in a claim for unliquidated damages. Such a clause may also prompt the debtor to perform voluntarily, when the penalty is heavy. To perform is then cheaper than paying the penalty. Paragraph (1) gives effect to such a provision, so that except as provided by paragraph (2) the court must disregard the loss actually suffered by the aggrieved party and must award it neither more nor less than the sum fixed by the contract. It follows that the aggrieved party is under no obligation to prove that it has suffered any loss.

Illustration 1:

B agrees to build a house for A and to complete it by 1 April. The contract provides that for every week's delay in completion B is to pay A the sum of £200. B completes the house on 29 April. A is entitled to £800 as agreed damages, whether his actual loss (eg: the cost of renting alternative accommodation during the four week period of delay) is greater or less than that sum.

Illustration 2:

A agrees to sell his house to B, from whom he obtains a deposit of 20 per cent of the price to secure B's performance of the contract. B refuses to complete the transaction. A may forfeit the deposit.

Where, however, the contract specifies merely the minimum sum payable by the non-performing party, the aggrieved party may recover a higher figure if it can prove that its loss exceeds the minimum sum. In this case the aggrieved party may elect to sue for damages at large instead of invoking the provision for agreed damages.

B. Court's power to reduce grossly excessive stipulations

To allow the parties complete freedom to fix the sum payable for non-performance may lead to abuse. If there is a gross disparity between the specified sum and the actual loss suffered by the aggrieved party the court may reduce the sum even if at the time of the contract it seemed reasonable. Since the purpose is to control only those stipulations which are abusive in their effect, the court's reducing power is exercisable only where it is clear that the stipulated sum substantially exceeds the actual loss. This power of the court has a limit: it should respect the intention of the parties to deter default and therefore should not reduce the award to the actual loss. The court has to fix an intermediate figure.

Illustration 3:

A supplies equipment to B on lease for five years at a rent of £50,000 a year. The agreement provided that if the lease is terminated because of default by B in performing its obligations B shall pay to A by way of agreed damages a sum equal to 80% of the future rentals. In light of circumstances existing at the time of the contract this stipulation is not unreasonable. After a year the agreement is terminated because of B's default in payment. As the result of an unexpected increase in the demand for the type of equipment in question A, having secured the return of the equipment, is able to re-let it at twice the rent payable under the original lease. The court may reduce the agreed damages payable so as to take account of this fact.

C. 'Excessive' sum

In deciding whether the stipulated sum is excessive the court should have regard to the relationship between that sum and the loss actually suffered by the aggrieved party, as opposed to the loss legally recoverable within the foreseeability principle embodied in Article 9:503. On the other hand, the computation of actual loss should take into account that element of the loss which has been caused by the unreasonable behaviour of the aggrieved party itself, eg: in failing to take reasonable steps in mitigation of loss.

D. Genuine options not covered

Article 9:509 does not apply to a genuine option to pay a sum of money instead of performing, since Article 4.509(1) deals with non-performance, not with alternative performance (forfeit clause, 'clause de dédit').

APPENDIX G

Article III–3:712 of the DCFR (stipulated payment for non-performance) provides:

III – 3:712: Stipulated payment for non-performance

- (1) Where the terms regulating an obligation provide that a debtor who fails to perform the obligation is to pay a specified sum to the creditor for such non-performance, the creditor is entitled to that sum irrespective of the actual loss.
- (2) However, despite any provision to the contrary, the sum so specified in a contract or other juridical act may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and other circumstances.

Comments

A. Stipulation as to payment for non-performance binding

It is common for the parties to a contract to specify a sum to be paid for the non-performance, with a view to avoiding the difficulty, delay and expense involved in proving the amount of loss in a claim for unliquidated damages. Such a term may also prompt the debtor to perform voluntarily, when the penalty is heavy. To perform is then cheaper than paying the penalty. Paragraph (1) gives effect to such a provision, so that except as provided by paragraph (2) the court must disregard the loss actually suffered by the creditor and must award neither more nor less than the sum fixed by the contract. It follows that the creditor is under no obligation to prove any loss. The terms regulating a non-contractual obligation may also provide for a stipulated payment to be made by the debtor in the event of non-performance.

Illustration 1:

B agrees to build a house for A and to complete it by 1 April. The contract provides that for every week's delay in completion B is to pay A the sum of €200. B completes the house on 29 April. A is entitled to €800 as agreed damages, whether his actual loss (eg: the cost of renting alternative accommodation during the four week period of delay) is greater or less than that sum.

Illustration 2:

A agrees to sell a house to B and obtains a non-returnable deposit of 20 per cent of the price to secure B's performance of the contract. B refuses to complete the transaction. A may keep the deposit.

Where, however, the contract specifies merely the minimum sum payable by the debtor, the creditor may recover a higher figure if the loss exceeds the minimum sum. In this case the creditor may elect to sue for damages at large instead of invoking the provision for agreed damages.

The treatment of agreed damages clauses varies from one legal system to another. Some systems admit them provided that the damages are not substantially greater than the loss that a non-

performance is likely to cause, and strike down stipulations for substantially more than that amount as unenforceable penalties. Others accept that the parties may agree on a penal sum but give the court power to reduce it in some circumstances. As it seems generally to be agreed that there is nothing wrong with the parties agreeing a penalty for non-performance provided that they are fully aware of what they are doing and it does not operate unfairly, the rules take the approach that penalties may be agreed but the court should have power to reduce them when necessary.

B. Court's power to reduce grossly excessive stipulations

To allow the parties to a contract complete freedom to fix the sum payable for non-performance may lead to abuse. If there is a gross disparity between the specified sum and the actual loss suffered by the creditor the court may reduce the sum even if at the time of the contract it seemed reasonable. Since the purpose is to control only those stipulations which are abusive in their effect, the court's reducing power is exercisable only where it is clear that the stipulated sum substantially exceeds the actual loss. This power of the court has a limit: it should respect the intention of the parties to deter default and therefore should not reduce the award to the actual loss. The court has to fix an intermediate figure.

Illustration 3:

A supplies equipment to B on lease for five years at a rent of €50,000 a year. The agreement provides that in the event of termination because of default by B on performing its obligations B is to pay A by way of agreed damages a sum equal to 80% of the future rentals. In the light of circumstances existing at the time of the contract this stipulation is not unreasonable. After a year A terminates because of B's default in payment. As the result of an unexpected increase in the demand for the type of equipment in question A, having secured the return of the equipment, is able to re-let it at twice the rent payable under the original lease. The court may reduce the agreed damages payable so as to take account of this fact.

The power to reduce the stipulated sum also applies to sums specified in unilateral juridical acts, where similar considerations apply. It does not, however, apply to sums stipulated by rules of law. It would be inappropriate to allow courts to modify such sums if the relevant rule of law has not provided for the possibility of such modification.

C. 'Excessive' sums

In deciding whether the stipulated sum is excessive the court should have regard to the relationship between that sum and the loss actually suffered by the creditor, as opposed to the loss legally recoverable taking account of the foreseeability principle. On the other hand, the computation of actual loss should take into account that element of the loss which has been caused by the unreasonable behaviour of the creditor, eg: in failing to take reasonable steps in mitigation of loss.

D. Genuine options not covered

The Article does not apply to a genuine option to pay a sum of money instead of performing a non-monetary obligation, since the Article deals with non-performance, not with alternative obligations or methods of performance (forfeit clause, 'clause de dédit').

APPENDIX H

Article 7.4.13 of the UPICC (agreed payment for non-performance) provides:

1. Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm.
2. However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.

Comment

1. **Agreed payment for non-performance defined**

This Article gives an intentionally broad definition of agreements to pay a specified sum in case of non-performance, whether such agreements be intended to facilitate the recovery of damages (liquidated damages according to the common law) or to operate as a deterrent against non-performance (penalty clauses proper), or both.

2. **Agreed payment for non-performance in principle valid**

National laws vary considerably with respect to the validity of the type of clauses in question, ranging from their acceptance in the civil law countries, with or without the possibility of judicial review of particularly onerous clauses, to the outright rejection in common law systems of clauses intended specifically to operate as a deterrent against non-performance, ie: penalty clauses.

In view of their frequency in international contract practice, paragraph (1) of this Article in principle acknowledges the validity of any clauses provided that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, with the consequence that the latter is entitled to the agreed sum irrespective of the harm actually suffered by it. The non-performing party may not allege that the aggrieved party sustained less harm or none at all.

Illustration:

- (1) A, a former international football player from country X, is recruited for three years to train the players of B, a football team from country Y, at a monthly salary of AUD 10,000. Provision is made for a severance allowance of AUD 200,000 in the event of unjustified dismissal. A is dismissed without any justification after six months. A is entitled to the agreed sum, even though A was immediately recruited by another team at double the salary received from B.

Normally, the non-performance must be one for which the non-performing party is liable, since it is difficult to conceive a clause providing for the payment of an agreed sum in case of non-performance operating in a force majeure situation. Exceptionally, however, such a clause may be intended by the

parties also to cover non-performance for which the non-performing party is not liable.

In the case of partial non-performance, the amount may, unless otherwise agreed by the parties, be reduced in proportion.

3. Agreed sum may be reduced

In order to prevent the possibility of abuse to which such clauses may give rise, paragraph (2) of this Article permits the reduction of the agreed sum if it is grossly excessive 'in relation to the harm resulting from the non-performance and to the other circumstances.' The same paragraph makes it clear that the parties may under no circumstances exclude such a possibility of reduction.

The agreed sum may only be reduced, but not entirely disregarded as would be the case were the judge, notwithstanding the agreement of the parties, to award damages corresponding to the exact amount of the harm. It may not be increased, at least under this Article, where the agreed sum is lower than the harm actually sustained (see however Comment 4 on Article 7.1.6). It is moreover necessary that the amount agreed be 'grossly excessive', ie: that it would clearly appear to be so to any reasonable person. Regard should in particular be had to the relationship between the sum agreed and the harm actually sustained.

Illustration:

- (2) A enters into a contract with B for the purchase of machinery which provides for payment in five instalments of EUR 50,000 each. The contract contains a clause allowing immediate termination in the event of non-payment by A of one instalment, and authorises B to keep the sums already paid and to recover future instalments as damages. A fails to pay the third instalment. B keeps the EUR 100,000 already paid and claims, in addition to the return of the machinery, the EUR 150,000 representing the three outstanding instalments. The court will reduce the amount since A's non-performance would result in a grossly excessive benefit for B.

4. Agreed payment for non-performance to be distinguished from forfeiture and other similar clauses

The type of clauses dealt with in this Article must be distinguished from forfeiture and other similar clauses which permit a party to withdraw from a contract either by paying a certain sum or by losing a deposit already made. On the other hand a clause according to which the aggrieved party may retain sums already paid as part of the price falls within the scope of this Article.

Illustrations:

- (3) A undertakes to sell real estate to B for EUR 450,000. B must exercise the option to purchase within three months and must pay a deposit of EUR 25,000, which A is entitled to retain if B does not exercise the option. Since this is not an agreed payment for non-performance it does not fall under this Article and the sum cannot be reduced thereunder even if grossly excessive in the circumstances.
- (4) A enters into a contract with B for the lease of a machine. The contract provides that in

the event of A's failure to pay one single rental the contract will be terminated and that the sums already paid will be retained by B as damages. The clause falls under this Article and the agreed amount may be subject to reduction.