

**Part I: Commentaries and Reflections****THE DEATH OF PENALTIES IN TWO LEGAL CULTURES?***Professor Sarah Worthington QC (Hon) FBA\****1 Introduction**

For anyone interested in private law in general, and commercial endeavours in particular, the penalties jurisdiction is inherently fascinating. This is the jurisdiction which entitles courts to review an agreed contractual term and declare it void if it is a penalty. In the UK at least, a clause is a penalty if, in substance, it imposes consequences for breach of contract that are extravagant, exorbitant, unconscionable or out of all proportion to any legitimate interest of the innocent party in performance of the contract.<sup>1</sup> It is irrelevant that the parties have fully agreed to the term, or that its inclusion has been priced into the contract.

The penalties doctrine thus throws into sharp relief the common assertion that party autonomy and freedom of contract are important values in common law systems. Those values are strong. As Lord Diplock put it in *Photo Production Ltd v Securicor Transport Ltd*:<sup>2</sup>

A basic principle of the common law of contract [...] is that parties to a contract are free to determine for themselves what primary obligations they will accept. They may state these in express words in the contract itself and, where they do, the statement is determinative [and, turning to the common

\* Downing Professor of the Laws of England and Fellow of Trinity College, University of Cambridge. This is the lightly edited text of a lecture given in Melbourne and Sydney in September 2016 during my term as Merralls Fellow, Melbourne Law School. I am grateful for that opportunity, and the stimulating debates after the lectures. Some of the issues considered here are addressed in more detail, in the UK context only, in a forthcoming chapter: S Worthington, 'Penalty Clauses' in G Virgo and S Worthington (eds), *Commercial Remedies: Resolving Controversies* (CUP 2017).

<sup>1</sup> *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Ltd v Beavis* [2015] UKSC 67, [2016] 1 AC 1172, [32] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), [152], [155] (Lord Mance), [291] (Lord Clarke), [293] (Lord Toulson). The law in Australia is different: see the discussion below.

<sup>2</sup> [1980] UKHL 2, [1980] AC 827, 848.

law's default rules, he continued] if the parties wish to reject or modify [those default] obligations which would otherwise be so incorporated, they are fully at liberty to do so by express words.

Yet this principle of party autonomy, however important, is not absolute. The detailed constraints on its operation require some careful unravelling.<sup>3</sup> The fascination of the penalties jurisdiction, however, is that even when party autonomy *does* seem to be prioritised, in commercial contracts in particular, the courts will still intervene to interfere with the substantive arrangements agreed between the parties. This form of intervention is not unique to penalties. Similar, if less dramatic, judicial oversight has also been directed at exclusion clauses<sup>4</sup> and express termination clauses,<sup>5</sup> for example. Indeed, Lord Diplock in *Robophone Facilities Ltd v Blank*, described exclusion clauses as 'penalty clauses in reverse'.<sup>6</sup>

Note the territorial divide marked out by these areas of intervention. It appears that parties are fully free to agree their primary obligations but not their 'remedial' obligations; they are fully free to occupy the space where the law has no default rules, but not where they propose to override the common law's default rules. Those default rules would have come into play if the parties had been silent. But where the parties make their own arrangements, then it seems the courts see a problem if the parties' agreement is not closely aligned with the courts' own default rules. In those circumstances, the courts may interfere to override the parties' agreement.

If such 'blatant interference with freedom of contract'<sup>7</sup> is to be defended in principle and applied consistently in practice, then its rationale must be exposed. Indeed, the UK Supreme Court ('the Court') in its most recent

<sup>3</sup> I attempted that in S Worthington, 'Common Law Values: The Role of Party Autonomy in Private Law' in A Robertson and M Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (Hart Publishing 2016) ch 14.

<sup>4</sup> Beyond the standard contract texts, see e.g. B Coote, *Exception Clauses* (Sweet and Maxwell 1964); J Morgan, *Great Debates: Contract Law* (Palgrave Macmillan 2012), especially 80-84.

<sup>5</sup> Beyond the standard contract texts, see, e.g. M Bridge, 'Freedom to Exercise Contractual Rights of Termination' in L Gullifer and S Vogenauer (eds), *English and European Perspectives on Contract and Commercial Law: Essays in Honour of Hugh Beale* (Hart Publishing 2014); J Randall, 'Express Termination Clauses in Contracts' [2014] CLJ 113; S Whittaker, 'Termination Clauses' in A Burrows and E Peel (eds), *Contract Terms* (OUP 2007) ch 13; H Beale, 'Penalties in Termination Provisions' (1988) 104 LQR 355; J Carter, 'Termination Clauses' (1990) 3 J of Contract L 90.

<sup>6</sup> *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428 (CA), 1446.

<sup>7</sup> *Cavendish Square Holdings BV v Makdessi* [2013] EWCA Civ 1539, [2014] 2 All ER (Comm) 125, [44] (Christopher Clarke LJ).

## *The Death of Penalties in Two Legal Cultures?*

decision on penalties set precisely this question as its own homework.<sup>8</sup> Other courts have attempted the same question. The answers to date are widely recognised as falling short.<sup>9</sup>

The underlying difficulties are worth exploring, especially given the four recent and highly significant judgments handed down by the highest courts in the UK and Australia in recent years, with those two courts avowedly adopting different approaches to the problem.<sup>10</sup> What follows exposes some of the issues. Adopting a rather journalistic style, the points are made under six headings: What types of cases have reached the courts? How have the courts approached the penalties rule in these latest cases? What rationale underpins judicial intervention in penalties cases? Which clauses are now amenable to review under the penalties jurisdiction? Which of these reviewable clauses are likely to be held to infringe the penalty rule? And, finally, what consequences follow upon such a finding?

### 2 What types of cases have reached the courts? Recent judicial activity in Australia and the UK

What is a typical combined sense of fascination and ill-ease with the penalties jurisdiction must now accommodate four cases from the highest courts in Australia and UK, two from each jurisdiction. These cases have profoundly changed the penalties landscape in the two countries. Their very different facts provide a pointed illustration of the vastly different contexts in which the penalties jurisdiction might have a role.

The Australians began the march. In 2012, in *Andrews v ANZ Banking Group Ltd*,<sup>11</sup> then this year in a follow-up appeal in *Paciocco v Australia and New Zealand Banking Group Ltd*,<sup>12</sup> the Australian High Court considered the validity of various banking charges (confined specifically to late payment fees in *Paciocco*) imposed by ANZ Bank on its customers.<sup>13</sup>

<sup>8</sup> *Makdessi* (n 1) [3] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)) ('But unless the [penalties] rule is to be abolished or substantially extended [neither of which was advocated], its application to any but the clearest cases requires some underlying principle to be identified.').

<sup>9</sup> *ibid* [3], noting that even the likes of Lord Eldon, Lord Justice Diplock and Sir George Jessel MR had been unable to explain the jurisdiction, quoting *Astley v Weldon* (1801) 2 Bos & Pul 346, 350 (Lord Eldon); *Wallis v Smith* (1882) 21 Ch D 243, 256 (Sir George Jessel MR); *Robophone* (n 6), 1446 (Diplock LJ).

<sup>10</sup> The detail appears below.

<sup>11</sup> *Andrews v ANZ Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205.

<sup>12</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28.

<sup>13</sup> In what follows, all the references to *Paciocco* are to this latest High Court decision (n 12), not to the earlier Full Federal Court decision in *Paciocco v Australia and New Zealand Banking Group Limited* [2015] FCAFC 50.

In England, in 2015, the UK Supreme Court heard conjoined appeals in *Cavendish v El Makdessi* and *ParkingEye Ltd v Beavis*,<sup>14</sup> The first case, *Cavendish Square Holding BV v Talal El Makdessi*, concerned a claim worth ~US\$44m relating to contract terms which, on one view, defined the sale price for shares delivering a controlling interest in an advertising group, and, on another view, imposed a penalty for breach by the seller of otherwise legitimate contractual restraint of trade clauses.<sup>15</sup> The second case, *ParkingEye v Beavis*, concerned an £85 parking ticket issued for overstaying the permitted period of free parking in a shopping centre car park.

These four cases hint at the broad range of factual circumstances which might be amenable to oversight under the penalties jurisdiction. Earlier cases across both jurisdictions are equally diverse. They illustrate penalties claims being advanced in the context of fees charged for late completion of contracts,<sup>16</sup> breach of restraint of trade clauses,<sup>17</sup> or breach of film screening licences;<sup>18</sup> interest rate hikes for breach of loan contracts;<sup>19</sup> liquidated damages for wrongful dismissal;<sup>20</sup> and so on.

Those illustrations cover broad swathes of commercial activity. Yet one rider might be added to all of this. Despite my own expressed dissatisfaction with the state of the law,<sup>21</sup> assertions that a clause is a penalty are rarely upheld by the courts. The assertions failed in all four of the recent decisions under particular discussion here. They also failed in the vast majority of leading decisions over the decades in both jurisdictions. Cases where the penalties jurisdiction has delivered intervention are thus few and far between, and each rare exception might in any event have been

<sup>14</sup> *Makdessi* (n 1).

<sup>15</sup> Makdessi agreed to sell to Cavendish a controlling stake in what had become the largest advertising group in the Middle East. The agreement contained restrictive covenants designed to ensure Makdessi did not compete in defined ways. Makdessi breached these. As a result, under clause 5.1, Makdessi would forfeit the final two instalments of deferred consideration payable by Cavendish for his shares. And under clause 5.6, he would be required to transfer all his remaining shares to Cavendish at a price which excluded any value referable to goodwill. Makdessi unsuccessfully claimed that clauses 5.1 and 5.6 were unenforceable penalty clauses. The UK Supreme Court reversed the Court of Appeal, which had in turn overturned the trial judge's conclusions.

<sup>16</sup> *Philips Hong Kong Ltd v Attorney General of Hong Kong* (1993) 61 BLR 41 (PC); *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1904] UKHL 3, [1905] AC 6. Similarly, *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71, (2005) 224 CLR 656; *State of Tasmania v Leighton Contractors Pty Ltd* [2005] TASSC 133.

<sup>17</sup> *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1914] UKHL 1, [1915] AC 79.

<sup>18</sup> *Metro-Goldwyn Mayer Pty Ltd v Greenham* [1966] 2 NSW 717.

<sup>19</sup> *Lordvale Finance plc v Bank of Zambia* [1996] QB 752.

<sup>20</sup> *Murray v Leisureplay plc* [2005] EWCA Civ 963.

<sup>21</sup> Worthington, 'Common Law Values: The Role of Party Autonomy in Private Law' (n 3).

### *The Death of Penalties in Two Legal Cultures?*

better justified on alternative grounds.<sup>22</sup> All of this might suggest that contracting parties have little to fear from the jurisdiction and its potential for interference with freedom of contract. But the waters which must be negotiated are choppy, and perhaps choppier still after the last four years of judicial hyperactivity.

### 3 How have the courts approached the penalties rule in these latest cases?

If the courts have made the waters choppier, how have they done this? In the four most recent cases in the highest courts in the UK and Australia, neither jurisdiction overruled earlier cases, yet both jurisdictions have now adopted a completely different view of the previously leading case on penalties. That obviously has profound consequences. It is a stark reminder that a turn in the road in applicable legal principles is not necessarily signposted by an overruling of earlier authorities.

Before *Andrews* and *Makdessi*, the leading case on penalties was the House of Lords' decision in *Dunlop Pneumatic Tyre Co v New Garage and Motor Co Ltd*.<sup>23</sup> There, the House of Lords had held that a retail price maintenance clause with a fee of £5 per breach was a liquidated damages clause, not a penalty clause. It was, therefore, a valid term of the contract, not void as a penalty provision. In reaching this conclusion, one of the Law Lords, Lord Dunedin, set out his guidance on the test for a penalty by way of four numbered points, with the last point encapsulating a further four sub-points.<sup>24</sup> With all the attraction so often ascribed to numbered lists, this test quickly achieved the status of a quasi-statutory code in the subsequent case law.<sup>25</sup> The full detail is not important here, but, taking the highlights, Lord Dunedin suggested that '[t]he essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party [while, by contrast,] the essence of liquidated damages is a genuine covenanted

<sup>22</sup> The claim succeeded in *Campbell Discount Co Ltd v Bridge* [1962] AC 600 (HL), although by contrast see *Cadogan Petroleum Holdings Ltd v Global Process Systems LLC* [2013] EWHC 214 (QBD (Comm)); *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130 (CA); *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana (The Scaptrade)* [1983] 2 AC 694 (HL); and *Stockloser v Johnson* [1954] 1 QB 476 (CA). And although relief was granted in *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] AC 573 (PC) (return of a 25% deposit); *Jobson v Johnson* [1989] 1 WLR 1026 (CA) (retransfer of shares on payment default); and *The Comr of Public Works v Hills* [1906] UKPC 35, [1906] AC 368 (forfeiture of a retention fund), all of these cases have some parallels with relief against forfeiture, and might, therefore, be subject to preferable alternative explanations.

<sup>23</sup> *Dunlop* (n 17).

<sup>24</sup> *ibid* 86-88.

<sup>25</sup> *Makdessi* (n 1) [22] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)).

pre-estimate of damage [...]’ and that a provision ‘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.’<sup>26</sup>

Notice that the test involves a simple opposition between a penalty and a liquidated damages clause: the clause under review will necessarily be one or the other. Moreover, classification under either head depends on the degree to which the parties’ nominated quantum differs from what might be recovered by way of damages under the common law default rules. Inherently, therefore, the relevant clause will be one which operates on breach, and, to avoid being caught by the rule, any clause conditioned on breach cannot provide for substantially more by way of liquidated damages than the parties would have estimated as likely to be recoverable under the common law default rules on damages.<sup>27</sup> This resonates powerfully with my earlier comment on the seeming need for the parties’ own provisions to align with the common law’s default rules. Inevitably, of course, this rule was subtly revised and adjusted to enable enhanced recoveries, thus blunting the sharpness of the rule as originally stated by Lord Dunedin.<sup>28</sup> Nevertheless, the fundamental drivers remained the same, and for present purposes we can ignore the various subtleties and turn immediately to the judicial activity of the last four years.

The four recent cases all substantially reinterpreted *Dunlop*. Without exception, they did this not by overruling the case but by shifting their focus from Lord Dunedin’s formulaic approach (at least as expressed in later cases) to Lord Atkinson’s more pragmatic and commercially oriented one. Lord Atkinson explicitly recognised *Dunlop*’s wider interest in retail price maintenance across *all* its retailers, not just its interest in the economic harm caused by the particular breach of contract committed by the defendant before the court. Earlier cases lent support to this move: consider the courts’ upholding of late payment clauses for the delivery of warships to Spain,<sup>29</sup> or the delivery of government infrastructure projects,<sup>30</sup> without requiring some demonstrated equivalent economic loss. The significant shift in all these recent decisions was, therefore, explicit judicial recognition

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<sup>26</sup> *Dunlop* (n 17) 86-87.

<sup>27</sup> See *Robophone* (n 6) 1446H-1447A (Diplock LJ) (there is a rule of public policy which does not ‘permit a party to a contract to recover in an action a sum greater than the measure of damages to which he would be entitled at common law’). See also *Exports Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 (HL) 403 (Lord Roskill).

<sup>28</sup> Those nuances are described in all the leading contract texts. See also the summary in Worthington, ‘Common Law Values: The Role of Party Autonomy in Private Law’ (n 3).

<sup>29</sup> *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1904] UKHL 3, [1905] AC 6.

<sup>30</sup> *Philips* (n 16).

### *The Death of Penalties in Two Legal Cultures?*

of the existence of a broad range of *non-financial interests* that the parties to a contract might legitimately protect.<sup>31</sup>

Although this explicit shift in focus from Lord Dunedin to Lord Atkinson was common to both the UK Supreme Court and the High Court of Australia, did both courts use that shift to advance the same ends? The courts themselves suggested they did not, with each recognising divergences between their different approaches, and indeed doing so rather robustly. The UK Supreme Court suggested that *Andrews* involved 'a radical departure from the previous understanding of the law',<sup>32</sup> and refused to follow in those footsteps. Responding tit-for-tat, the High Court of Australia suggested that, '[t]o the extent that the statement refers to the common law of Australia, the statement is wrong and appears to be based on a misunderstanding of *Andrews*.'<sup>33</sup> I doubt the divide is as substantial as the courts themselves suggest, but we will be in a better position to judge that at the end of this analysis. For now it is enough to notice that both courts conceded that contract terms might protect non-financial or non-monetary losses.

But there was more. The *Andrews* decision departed from the previously orthodox understanding of the penalty doctrine in two further significant respects. First, it discarded the breach requirement. The advantage of this is that it seems to avoid the problem of the parties being able very simply to draft around the rule. But the change itself introduces its own complications, which will be discussed further below.

Secondly, the High Court of Australia indicated that the doctrine had its foundations in equity and those foundations remained active; they had not withered and died in favour of the later-developing common law rule.<sup>34</sup> Pursuing this line, *Paciocco* makes it plain that both jurisdictions are operational in Australia. Parties will generally rely on the common law rules, but the equitable rules will assist in circumstances where the doctrine is necessarily extended to cover non-breach situations, or where performance is needed rather than damages or money. These are rare cases,

<sup>31</sup> As an aside, in the context of case (re)interpretation, it is interesting to note the significance ascribed in *Paciocco* to the use of the word 'damage' rather than 'damages' in *Dunlop*, with the former taken to be referring to wider interests, and the latter to the interests protected and the sums recoverable under the common law default rules on damages: *Paciocco* (n 12) [145] (Gageler J), [283] (Keane J). This was not determinative, but in any event seems to lay too much stress on wording: judgments are not drafted as statutes, with each word amenable to such forensic analysis.

<sup>32</sup> *Makdessi* (n 1) [41] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)).

<sup>33</sup> *Paciocco* (n 12) [121] (Gageler J).

<sup>34</sup> *ibid* [123]. Also see more generally [122]-[126], which makes the points noted in the accompanying text.

as acknowledged in *Paciocco*. Indeed, the consideration of non-breach cases in *Andrews* seems to be the only known modern instance. *Paciocco* itself was recognised by the court as exclusively within the common law domain: the banking fees clause operated on breach, and the only consideration was whether the money payment provided for by way of late fees was penal or not.

I remain unpersuaded by this suggested operation of the penalties jurisdiction in equity. It seems to me that the early equity cases on penal bonds all approached the problem on the basis that equity would (and could) only intervene if the arrangement between the parties was specifically intended as an agreement by way of security, and that equity had no jurisdiction if the agreement was merely intended to quantify agreed damages or provide an alternative secondary mode of performance of the contract.<sup>35</sup> The legal solution follows directly and inevitably from that particular characterisation of the agreed arrangement: enforcement of rights against the security is barred beyond the interest which is secured. This view of the early equity cases seems to be reinforced, not undermined, by all the references to the early equity cases in *Paciocco* itself. In this sense, equity's approach to penal bonds shares much with equity's approach to relief from forfeiture in that class of case where the forfeiture provision is inserted by way of secu-

<sup>35</sup> So much is this the case that the courts themselves typically pose the characterisation question as a simple opposition between clauses intended to define the parties' agreed quantum of damages and clauses intended merely by way of security (usually for court-assessed default damages). Equity will not intervene in the first class, a conclusion reached without further consideration of whether the agreed damages are excessive. By contrast, equity intervenes in the latter class to ensure recovery is limited to the damages secured. The older cases are often thin on reasoning, but see especially *Sloman v Walter* (1783) 1 Bro CC 418, 419, 28 ER 1213, 1214, with Lord Chancellor Thurlow saying that 'the only question was, whether this was to be considered as a penalty, or as assessed damages. The rule, that where a penalty is inserted merely to secure the enjoyment of a collateral object, the enjoyment of the object is considered as the principal intent of the deed, and the penalty only as accessorial, and, therefore, only to secure the damage really incurred, is too strongly established in equity to be shaken.'

Similarly, see *Sir Harry Peachy v Duke of Somerset* (1721) Precedents in Chancery 568, 572; 24 ER 255, 257 and *Tall v Ryland* (1670) 1 Cases in Chancery 183, 184, 22 ER 753, 753 (the courts in both cases interpreted the parties' agreement as quantifying damages, not as intending security, so there was no equitable intervention). To the same effect, but also noting that any agreed damages clause must of course be properly agreed, see *Roy v The Duke of Beaufort* (1741) 2 Atkyns 190, 192 (proper consent), 193-94 (security), 26 ER 519, 520 (proper consent), 520-21 (security) (although here the court did intervene, but on the basis that there had been no breach to justify the damages payment). See too *Rolfe v Peterson* (1772) II Brown 436, 442-3, 1 ER 1048, 1052 (no reasons are given, but presumably the court accepted the argument of the winning side that relief was possible only when the parties intended a security (442, 1052), and rejected the argument of the losing side that equity would intervene simply because the terms were unfair or unduly onerous (442-43, 1052). Other cases cited in *Paciocco* (n 12) [21] (Kiefel J) are not on point.



### *The Death of Penalties in Two Legal Cultures?*

riety for performance of a primary obligation.<sup>36</sup> The issue matters, if only because any misunderstanding of the rationale for equity's intervention is likely to lead to analytical problems down the track. With the High Court of Australia, this is likely to be in its own assessment of potential infringements of the penalties jurisdiction. With the UK Supreme Court, it is likely to be with its running together the possibility of reviewing clauses under both the penalties jurisdiction and the forfeiture jurisdiction.<sup>37</sup> For any equity lawyer, these are fascinating alleyways, but not of central importance to this overview.

To summarise, the Australian position after *Andrews* and *Paciocco* might be put like this. The High Court of Australia has made three quite significant advances on the previously orthodox *Dunlop* rule: first, expanding the rule beyond the penalties/liquidated damages direct comparator; secondly, eliminating the breach requirement, and thus the ability to draft around the rules with relative ease; and, thirdly, claiming a surviving equitable penalties jurisdiction, giving the court added flexibility for intervention into parties' arrangements. Interestingly, the first favours contracting parties in the exercise of their own autonomy, but the latter favour increased judicial intervention.

The seven-member panel of the UK Supreme Court in *Makdessi* pursued a very similar tack. The Court also discarded Lord Dunedin formulations in *Dunlop* in favour of the broader Lord Atkinson approach, suggesting that this was not only a preferable approach, but also the dominant approach of the House of Lords in *Dunlop* itself,<sup>38</sup> although recognising that this alternative approach had been lost sight of in favour of the focus on a few enticingly numbered paragraphs in Lord Dunedin's judgment. By contrast with the Australians, however, the UK Supreme Court explicitly retained the breach requirement, refusing to follow the Australian lead, and suggesting that the penalties jurisdiction was anomalous enough as it stood without the Court volunteering to expand its potential application.<sup>39</sup> Nevertheless, it conceded that this question of whether a clause was

<sup>36</sup> See most recently *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd* [2013] UKPC 2, [2016] 1 AC 923; *Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd* [2013] UKPC 20, [2016] 1 AC 923.

<sup>37</sup> This is a complicated issue, discussed in detail in S Worthington, 'Penalty Clauses' in G Virgo and S Worthington (eds), *Commercial Remedies: Resolving Controversies* (CUP 2017), ch 16 (forthcoming), pt V.

<sup>38</sup> See e.g. *Makdessi* (n 1) [22] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)) ('none of the other three Law Lords expressly agreed with Lord Dunedin's reasoning, and the four tests do not all feature in any of their speeches').

<sup>39</sup> *ibid* [13] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), see also [239], [241] (Lord Hodge).

triggered by breach should be judged as a matter of substance not form.<sup>40</sup> This may in the end leave very little between the two jurisdictions on this particular front.<sup>41</sup> Going further, the Court has denied the survival of any equitable penalties jurisdiction, treating the Australian analysis in *Andrews* rather scathingly.<sup>42</sup> But, as already noted, the Court seems to have tied itself in very similar knots by suggesting forfeiture as an alternative secondary review mechanism for some of these clauses.<sup>43</sup>

Both courts, in rejecting the liquidated damages/penalty clause dichotomy, opted instead to focus on punishment, as indeed might be suggested by the term ‘penalty’ itself. Numerous paragraphs could be cited from the various judgments, but all in one way or another describe the search as being one for a clause which has the purpose, or even the sole purpose, of punishing the counterparty rather than supporting the innocent party’s legitimate interests.<sup>44</sup> In the search for punishment, it is also universally accepted that the indicators ‘extravagant and unconscionable’ (as per Lord Dunedin in *Dunlop*), or exorbitant,<sup>45</sup> or disproportionate,<sup>46</sup> or ‘out of all proportion to any legitimate interest’,<sup>47</sup> all remain material. It is perhaps worth noting that while the High Court of Australia seemed set on expanding the interventionist penalties jurisdiction, the UK Supreme Court expressly considered whether the entire doctrine should be abolished. I had argued for this, and remain of that view.<sup>48</sup> However, the Court in *Makdessi* adamantly declined to abolish the penalties rule either generally or in the commercial context,<sup>49</sup> with Lord Neuberger and Lord Sumption adding:

<sup>40</sup> *ibid*, [15], [34], [77] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), [130] (Lord Mance); [258], [270], [280] (Lord Hodge).

<sup>41</sup> Although the UK Supreme Court also admitted, a little inconsistently it might be thought, that clever drafting might nevertheless enable an escape: *ibid* [43] (Lord Neuberger and Sumption (with whom Lord Carnwath agreed)).

<sup>42</sup> *ibid* [41].

<sup>43</sup> See *Makdessi* (n 1) [17]-[18] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)); [160]-[161], [170] (Lord Mance); [227] (Lord Hodge); [291] (Lord Clarke).

<sup>44</sup> *Paciocco* (n 12) [165]-[166]; *Makdessi* (n 1) [31] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) (‘The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not therefore, at any rate without more, mean that it is penal.’).

<sup>45</sup> *Paciocco* (n 12) [53] (Kiefel J).

<sup>46</sup> *Ringrow* (n 16) [31]-[32] (Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ); *Paciocco* (n 12) [54] (Kiefel J); *Makdessi* (n 1) [32] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)) (‘out of all proportion to any legitimate interest’).

<sup>47</sup> *Makdessi* (n 1) [32] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)); *Paciocco* (n 12) [54], [67]-[69] (Kiefel J).

<sup>48</sup> Worthington, ‘Common Law Values: The Role of Party Autonomy in Private Law’ (n 3).

<sup>49</sup> *Makdessi* (n 1) [36]-[39] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath

### *The Death of Penalties in Two Legal Cultures?*

‘We rather doubt that the courts would have invented the rule today if their predecessors had not done so three centuries ago. But this is not the way in which English law develops, and we do not consider that judicial abolition would be a proper course for this court to take.’<sup>50</sup>

This is reminiscent of the Court’s approach in *Petrodel Resources Ltd v Prest*,<sup>51</sup> there declining to abolish the jurisdiction to pierce the corporate veil, a jurisdiction also existing elsewhere, but unable to suggest instances where it was really needed and where no other intervention already did the job equally well and on a more principled basis. It is easy to see why any court might be reluctant to cede powers, especially since the circumstances where they might prove useful in the future could be difficult to anticipate in the abstract. But the approach adopted in *Petrodel* at least has the merit of making the Court’s views explicit, thus ensuring that few if any cases are likely to advance ‘piercing’ arguments to the court. The same is unlikely to be true with penalties claims.

In short, both jurisdictions have formally upheld the authority of *Dunlop* but radically reinterpreted its basis by moving from Lord Dunedin’s technical analysis to Lord Atkinson’s more pragmatic and commercial analysis. Both have liberalised the scope of the jurisdiction: the Australians, by eliminating the breach requirement; the UK, by liberalising the form over substance question and the varieties of detriment which might be reviewable. The Australian courts have gone still further and embraced a revived equitable jurisdiction to sit alongside the common law jurisdiction. Courts on both sides of the equator deny that they have done anything radical, and yet the general response of both practising and academic lawyers is certainly to the contrary. The changes are hardly insignificant.

It is difficult to say what caused this sudden and rather dramatic move on both sides of the globe. Reading history backwards, it might simply have been the build-up to breaking point of the inherent tension between party autonomy and judicial interference with genuinely agreed substantive contractual terms, the discomfort over the technical formalism of the breach

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agreed)), [162]-[170] (Lord Mance), [256] (Lord Hodge), [291]-[292] (Lord Clarke). For suggestions that the penalties jurisdiction should be abolished, see J O’Sullivan, ‘Lost on Penalties’ [2014] CLJ 480; E Peel, ‘Unjustified Penalties or an Unjustified Rule against Penalties?’ (2014) 130 LQR 365; S Worthington, ‘Common Law Values: The Role of Party Autonomy in Private Law’ (n 3). And implicitly to the contrary, discussing the common law more generally, see Lord Neuberger MR, ‘The Life of the Law: The Logic of Experience’ (Lionel Cohen Lecture, Jerusalem, 29 June 2010).

<sup>50</sup> *Makdessi* (n 1) [36] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)); [291] (Lord Clarke).

<sup>51</sup> *Petrodel Resources Ltd v Prest* [2013] UKSC 34, [2013] 2 AC 415.

rule which seemed implicitly to deny a coherent motivating policy or principle, all brought slowly to explosion point by a series of cases over recent decades where the courts have strained to avoid intervention based on the jurisdiction, pushing the analytical envelope as far as it was possible to enable parties to adopt terms imposing default charges, interest rate hikes, late payment provisions and more.<sup>52</sup> Something clearly had to be done to settle the jurisdiction on firmer and more principled foundations.

#### 4 What rationale underpins judicial intervention in penalties cases?

In seeking principled foundations for the penalties jurisdiction, what conclusions did the courts advance in these four important cases? Perhaps surprisingly, especially in light of its other radical moves, the High Court of Australia did not really engage with this question other than to insist that the real objection is to private punishment.<sup>53</sup> But punishment suggests the visiting of an unexpected detriment, and in all these contract cases which incorporate 'penalty' clauses, the detriment is clearly agreed and priced into the contract, and so is hardly unexpected. Indeed, the more compelling view might see the innocent party as being punished precisely because the agreement is not enforced.

The UK Supreme Court fared no better. In *Makdessi*, the Court indicated that the rule's underlying rationale is that a provision operating on breach is unenforceable if its consequences are out of all proportion to any legitimate interest of the parties.<sup>54</sup> But this restates and reformulates the rule; it does not provide a rationale. And even as a rule, it faces problems. If this rule makes sense, then surely it would make still more sense to refuse enforcement of *any* provision if its consequences are out of all proportion to any legitimate interest of the parties. But where would that get us? And surely the most basic 'legitimate interest' of contracting parties lies in having the law uphold the terms of their arrangements provided they are within the law and properly agreed?

Effectively, therefore, the courts are saying that such arrangements, even if properly agreed, are not 'within the law'. So we are full circle – the divide between primary and remedial provisions seems important to the

<sup>52</sup> See e.g. *Lordsvale* (n 19); *Leisureplay* (n 20); *Cine Bes Filmcilik ve Yapimcilik AS v United International Pictures* [2003] EWCA Civ 1669; *Philips* (n 16).

<sup>53</sup> *Paciocco* (n 12) [254]-[256] (Keane J).

<sup>54</sup> *Makdessi* (n 1) [29] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), but generally too.

courts,<sup>55</sup> but for reasons which they cannot explain, and which still seem to me to be inexplicable. This failure to nail the underpinnings of the penalties jurisdiction will undoubtedly have consequences: it is impossible to deal with hard cases if the relevant principles and policies are unclear.

However, despite this lack of clarity, the courts still have a job to do. They must decide which contract terms are legitimately within their sightlines as potential penalties, and – from that class – which should then legitimately be judged to be penal. These are the issues addressed in the two final questions.

## 5 Which clauses are now amenable to review under the penalties jurisdiction?

Given all the differences just outlined, it might seem surprising that the courts in the UK and Australia seem to have adopted remarkably similar tests to determine which contract terms are reviewable under the penalties jurisdiction. In Australia, the High Court's discussion is of contracts which contain 'primary stipulations' and 'collateral stipulations', with the collateral stipulation not necessarily operative only on breach of the primary stipulation.<sup>56</sup> In the UK, the Court's discussion is of contracts which contain 'primary obligations' and 'secondary obligations', with a secondary obligation necessarily arising on breach of the primary obligation if review under the penalties jurisdiction is to be attracted.<sup>57</sup>

On reflection, however, some notion of alternative primary and collateral stipulations (in Australia) or primary and secondary obligations (in the UK) is inevitable; otherwise, the penalties jurisdiction has nothing on which to bite. It cannot bite on a single stipulation defining a mode of performance. Such a stipulation is at large, and non-performance would necessarily be remedied by the common law's own default rules. By contrast, clauses amenable to the penalties jurisdiction must necessarily provide for an alternative to the default rules: it is these agreed alternatives which may, sometimes, be scrutinised, and on scrutiny held to be void despite being an agreed arrangement between the parties.

Notice the consequences, however. With a red line through the offending alternative stipulation, the consequence is that only the primary stipulation

<sup>55</sup> *ibid* [13] ('There is a fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach. [...] the courts do not review the fairness of men's bargains either at law or in equity. The penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves.').

<sup>56</sup> *Andrews* (n 11) [10] (French CJ, Gummow, Crennan, Kiefel and Bell JJ).

<sup>57</sup> *Makdessi* (n 1) [40]-[43] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), [129]-[130], [153] (Lord Mance).

stands, and, if it is not complied with, then the innocent party will necessarily be left to claim damages under the common law's default rules on damages.<sup>58</sup> Even phrasing the analysis like this highlights a potential complication. The court's intervention must be such that it is reasonable to take away one limb of the parties' own agreed alternative modes of performance – i.e. the collateral or secondary stipulation – and leave the primary stipulation as a self-standing sole mode of performance, in the absence of which the innocent party will be left to damages assessed under the common law's default rules.

It was precisely this concern that caused the UK Supreme Court to refuse to follow the Australians down the no-breach route. The Court saw the jurisdiction to interfere as inappropriate in circumstances where the parties had genuinely laid out alternative modes of performance. In that latter category, the Court put take-or-pay clauses, bad leaver clauses, break fee clauses, and such like,<sup>59</sup> implicitly suggesting that these clauses could be interpreted as alternative primary obligations, not remedial secondary ones.

It is thus crucial to know which alternatives will count as reviewable 'collateral' or 'secondary obligations' and which as unreviewable 'primary', but alternative, options. The penalties jurisdiction turns on the difference. Before *Andrews* and *Makdessi*, the distinction was purely a matter of form: an obligation worded as conditional on breach was open to scrutiny; the same obligation avoiding that phraseology was not. This was, quite fairly, seen as yet another fundamental flaw in the penalties jurisdiction because it made plain that the jurisdiction operated on a technicality rather than in a principled manner.

Now, however, something more subtle must be relied upon. The problem was addressed in *Makdessi*, but not in *Andrews* or *Paciocco*. In *Makdessi*, the Court recognised that the parties might provide for genuinely alternative modes of performance. They called these 'primary obligations' and 'conditional primary obligations' (conditional on non-performance of the first primary obligation).<sup>60</sup> The problem is, of course, obvious. The structure or phraseology of the proffered contractual options reveals nothing: this is the structure of all primary/secondary options, as well as all primary/conditional primary options. Furthermore, the contract terms themselves typically reveal indifference as to the choice to be made between options. And

<sup>58</sup> This is the practical result. There are subtle differences in how this is achieved in both jurisdictions. Interestingly, the two jurisdictions differed in their approaches before these latest cases, and now still differ, with each having swapped to the other's earlier preferred approach.

<sup>59</sup> *Makdessi* (n 1) [43] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)).

<sup>60</sup> *ibid* [14].

### *The Death of Penalties in Two Legal Cultures?*

no test could turn on the subsequent (and likely self-serving) assertion by the promisee that there was no factual preference for one mode of performance over the other.<sup>61</sup> Such a test would in any event fly in the face of the concessions in both *Andrews* and *Makdessi* that deterrence is a permitted and valid part of contracting.

Nevertheless, *Makdessi* held that there was a distinction, and that it mattered. If the penalties jurisdiction is to work, then this distinction must be applied to protect certain alternatives from review. Yet even the seven Justices of the Court who invented the distinction could not themselves agree upon whether the various provisions in the *Makdessi* share sale were conditional primary obligations (i.e. redefining the sale price and reshaping the primary relationship between the parties) or secondary obligations (i.e. defining the remedial consequences following a breach of the primary obligations) and so opening up the possibility of review under the penalties jurisdiction.<sup>62</sup> This clearly will not do if commercial parties and their lawyers are now to be required to draw these very same lines.

The High Court of Australia did not address this issue directly, but precisely the same problem is likely to arise given the very precise wording adopted in *Andrews* in describing primary and collateral stipulations.<sup>63</sup>

In short, in both jurisdictions the only clauses reviewable under the penalties jurisdiction are some defined subset of 'then' or 'or' clauses appearing in contracts worded either as 'if not X, then Y' (meeting the UK breach requirement) or 'either X or Y' (meeting the broader Australian test, and perhaps falling foul of the UK substance over form test). But in both jurisdictions it is unclear how this subset is to be identified; it is unclear which clauses will be classed as 'secondary obligations', or 'collateral stipulations', and which will not.

This problem seems insoluble. To me, it indicates a flaw in the logic which is otherwise presented so attractively in both *Andrews* and *Makdessi*. When one party fails to perform under the first option in a contract, is

<sup>61</sup> Equally the test of whether the clause being reviewed is penal does not depend on any proof that one party intended to punish the other: *ibid* [28]; *Paciocco* (n 12) [242] (Keane J).

<sup>62</sup> See *Makdessi* (n 1) [73]-[88] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), [180]-[183] (Lord Mance), [270] and [280] (Lord Hodge), [291] (Lord Clarke), [292] (Lord Toulson). A useful summary of the divisions on the different clauses is provided by W Day, 'Penalty Clauses Following *Makdessi*: Postscript' [2016] JBL 251.

<sup>63</sup> *Andrews* (n 11) [10] (French CJ, Gummow, Crennan, Kiefel and Bell JJ) ('In general terms, a stipulation *prima facie* imposes a penalty [...] 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.').

there *any* test which can determine whether the second option is, at law, a 'collateral stipulation' or 'secondary obligation' (thus reviewable under the penalties rule) or a 'conditional primary obligation' (merely providing an alternative mode of performance, and therefore not reviewable)? And yet the distinction is said to be crucial.

The approach adopted in the *Makdessi* judgments is that the distinction turns on whether the initial primary obligation is mandatory (so failure constitutes a breach, and the second option is then remedial and secondary) or permissive (so failure does not constitute a breach, and the second option is therefore an alternative conditional primary obligation).<sup>64</sup> But this distinction is tenuous. If the contract itself provides for an alternative mode of performance, then the primary obligation cannot be mandatory in the sense which seems necessary here, and the suggested distinction falls away.<sup>65</sup>

How did we get into this muddle? Some part is simply terminology, and using words without thinking carefully about their significance. On any sensible analysis, the agreed contractual obligations in these penalties contexts are surely all primary obligations. The parties agree who will do what, and when they will do it, and what will count as proper performance. All contractual obligations are inherently conditional. That is what consideration requires: if A does X, then B will do Y. This does not stop the obligations being primary. Adding complications by providing for performance alternatives does not change this principal point. Despite the added complication, these too are all primary obligations agreed by the parties. The difference between them is simply their different conditionalities.

True secondary obligations really *are* different. They may be imposed by the courts or agreed by the parties. On the first, the relatively modern jargon is to speak of primary obligations under a contract, and secondary obligations arising upon breach of those primary obligations. The use of the term 'secondary obligations' in this context defines a liability to a range of judicially imposed default remedies, being a different source of obligations, and has nothing to do with the penalties jurisdiction.

Secondary obligations agreed by the parties are different again. Agreements to provide security fall into this category. So do insurance contracts. These

<sup>64</sup> *Makdessi* (n 1) [14] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), but contrast [280] (Lord Hodge).

<sup>65</sup> Notice one interesting question, however. If a threatened breach of the initial primary obligation is discovered early enough, would a court order injunctive relief (e.g. in relation to restraint of trade or non-disclosure clauses) or specific performance (e.g. in relation to timely transfer of assets)? The answer to that question cannot, however, be determinative of the answer to the question in issue here.



*The Death of Penalties in Two Legal Cultures?*

agreements themselves specify primary obligations between the parties, but their protective objective is secondary in that the required performance is *necessarily* defined and quantified by some other (primary) obligation. These obligations are properly secondary in that they are supportive only, and fall away completely if there is no underlying primary obligation. These obligations also have nothing to do with the penalties jurisdiction. Many illustrations could be given. Forfeiture cases very often fall within this category (and in these circumstances any suggested overlap with the penalties rule seems doubtful). As suggested earlier, it seems to me that the penal bonds which provided the genesis of the equitable penalties jurisdiction also fall into this category.<sup>66</sup>

There are no analogies between these types of secondary obligations and the distinctions the judges are seeking to identify between 'primary' or 'conditional/alternative primary' and 'collateral' or 'secondary' obligations in the types of contracts before the courts in the penalties jurisdiction. Whatever the judges say about how obvious these distinctions are,<sup>67</sup> there is, I suggest, no legal or practical substantive distinction in play at all.<sup>68</sup> I would prefer to say that *all* these choices describe primary obligations.

On the test adopted in both *Andrews* and *Makdessi*, this would leave the penalties jurisdiction with no content. That would be no bad thing in my view. But it makes plain that if the penalties jurisdiction is to have teeth, and if the courts are not to tie themselves in knots in finding secondary or collateral clauses to review, then they may be forced to take the opposite stance. They may be forced to say that *every* time a contract provides for alternative modes of performance, then the courts will regard one mode as primary and the other as secondary. Which of the two should be regarded as primary and which as secondary might need to be explained: one clause will be reviewed and perhaps declared void; but not the other, whatever its onerous characteristics. This makes plain the radical judicial intervention in play under the penalties jurisdiction.

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<sup>66</sup> See above, (n 35). To similar effect, see *Makdessi* (n 1) [4]-[7] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), citing AWB Simpson, 'The Penal Bond with Conditional Defeasance' (1966) 82 LQR 392.

<sup>67</sup> See especially *ibid*, [13] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)) and [130] (Lord Mance) ('a real distinction, legal and psychological'), notwithstanding their own failure to achieve consensus.

<sup>68</sup> As Lord Neuberger and Lord Sumption said in a different context, 'the law relating to penalties has become the prisoner of artificial categorisation': *ibid* [31].

## 6 Which reviewable contract terms will be held to be penal?

Having established a jurisdiction to intervene, the court must then decide whether the identified ‘secondary’ or ‘collateral’ obligation in their sightlines is penal. The test is simple. The secondary obligation must not impose a detriment which is ‘out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation’,<sup>69</sup> or ‘exorbitant or unconscionable when regard is had to the innocent party’s interest in the performance of the contract’,<sup>70</sup> or some similar wording. The High Court of Australia in *Paciocco* put it even more strongly: the primary objective of the clause must not be punishment, rather than securing some legitimate interest.<sup>71</sup>

All this may have made sense under the earlier penalties rule, but it makes little sense now that the courts have conceded that deterrence is acceptable.<sup>72</sup> The essence of deterrence is presenting an option which the counter-party will seek to avoid, and one which will, therefore, seem punitive if applied. So much is this so that *ParkingEye* makes it plain that deterrence can be the sole objective of the engagement, in that case the deterrence of overstaying motorists. It is hard to overstate the significance of this move for the penalties jurisdiction. An explicit recognition that parties may have a legitimate interest in performance, not merely in compensation for non-performance,<sup>73</sup> means that there is no longer any simple opposition between a clause which imposes punishment, even one

<sup>69</sup> *ibid* [29], [32] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)); *Andrews* (n 11) [75] (French CJ, Gummow, Crennan, Kiefel and Bell JJ); *Paciocco* (n 12) [32], [52], [54], [57], [67]-[69] (Kiefel J), [269]-[270] (Keane J).

<sup>70</sup> *Makdessi* (n 1) [241], [255] (Lord Hodge); similarly, see [152] (Lord Mance). The onus of proof is on the party in breach: [143] (Lord Mance). See also [31]-[33] (Lord Neuberger and Lord Sumption (with whom Lord Clarke agreed)), [162] (Lord Mance), [293] (Lord Toulson). Also see *Paciocco* (n 12) [29], [34], [53] (Kiefel J) (immaterial if the sum specified is ‘only egregious’), [54] (Kiefel J), [330] (Nettle J).

<sup>71</sup> *Paciocco* (n 12) [32] (Kiefel J), [158], [165]-[166] (Gageler J), [253], [271] (Keane J). But Keane J expressly recognises that this inquiry is fraught once the protection of parties’ wider interests is accepted: [216]. See also *Makdessi* (n 1) [31], [77], [82] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), [243], [251], [278] and [282] (Lord Hodge).

<sup>72</sup> *Makdessi* (n 1) [23], [28], [75], [81], [82], [98]-[99] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), [172], [198] (Lord Mance), [248], [271]-[278], [282], [285] (Lord Hodge); *Andrews* (n 11) [75] (French CJ, Gummow, Crennan, Kiefel and Bell JJ); *Paciocco* (n 12) [30], [57] (Kiefel J), [161]-[166] (Gageler J), [270] (Keane J).

<sup>73</sup> This is not to deny the advantages of a liquidated damages clause. These are common, and such contracts are unlikely in practice to come before the court for review under the penalties jurisdiction. This was true under the old penalties rule, and remains true. By contrast, litigated penalties cases invariably reflect objectives going beyond recovery of compensation.

### *The Death of Penalties in Two Legal Cultures?*

with the primary objective of imposing punishment,<sup>74</sup> and one which secures some legitimate interest.

But although deterrence is now possible, the adopted deterrent must not be wholly disproportionate or exorbitant or unconscionable in view of the interest in performance which is being protected.<sup>75</sup> Judicial assessment of this is undoubtedly made easier by the wide margin of appreciation allowed to the parties. Nevertheless, in assessing contractual terms against this new standard of acceptability, there is now no easy benchmark provided by compensatory damages.<sup>76</sup>

This new context requires a sea change in judicial approach to the review exercise. Under the old *Dunlop* rules as understood – or perhaps misunderstood – for such a long time, a penalty was any secondary obligation which required the offending party to pay a sum that was extravagant and unconscionable in comparison with the greatest provable economic loss that could conceivably flow from breach of the primary obligation.<sup>77</sup> The numbers on either side of the ledger were clear. It made no difference that the parties had consented to the extravagance, nor that their contractual objectives went beyond recovery of compensatory damages. This rule attracted its own subtle accretions, especially in relation to the extent of the permitted deviation from normal contract damages,<sup>78</sup> and, more recently, the possibility that there might be acceptable commercial<sup>79</sup> or social<sup>80</sup> justifications for deviation from the compensatory norm. But all that is now gone.

Now the focus must simply be on whether the chosen scale of punishment is excessive in the light of the legitimate interests being protected by the contract term. But then the entire edifice seems to collapse under the straightforward logical inconsistency in one party insisting that a term in a contract is ‘extravagant and unconscionable’ or a ‘punishment’, when it is no more than the parties have properly consented to and priced into their agreement as the terms of their deal at the time of contracting. The only ground for complaint ought to be that their agreement is apparent, not real.

In practice, although of course they do not say this expressly, the courts seem to have come pretty close to applying their own test in just this way.

<sup>74</sup> As in *ParkingEye* (n 1).

<sup>75</sup> See (nn 69, 70, 71).

<sup>76</sup> See the explicit recognition of this by Keane J in *Paciocco* (n 12) [216].

<sup>77</sup> *Dunlop* (n 17); *Makdessi* (CA) (n 7). By contrast, a secondary obligation which merely provided for a reasonable pre-estimate of the likely loss would survive as a liquidated damages clause. For literature on this earlier rule, see the authorities cited in Worthington, ‘Common Law Values: The Role of Party Autonomy in Private Law’ (n 3).

<sup>78</sup> *AMEV UDC Finance Ltd v Austin* [1986] HCA 63, (1986) 162 CLR 170, 193 (Mason and Wilson JJ); *Philips* (n 16).

<sup>79</sup> *Lordsvale* (n 19); *Leisureplay* (n 20); *Philips* (n 16); *United International Pictures* (n 52).

<sup>80</sup> *ParkingEye Ltd v Beavis* [2015] EWCA Civ 402 (CA) [30] (Moore-Bick LJ, V-P).

In both *Paciocco* and *ParkingEye*, the courts took notice of the fact that large numbers of people used the banking facilities and the parking centre and thus impliedly confirmed that the fees were reasonable.<sup>81</sup> But a test of 'reasonableness' seems more appropriate in applying consumer protection statutes than penalties rules. Taking another tack, the courts were further reassured that the claimants before the court had consciously elected to use the bank's services, and indeed sail close to the wind in exposing themselves to the risk of having the relevant fees and charges imposed on certain occasions. But this seems to prove no more than that there was an agreed contract incorporating well-advertised, understood and utilised optional terms. These factors relate to proper consent, not to assessment of the penal quality of the term in issue.

In *Makdessi*, the problem is even more difficult and the solution even more obvious. In judging the parties' alternative terms, there are no consumer markets, no repeat transactions, no obvious benchmarks. Without these, courts are inevitably thrown back on the wisdom of the parties themselves, having tested that they too have truly consented to the deal in question. As Lord Neuberger and Lord Sumption put it:<sup>82</sup>

These [the precise contract terms] are matters for negotiation, not forensic assessment [...] They were matters for the parties, who were, on both sides, sophisticated, successful and experienced commercial people bargaining on equal terms over a long period with expert legal advice and were the best judges of the degree to which each of them should recognise the proper commercial interests of the other.

This describes a search for proper consent, not an exercise in judicial assessment of whether a clause is penal.

Perhaps trying to keep the genie in the bottle, Lord Sumption suggested in his oral handing down of the *Makdessi* judgment that parties do not normally have a legitimate interest in performance or deterrence beyond the recovery of compensation for breach.<sup>83</sup> In short, his Lordship suggested that these cases are rare. But, to the contrary, a surprising number

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<sup>81</sup> Other objective comparators might provide further support for that conclusion, as with the analogous statutory parking fines for public car parks considered as comparators in *ParkingEye* (n 1).

<sup>82</sup> *Makdessi* (n 1) [75] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)).

<sup>83</sup> *Cavendish Square Holding BV v Talal El Makdessi* (UK Supreme Court, Case ID UKSC 2013/0280, Judgment Summary, 4 November 2015) <[www.supremecourt.uk/watch/uksc-2013-0280/judgment.html](http://www.supremecourt.uk/watch/uksc-2013-0280/judgment.html)> accessed 14 November 2016.

### *The Death of Penalties in Two Legal Cultures?*

of contracts fall into Lord Sumption's rare category. In every penalties case, actual performance is regarded as more important than the market value of obtaining performance: consider contracts designed to ensure attendance and participation, or timely delivery, or business continuity, or strict confidentiality; alternatively, consider contracts designed to protect the value of underlying assets (as in *Makdessi* and *Dunlop*) or to ration the distribution of limited assets (as in *ParkingEye*). Whenever parties agree to prescribe alternative modes of performance, one alternative is frequently designed to deter deviation from selection of the other.<sup>84</sup> This is certainly true of all the leading penalties cases.<sup>85</sup>

But the real difficulties in assessing whether a clause is penal go well beyond this. Even judged hypothetically, how can courts sensibly decide whether a properly agreed deterrent term in a contract is wholly disproportionate or exorbitant or unconscionable in view of the interest in performance which is being protected, when the courts cannot articulate what the overly-deterred victim is being protected *from*? It is surely not simply protection from the punishing payment of an exorbitant sum, as the relevant protective rules would then need a much broader reach, extending well beyond review of a restricted class of 'secondary obligations' or 'collateral stipulations'.

Take a simple illustration. Neither the court nor the common law default rules on damages will rescue a contracting party who has agreed to pay double the market price for an asset. Why then should the penalties rules protect a party who has agreed to pay the market price by Friday, or double the market price if paid later? All that really matters, surely, is whether each agreement has proper consent. To that end, it is undoubtedly true that 'tough terms' will likely alert the court to the need for rigorous forensic assessment of the validity of consent.<sup>86</sup> But is anything more than that warranted? In short, assuming there is proper consent, should the party to the first contract be left to suffer and the party to the second rescued? If so, why?

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<sup>84</sup> This is not to suggest that the alternative category is empty of content. Opportunities to pay in cash or by debit or credit card may express no preference as to which the payee prefers (although notice that the options are often priced slightly differently).

<sup>85</sup> And in almost every single one the court concluded that the clause was valid, and not a penalty: consider *Dunlop* (n 17); *Philips* (n 16); *Lordsvale* (n 19); *United International Pictures* (n 52); *Leisureplay* (n 20); *Andrews* (n 11); *Makdessi* (n 1); *Paciocco* (n 12).

<sup>86</sup> See S Worthington, *Equity* (2nd edn, OUP 2006) ch 7. In the end it may be better to return to the analysis adopted in the early equity cases in this area. Overly onerous remedies simply raised an inference that the compromised party had not properly agreed to the particular term: there was an inference of impaired consent. An approach that relies on procedural unfairness, rather than substantive unfairness, is both easier to implement and easier to justify.

This is simply another way of making the point that judicial insistence on a thorough review of ‘secondary obligations’ or ‘collateral stipulations’ which impose deterrents looks all the more odd when judged against other types of clauses which equally incentivise or deter, yet are never subjected to substantive review: consider discounted prices for early payment, insurance concessions for safe operators, legal security arrangements, termination clauses, forfeiture clauses, and so on. All these clauses are only ever subjected to procedural review to confirm that there is proper consent to their terms.

This is all a rather longwinded way of saying that it seems odd that vendors are completely free to reach agreements which settle the purchase price at punitive levels, which will then be fully protected by the common law default rules on damages. By contrast, although a contract can deal in and protect commercial and practical interests which cannot be measured in compensatory damages, the parties to these types of contracts cannot make their own arrangements as to pricing of the incentives or deterrents which promote performance.

## 7 What consequences follow if the secondary or collateral clause is penal?

If a clause is found to be a penalty, then it is void.<sup>87</sup> In this respect, *Makdessi* has altered the law in England & Wales. In the past, a penalty clause was unenforceable to the extent that it was penal;<sup>88</sup> now it is simply void. Of course, if the clause is not a penalty then it is enforced to full effect. This was the case with all the clauses in *Andrews*, *Paciocco*, *Makdessi* and *ParkingEye*.<sup>89</sup>

Interestingly, the High Court of Australia in both *Andrews* and *Paciocco* suggests that ‘partial voidness’ is the appropriate outcome if the clause is held to be penal in Australia under the equitable branch of the penalties doctrine rather than the common law branch.<sup>90</sup> This looks dubious. Indeed, the analysis adopted to reach this conclusion seems instead to reinforce the suggestion made earlier that all these equity cases are not penalty cases, but are instead agreed security arrangements between the parties, and the

<sup>87</sup> *Makdessi* (n 1) [9], [84]-[87], (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)), [283] (Lord Hodge), [291] (Lord Clarke), [292] (Lord Toulson). Similarly, *AMEV UDC Finance* (n 78), 192-3 (Mason and Wilson JJ).

<sup>88</sup> *Jobson v Johnson* [1989] 1 WLR 1026 (CA).

<sup>89</sup> *Andrews* (n 11); *Paciocco* (n 12); *Makdessi* (n 1); *ParkingEye* (n 1).

<sup>90</sup> *Andrews* (n 11) [60] (French CJ, Gummow, Crennan, Kiefel and Bell JJ); *Paciocco* (n 12), especially [247]-[248], [252] (Keane J).

appropriate remedies follow necessarily from that.<sup>91</sup> This security analysis in the equitable context is also espoused by the Court in *Makdessi*.<sup>92</sup>

## 8 Conclusion

A pessimist might say that the law on penalties is now far more uncertain than it was in 2012. To that extent, one should heed the old adage to be careful what you wish for. Several headline points can be made: *Dunlop* remains a leading precedent, but with focus retrained on Lord Atkinson rather than Lord Dunedin; courts in both the UK and Australia now recognise that modern contracts can be legitimately structured to protect far more than immediate financial interests; in both jurisdictions, there is an avowed liberality in relation to what contracting parties may agree in relation to their primary obligations, but an unexplained and unjustified paternalism in relation to the parties' secondary or collateral obligations; this distinction persists even though in practical terms it now seems impossible to distinguish between these two categories of terms.

I am tempted to go further and suggest that although neither the UK Supreme Court nor the High Court of Australia has formally abolished the penalties rule, in creating this profound ambiguity they have in substance achieved the same ends. Of course, given my views, I should regard that as a positive outcome. But vestiges of the jurisdiction remain, and neither the UK Supreme Court nor the High Court of Australia have managed to nail a rationale for the penalties rule. This means that any difficult distinctions must be drawn without any clear sense of principle or purpose. This will inevitably create problems for the future.<sup>93</sup> But given the direction of travel in both jurisdictions, it will at least, I suggest, be a deeply shared, if difficult, future.

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<sup>91</sup> See (n 35).

<sup>92</sup> *Makdessi* (n 1) [84]-[87] (Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed)).

<sup>93</sup> With luck, the courts will simply continue to hold that properly consenting parties are generally the best arbiters of what they want, and will leave matters to them, just as they have done for most of the past century in this area.