The Penalty Doctrine: Protective or Punitive?

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When contracting parties agree to a specified sum payable upon breach, typically termed a liquidated damages clause, they avoid the cost of damages litigation and facilitate a seamless trading environment. The equitable doctrine of penalties has interrupted this right, enabling a court to strike down such a clause if it is enforced in terrorem *over the head of the breaching party. For over a century, courts have grappled with what exactly deems a clause to be* terrorising *and in what circumstances the penalty doctrine ought to be invoked. This article explores the classic debate between the need for certainty and the need for substantive justice in light of recent developments in Australia and the United Kingdom. These developments have challenged the jurisdictional scope and practical operation of the doctrine's rules. The author argues that the application of the doctrine ought to be restrained to situations of true injustice in order to minimise its encroachment on the freedom of parties to contract on the terms of their choice. Lastly, this article considers the theoretical and practical significance of the doctrine's operation on drafting practices in the sphere of commerce.*

I INTRODUCTION

The purpose of imposing contractual damages in cases of breach is to restore the innocent party to the position they would have been in had the contract been performed.[1] This is a cornerstone of contract law as it affirms the value of performance. It has long been accepted that contracting parties are at liberty to agree to a sum of damages payable in the event of some specified breach.[2] These are called liquidated damages clauses: damages fixed by the contracting parties to estimate and agree on the quantum of payment should breach occur. This encourages efficient commerce and minimises the social

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1 *Wertheim v Chicoutimi Pulp Co* [1911] AC 301 (PC) at 307.

2 See *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 (HL).

cost of damages litigation.[3] As a result, liquidated damages clauses are common in many standard form contracts.

However, this is not an unbridled liberty. This is because equity has long held the view that the promisor acts unconscionably if they demand indemnification that is disproportionate to the position they would have been in had the contract been performed. The penalty doctrine states that the pre-determined sum must be compensatory in nature — that is, it must evidence an honest pre-estimate of the loss to be suffered upon breach.[4] If this is the case, then the sum is considered a legitimate liquidated damages clause and will be enforced without the need for the innocent party to prove any actual loss. Thus, if the sum fails to establish the requisite nexus with pre-estimate of loss, a court can exercise its equitable jurisdiction and invoke the doctrine of penalties.

A penalty is the imposition of supplementary liability upon breach as a form of punishment for the non-observance of a contractual provision.[5] The court will deem the clause to be a non-recoverable penalty because, rather than compensating for loss, it attempts to compel or secure performance by holding the sum *in terrorem* over the head of the promisee.[6] Striking such clauses down is in line with the classic authority in *Addis v Gramophone Co, Ltd* that punitive damages have no place in the common law of contract.[7]

Therefore, the question of whether an agreed sum is liquidated damages or a penalty is of great importance and is subject to substantial debate. As a result, we have seen a large number of judicial attempts to ameliorate the law since its modern definition was laid down in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* over a century ago.[8]

The doctrine of penalties involves a two-step analysis. First, the scope rules will exclude the circumstances which can never be deemed penalties for policy reasons. The circumstances that are included are said to *trigger* the operation of the doctrine and are thus subject to the second stage of the analysis: the penalty identification rules. Those rules are designed to reflect and balance policy considerations.

In Part II, this article examines the doctrine's inherent tension with the freedom of contract. As stated by Lord Woolf in *Philips Hong Kong Ltd v The Attorney General of Hong Kong*, an approach to the doctrine of penalties that weakens the force of objective contractual intention will lead to "undesirable uncertainty especially in commercial contracts".[9] I argue that the doctrine's application must be restrained to uphold the freedom of contract, which both private law and the free market depend upon.

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3 See HG Beale (ed) Chitty on Contracts (32nd ed, Sweet & Maxwell, London, 2015) vol 1 at [26-178]–[26-179].
4 *Dunlop*, above n 2, at 87.
5 *Dunlop*, above n 2, at 86–87.
6 *Dunlop*, above n 2, at 88.
7 *Addis v Gramophone Co, Ltd* [1909] AC 488 (HL) at 494.
8 *Dunlop*, above n 2, at 86–88.
9 *Philips Hong Kong Ltd v The Attorney General of Hong Kong* (1993) 61 BLR 41 (PC) at 59.

In Part III, I will examine the purpose of the scope rule and seek to justify that the need for certainty far outweighs the policy consideration of achieving case-by-case fairness. Thus, I will argue that the orthodox position — that the penalty doctrine can be engaged only upon a breach of contract — is the preferred position. This is particularly so in light of Australian developments in *Andrews v Australia and New Zealand Banking Group Ltd*, where the High Court of Australia contentiously — and somewhat arbitrarily — extended the doctrine to be triggered by circumstances other than breach.[10]

Part IV will assess the operation of the identification rules. I begin by analysing the judicial treatment of the *Dunlop* rules over the last century. These developments have been unfortunately characterised by an overly-mechanical analysis and a judicial predisposition for ascertaining the compensatory (as opposed to the oppressive) nature of liquidated damages clauses.[11] I argue that the developments made by the Supreme Court of the United Kingdom[12] bring clarity to the law and propel the operation of the identification rules out of the sphere of form-based technicalities and into a substance-based determination.

Finally, Part V of this article will briefly scrutinise the abolitionist view, purported by several academics who believe the doctrine to be an unjustifiable inroad into the freedom of contract.[13] I conclude that this stance fails to account for international developments and that the doctrine is better modified than abolished.

II THE FREEDOM OF CONTRACT

Freedom of contract is essential to the functioning of a minimally-interventionist, free market, libertarian state. Without it, the bargaining autonomy of contracting parties is jeopardised, and the cornerstone of contractual certainty and enforceability is weakened. Freedom of contract entails that one is at liberty to contract with whomever they wish, on whatever terms they see fit. On this view, there should be full liberty to impose pre-determined damages in contract in the case of non-performance.

However, just as we as a society are not fully committed to laissez-faire economics, we do not accept unbridled freedom of contract. Much like the Illegal Contracts Act 1970 prohibits the contracting of unlawful performance, the doctrine of penalties proscribes the enforcement of pre-determined damages which are considered to be punitive in nature. But the mere premise that the common law disallows punitive damages is in and of

10 *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205 [*Andrews*].
11 *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67, [2016] AC 1172 at [22] at [131].
12 *Makdessi,* above n 11.
13 Jonathan Morgan "The Penalty Clause Doctrine: Unlovable But Untouchable" (2016) 75 CLJ 11.

itself an inroad into contractual freedom, because it supersedes what the parties agreed to and signed for.

Accordingly, there is a tension between freedom of contract and the practice of striking down punitive clauses. On the one hand, pre-agreed damages give certainty to the contracting parties by imposing a foundation of confidence onto the contractual bargain. Likewise, contractually-agreed damages eliminate the social cost of litigation, particularly where the damages are difficult to estimate. Accordingly, these clauses are able to overcome the complexities of proving loss in a common law claim for damages. This is particularly useful in fraught areas of remoteness and mitigation where idiosyncratic or indirect losses are not taken into account by courts.[14] The United Kingdom Supreme Court observed that, for these reasons, ascertaining the value of a complex interest to be protected was best left to negotiation between parties.[15]

On the other hand, one could argue that parties' pre-agreed damages can never be optimally efficient because pre-determined damages usurp a court's function in determining the appropriate quantum of damages upon breach. This begs the question: who is in the better position to determine the quantum of damages? Is it the parties, who best understand the weight of their performance interest? Or is it the courts, who specialise in crafting restorative balance? The argument for upholding the freedom of contract entails that it is not for the courts to value the adequacy of consideration between parties. Conversely, arguments against unrestrained freedom point to the notion that the doctrine of penalties is shrouded in equity and, thus, the court must intervene in some cases. From the eyes of the common law, this encroachment upon the freedom of contract is grounded in public policy.[16]

For these reasons courts have historically demonstrated reluctance in finding a clause to be punitive. The penalty doctrine is an exception to the rule that parties may agree to bargains as they so desire. As stated by Dickson J: "the power to strike down a penalty clause is a blatant interference with freedom of contract".[17] If we accept that courts play a somewhat interventionist role in their contractual jurisdiction, then we must understand where and how the balance is struck between contractual freedom and judicial interventionism.

III THE SCOPE OF THE PENALTY DOCTRINE

An impugned provision must trigger the operation of the penalty doctrine before it can be classified as a penalty. The scope rules establish the point

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14 See *Abrahams v Performing Right Society Ltd* [1995] ICR 1028 (CA) at 1041. In this case it was held that the concept of the "duty to mitigate" is foreign to the law of liquidate damages.

15 *Makdessi*, above n 11, at [82].

16 *Robophone Facilities v Blank* [1966] 1 WLR 1428 (CA) at 1446, per Diplock LJ. Note that in Australia, equitable principles are seen as the primary justification, per *AMEV-UDC Finance Ltd v Austin* [1986] 162 CLR 170 (HCA) at 197.

17 *Elsey v JG Collins Insurance Agencies Ltd* [1978] 2 SCR 916 at 937.

where it becomes superfluous for a court to grant equitable relief. These rules are largely grounded in policy considerations that must balance the equitable roots of the doctrine (which seek to punish all unconscionable conduct) and the freedom of contract (which seeks to uphold certainty in contractual bargains).

Orthodoxy: The "Breach Rule"

The orthodox balance struck between those two factors results in what is aptly named the *breach rule*. The orthodox view stands steadfast in its application in the United Kingdom[18] and New Zealand.[19] This entails that the penalty rules are only invoked in the case of a contractual *breach* which triggers the payment of the agreed sum. The obligation to pay must be a new right in consequence of, and dependent upon, the contractual breach.[20] Additionally, this breach must occur between the plaintiff and the defendant, not a breach to a third party.[21] Once it is established that the arising obligation is accessory to the obligation for primary performance, the court assesses whether the agreed sum is compensatory or punitive in nature. Thus, a sum payable on some other event (such as the election to terminate) is prima facie not a penalty because the doctrine will never operate in the first place.

1 Justifications for the Orthodox Position

In order to challenge the orthodox position, one must appreciate its underlying rationalisations. The predominant defence of the breach rule is that it most minimally violates the freedom of contract. This is best demonstrated via a counterfactual — if courts were able to capriciously relieve parties from onerous obligations, they would effectively be valuing consideration and questioning the validity of objective bargain. This would frustrate the indispensable philosophies of contract, as it is not the role of a court to relieve parties from subjectively burdensome or commercially imprudent obligations. Lord Justice Hoffmann perpetuated this view in *Else (1982) Ltd v Parkland Holdings Ltd*, where his Lordship stated that an extension of the penalty doctrine beyond breach would result in an excessive inroad into the freedom of contract.[22]

Moreover, the breach rule is further justified by the clarity and certainty it ensures. As Harvey McGregor depicts, the rule "appears to be a straightforward, even self-evident, proposition".[23] However, while there is

18 *Makdessi*, above n 11, at [12].
19 *Dark v Weenink* HC Auckland CIV-2003-404-5846, 11 August 2005 at [93]; and *Wilaci Pty Ltd v Torchlight Fund No 1 LP (in rec)* [2017] NZCA 152 at [51].
20 *Cadogan Petroleum Holdings Ltd v Global Process Systems LLC* [2013] EWHC 214 (Comm), [2013] 1 CLC 721 at [34].
21 *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 (HL) at 402–403.
22 *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130 (CA) at 145.
23 Harvey McGregor *McGregor on Damages* (19th ed, Sweet & Maxwell, London, 2014) at [15-009].

merit in propagating a clear and certain scope rule which pragmatically adheres to the rule of law, it is far less compelling as a justification for the rule. This is because it is so easily contradicted by the internal equitable rigours of the doctrine itself. How can an equitable doctrine be so confined to the limits of formality in place of substantive justice? After all, the second limb of the penalty doctrine — the identification rules — *are* subject to a substantive, circumstantial analysis, as I will discuss in Part IV.

2 Downfalls of the Breach Rule

Unsurprisingly, the stringent rigidity of the doctrine's application has presented an uncomfortable difficulty in some cases, particularly where the line segregating *breach* and *non-breach* is blurred. An infamous example exists in hire-purchase contracts — contracts providing for the hire of a good (from the "owner" to the "hirer"), with the option to purchase the good upon completion of the hire-term. Generally, if the hire ends prior to the completion of the hire-term, the hirer must pay a sum stipulated in a minimum-payment clause.[24] Prima facie, the hirer exercising their option to terminate is not a technical breach, so it will not satisfy the breach rule. Essentially, as long as the contract is drafted to impose a payment obligation on some event *other* than breach, the penalty doctrine cannot be invoked.

Lord Denning, writing for the House of Lords in *Bridge v Campbell Discount Co Ltd*, referred to the "absurd paradox" created by this rule — equity "will grant relief to a man who breaks his contract but will penalise the man who keeps it".[25] Despite this, courts demonstrate an austere reluctance to invoke the penalty rules in cases where the hirer's option to terminate has been exercised.[26] This evidences the court's innate desire to prefer certainty over flexibility, even where the vehement adherence to such a rule creates irrational outcomes.

The Rule in *Andrews v ANZ*

The breach rule was contentiously challenged by the High Court of Australia in the landmark judgment of *Andrews v Australia and New Zealand Banking Group Ltd*, where it held that sums payable on the occurrence of contingencies *other* than breach may invoke the doctrine.[27] Consequently, this case expands the scope of the penalty doctrine:[28]

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24 *Bridge v Campbell Discount Co Ltd* [1962] AC 600 (HL) at 628.

25 At 629. On the facts, the appellant would have been better off if the Court had found that he had breached the contract, rather than exercised his option to terminate.

26 *Associated Distributors Ltd v Hall* [1938] 2 KB 83 (CA) at 88. The Court held that the doctrine of penalties was not applicable where the contract had not been breached. Note also that where the owner exercises the right to terminate, the rules are different. See *Cooden Engineering Co Ltd v Stanford* [1953] 1 QB 86 (CA) at 87. This is to prevent the owner from writing an onerous contract that favours their position on termination.

27 *Andrews*, above n 10, at [10].

28 *Cedar Meats (Aust) Pty Ltd v Five Star Lamb Pty Ltd* [2014] VSCA 32, (2014) 45 VR 79 at [43] (footnotes omitted).

> Prior to *Andrews*, it was generally considered to be the law that a provision of the kind in question was incapable of being a penalty unless it secured the performance of a contractual obligation. *Andrews* re-established that such a provision may still be regarded as penal if it secured a primary stipulation even though the stipulation does not import a contractual promise.

Andrews dealt with a range of fees charged by ANZ to credit-account customers who had either failed to pay their fees or exceeded their permitted borrowing limits. The class action suit attempted to argue that charged fees were unenforceable as penalties and, thus, refundable to the customers. The High Court accepted the Federal Court's finding that ANZ had not charged the fees upon breach of contract, and the customers had no obligation to avoid the occurrence of the event (an overdraft) that caused the fee being charged.[29] However, the High Court disagreed with the Federal Court's conclusion that this meant the sums were, therefore, unable to be classified as a penalty.[30]

Traditionally, bank-fees do not arise out of a technical, autonomous breach of a primary obligation. As a result, they have been exempt from penalty classification. For example, in *Marac Financial Services Ltd v Stewart*, the New Zealand High Court held that a high interest rate charged by a bank for outstanding account balances could not be penal. This is because the interest was only payable upon the closing of a customer's accounts; and that closure was an autonomous decision made by the customer, not an unavoidable consequence of contractual breach.[31]

Overturning the judgment at first instance by Gordon J, who had expressed that the doctrine's equitable jurisdiction is limited to circumstances of breach, the High Court of Australia held that *because* penalties were grounded in equitable jurisprudence, such a limitation was unnecessary.[32] Framing this in technical terms, the High Court offered a general definition of a penalty and then defined its limits with an exception definition.

1 The General Definition

The primary consideration is whether the impugned provision satisfies the broad-spectrum definition:[33]

> 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

29 *Andrews v Australia and New Zealand Banking Group Ltd* [2011] FCA 1376, (2011) 211 FCR 53 at [205].

30 At [5]. Note that this position overrules earlier authority in *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* [2008] NSWCA 310, (2008) 257 ALR 292.

31 *Marac Financial Services Ltd v Stewart* [1993] 1 NZLR 86 (HC) at 96.

32 *Andrews*, above n 10, at [78].

33 *Andrews*, above n 10, at [10] (emphasis added, footnotes omitted).

> first party an additional detriment, the penalty, to the benefit of the second party.

In simple terms, this means that the court must distinguish between an obligation to pay a fee as *security* for the performance of some contractual obligation and an optional obligation to pay a fee for the enjoyment of an additional right or service.

Operatively, the penalty rule is triggered by a *failed primary stipulation*. This is described plainly (and somewhat uselessly) as "the occurrence or non-occurrence of an event which need not be the payment of money".[34] However, in using this terminology, the High Court intended to broaden the scope rules by extending their operation to situations of "failure" which "impose an additional detriment" — encompassing situations much broader than simple breach.[35] This signals the intention to shift away from the judicial predisposition to focus on *form* in establishing their equitable jurisdiction and shift it to *substance*. This shift is augmented by the use of "stipulation". It does so by eliminating the awkward dichotomy presented by the use of the word "condition" in modern legal discourse between promissory and non-promissory conditions.[36] Therefore, courts need not undertake the over-technical task of pigeon-holing contractual terms into these categories. Instead, they can focus on the interrelations ("collateral or accessory") and consequences ("additional detriment") of these terms, to determine whether the purpose of the impugned provision satisfies the scope requirements.[37]

The impugned provision itself is redefined as the "collateral or accessory" stipulation. It was described to be "in the nature of a security for and in terrorem of the satisfaction of the primary stipulation", meaning that it represents compensation for loss suffered by the first party for the failure of the primary stipulation.[38] Hence, the *Andrews* test encompasses essentially any stipulation enforced as security for the performance of another. The practical impacts of this test are wide-ranging and will be discussed below.

2 The Exception Definition

The general definition is then qualified by excluding stipulations which "giv[e] rise consensually to an additional obligation",[39] on the true construction of the contract.[40] This exception bears a stark resemblance to the orthodox position on optional termination, whereby the autonomous

34 At [12].
35 At [10].
36 At [33]–[37]. The High Court explains that the new terminology — "stipulation" — best reflects the origin of penal obligations in Roman law, which were concerned with pure contingencies.
37 At [10].
38 At [10].
39 At [80].
40 *French v Macale* (1842) 4 I Eq R 568 (Ch) at 574 as cited in *Andrews*, above n 10, at [80].

exercise of an option to cancel or terminate a contract falls outside the scope of the penalty doctrine, as demonstrated above in the hire-purchase cases.[41]

To demonstrate the operation of this exception, the High Court alludes to the judgment of *Metro-Goldwyn-Mayer Pty Ltd v Greenham*, which concerned a contract for the hiring of films, whereby the exhibitor was obliged to pay for each additional screening a sum four times the value of the original fee. It was held, on the construction of the contract, that the exhibitor exercised an option provided by the agreement. Thus, the penalty doctrine could not be invoked.[42]

Consequence of the Australian Position

The present Australian position states that a fee may trigger the operation of the penalty doctrine, even if it is not itself a direct bargain in nature. Where the promise to pay a fee is collateral to the promise of some other provision, the fee is seen as security for the satisfaction of the *overall* performance. As a result, *Andrews* has a complex impact on the drafting of standard-form contractual mechanisms (such as break-fees, take-or-pay provisions, late interest-rate payments and time-bar clauses in construction contracts).[43]

If a time-bar clause stipulates that a builder will receive a certain amount for work completed by a certain date — and a lesser amount for work completed later — this will potentially be subject to the penalty doctrine under the *Andrews* reasoning. Despite the absence of any breach, the fee exists to impose an additional detriment arising upon the failure of the primary stipulation (the completion of work by a specified date), presuming the extension of time was not expressly provided for under a contractual option. The contractual certainty facilitated by time-bar clauses is integral to the economic efficiency of the construction industry. Similarly, take-or-pay provisions commonly used in the energy industry to enforce either the taking of a predetermined quantity of production or the payment of a fee will be subject to penalty determination under *Andrews*. This is because the payment can be seen as a collateral stipulation as security for the performance of the taking provision. But, to the parties, such terms simply signal alternative means of performance. These provisions are essential to the industry for securing and stabilising revenue streams. To strike these clauses down would create an unjustifiable inroad into contractual freedom and free-market efficacy. Thus, *Andrews* can be criticised for opening the floodgates to penalty disputes, albeit with little consequence on the amount of clauses struck as penal.[44]

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41 Hence, *Andrews* does little to mitigate the "absurd paradox" of the hire-purchase cases. It is submitted that those cases fall outside the scope of the penalty rule for good reason and should be dealt with under statute or otherwise.

42 *Metro-Goldwyn-Mayer Pty Ltd v Greenham* [1966] 2 NSWR 717 (NSWSC) at 723.

43 Richard Manly "Breach no longer necessary: The High Court's reconsideration of the penalty doctrine" (2013) 41 ABLR 314 at 315.

44 Manly, above n 43, at 316.

1 Theoretical Advantages: From a Form-Based to a Substance-Based Approach

Nonetheless, the very essence of the Court's approach was to undertake a more substantive analysis of the scope rules. The High Court succeeded in judging the jurisdictional limits of the penalty doctrine on the fundamental character of a penalty, rather than being constrained to a form-based analysis. In the later case of *Paciocco v Australia and New Zealand Banking Group Ltd*, Allsop CJ confirmed that this substantive analysis was to be determined "in substance, in reality".[45] After all, equity encourages a substantive focus.[46] That is not to say that the test is purely one of substance. His Honour emphasised that the test was one of substance *and* form.[47] Once a contextual analysis is undertaken, a "process of characterisation" may be necessary to determine whether a stipulation gives rise consensually to an additional obligation.[48] However, that consideration itself ought not to be mechanical.[49] This indicates that the earlier judgment in *Andrews* succeeded in shifting judicial attitude away from mechanised form-based considerations and towards a flexible, substantive approach.

There is also considerable merit in the central argument forwarded by the High Court of Australia. The Court affirmed that it is nonsensical to restrict the doctrine's operation to a confined set of circumstances simply because it is grounded in equity. After all, the famous equitable maxim that equity looks to *substance* — *not form* — alludes to this very dilemma. The substance-based terminology (failed primary stipulations) is advantageous as it would ameliorate the complexities in proving a claim for unsophisticated parties instead of the form-based breach rule

2 The Failure of the Andrews *Judgment*

The crux of academic criticism stems from the fact that *Andrews* drastically expanded a doctrine which was previously well-settled.[50] Carter and others posit that the lack of policy justifications — both for a departure from an uncontroversial position and for extending the penalty doctrine beyond breach — undermine the judgment.[51] The High Court, in both *Andrews* and *Paciocco*, referred simply to the antiquated equitable origins of the doctrine, omitting any reference to modern contractual practice. Since *Dunlop*, the doctrine has not existed on its own as an equitable remedy. Rather, it is a

45 *Paciocco v Australia and New Zealand Banking Group* [2015] FCAFC 50, (2015) 236 FCR 199 at [200].

46 At [205]. See also [95], [128], [187] and [201]. At these paragraphs Allsop CJ alludes to the importance of a flexible, substantive approach.

47 At [200].

48 *Andrews,* above n 10, at [80]–[82] as cited in *Paciocco,* above n 45, at [199]–[200]. Here *Paciocco* cites the abovementioned "Exception Definition" from *Andrews*.

49 *Paciocco,* above n 45, at [201].

50 Anthony Gray "Contractual Penalties in Australian Law after *Andrews*: An Opportunity Missed" (2013) 18 Deakin LR 1 at 12.

51 JW Carter and others "Contractual Penalties: Resurrecting the Equitable Jurisdiction" (2013) 30 JCL 99 at 128.

principle of contract, thus rendering the High Court's justification for change unpersuasive. Accordingly, the decision received stark criticism from the United Kingdom Supreme Court which deemed *Andrews* to be a "radical departure" from the law.[52] The judgment, as a whole, fails to undertake a satisfactory analysis of the previous state of the law and how a solution may ameliorate its misgivings. For this reason, commentators have suggested "*Andrews* did not make its case".[53]

Moreover, the *Andrews* approach demonstrates technical inadequacy internal to the judgment itself. The High Court has failed to establish adequate procedural guidelines for the operation of the proposed scope rules. Effectively, it eliminates the requirement for breach without imposing proper limitations on just what circumstances invoke the doctrine. This redefinition has ostensibly created substantial uncertainty for contract drafters.[54]

Conclusion: Where To For The Scope Rule?

The intention of the scope rules is to limit the scenarios upon which the equitable doctrine of penalties can operate. These scenarios ought to reflect situations where oppression may exist. While the traditional breach rule offered a comfortable level of certainty, it created injustices in several subsets of cases — including the hire-purchase cases discussed above. Courts have attempted to circumvent this awkwardness. However, before *Andrews* they had never attempted a courageous departure from the breach rule. In reframing the scope rules to consider failed primary stipulations, the High Court of Australia significantly broadened the scope and application of the doctrine to include subsets of stipulations that would never have traditionally been considered penalties.

Due to the strong adherence to the traditional stance, it is unlikely we will see an adoption of *Andrews* in New Zealand in the foreseeable future. But, should we? On the one hand, the Australian view enables courts to move past their concern for compensatory and form-based technicalities. The courts can, instead, adopt a principled and flexible system reflecting the doctrine's equitable roots — to relieve against penalties.

On the other hand, an overly-extended set of scope rules would significantly inhibit the freedom of contract by enabling the doctrine to be used in an invasive manner. This is not what equity intended. In allowing for the penalty rule to be activated by circumstances other than breach, we risk an enquiry that subverts the parties' objective intentions. This creates undesirable consequences for several industries which draft obligations arising upon contingencies as a matter of standard-form contractual practice, such as the aforementioned time-bar clauses in construction contracts. Moreover, as demonstrated by *Andrews*, *Paciocco* and subsequent

52 *Makdessi*, above n 11, at [41].
53 Gray, above n 50, at 17.
54 Carter and others, above n 51, at 101.

judgments,[55] redefining the scope rule to include contingent liabilities, while remaining within reasonable bounds, is difficult, if not impossible. This approach thereby fails to meet the standard of certainty required to abrogate the fundamental principles of contract law: party autonomy; and contractual freedom. Therefore, aside from the obvious downfalls of the breach rule, the approach allows the courts to maintain a steadfast limitation on the penalty doctrine's application. Otherwise, it risks becoming a mechanism for valuing bargains and judging contractual legitimacy.

IV IDENTIFICATION OF A PENALTY

Once the court establishes its requisite jurisdiction under the scope rules, it undertakes the task of identifying whether the impugned provision is an enforceable liquidated damages provision or an unenforceable penalty. To assess the mechanical intricacies of the penalty doctrine's operation, we must first understand the rationale behind its application. At a basic level, the doctrine operates in a way that allows all pre-agreed damages except for those that are punitive in nature. The threshold between the two is where the pre-agreed damages provision no longer works simply to put the innocent party in the position they would have been in had the contract been correctly performed but instead works to coerce the other party into performance. But this coercion is not simply the normal level of enforcement of performance. Rather, it is something more intimidating and compulsive. Hence, the threshold of the penalty doctrine's operation triggers the notion that the innocent party is acting unconscionably. Because the doctrine is grounded in equity, it operates to strike down clauses that demonstrate this loss of conscience. As the English Court of Appeal stated, the doctrine can only permit relief where there has been "unconscionable conduct" or an "unconscientious use of power".[56]

Having recognised that the distinction between allowed and disallowed pre-agreed damages clauses is harnessed in equity, I will now analyse the ways that courts have imported this into the common law.

Orthodox Position: *Dunlop*

The orthodox approach to the modern operation of the penalty doctrine was laid out by Lord Dunedin in the landmark case: *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd.*[57] The underlying consideration is the deterrent or compensatory intention of the parties at the time of contractual creation. To ascertain this intention, the court must be able to infer from the

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55 For decisions of lower courts which demonstrate the difficulty in applying the *Andrews* test, see, for example, *Cedar Meats Pty Ltd*, above n 28; and *Grocon Constructions (Qld) Pty Ltd v Juniper Developer (No 2) Pty Ltd* [2015] QCA 291.

56 *Alec Lobb (Garages) Ltd v Total Oil (Great Britain) Ltd* [1985] 1 WLR 173 (CA) at 182.

57 *Dunlop*, above n 2.

terms, circumstances and context of the contract an objective intention to form an agreement to genuinely pre-estimate the loss incurred from the contemplated breach.[58] The critical academic question that arises is: what *is* a genuine pre-estimate of loss? That is, at what point does the obligation to make payment cease to become an honest approximation and instead become punitive? The *Dunlop* judgment offers a set of rudimentary and formulaic guidelines to assist in drawing this dichotomy.

The case concerned a trading contract between the appellant manufacturer and respondent dealer of tyre-related goods. In an effort to protect its market position, Dunlop imposed contractual terms which stipulated that a £5 fee would be payable per good in the event of any of several breaches, including tampering with the markings on the goods, on-selling below listed price and supplying to suspended persons.[59] New Garage committed a breach by underselling below list value, but sought to invoke an argument that the £5 fee was a penalty, on the grounds that it was a single sum payable on several breaches of varying importance.[60]

Overturning the decision of the Court of Appeal, the House of Lords held that, on the *balance* of a series of factors, the sum was not a penalty provision. The factors utilised in this determination were:[61]

(1) If the sum is "extravagant and unconscionable" compared to the greatest loss which could conceivably flow from the breach, it is a penalty;
(2) If a single lump-sum payment is required on the occurrence of several breaches (some serious and some trivial), there is a presumption of penalty; and
(3) Just because specific pre-estimation of loss is impossible, that does not mean it is automatically a penalty (in fact, it points the other way).

While the £5 fee appeared disproportionate to the loss incurred, the indirectly consequential damage to Dunlop's sales process was impossible to accurately estimate and the sum was not extravagant.[62] Thus, the clause was held to be an enforceable liquidated damages clause.

The Downfall of Certainty: The Subsequent Treatment of *Dunlop*

Lord Dunedin's dicta in *Dunlop* "achieved the status of a quasi-statutory code in the subsequent case law".[63] This consequent application of *Dunlop* demonstrated a rigorously methodological view of the penalty doctrine, constraining its application to situations where the stipulated sum exceeded

58 At 88.
59 At 80-81.
60 At 81.
61 At 87.
62 The House of Lords refers to the earlier judgment of *Ford Motor Co (England) (Ltd) v Armstrong* (1915) 31 TLR 267 (CA). In this case a £250 fee for a similar series of breaches was held to be fixed in terrorem and arbitrary, thus not a reasonable pre-estimate of loss. This demonstrates the highly subjective nature of the enquiry.
63 *Makdessi*, above n 11, at [22].

the sum that would have been decided at common law.[64] The justifications for this approach rested on the need for certainty and a strong desire to provide a compensatory sum upon breach — an aspiration that courts have long-struggled to let go of.[65] The obvious issue with this overtly-technical approach is that it failed to take into account the underlying equitable foundations of the doctrine. Such a view was expounded as early as 1986 in *AMEV-UDC Finance Ltd v Austin*. The High Court of Australia criticised the erosion of the *extravagance or unconscionability* test by the implementation of a more certain rule which simply examined whether the sum of pre-agreed damages was numerically higher than what would have been awarded under the common law.[66] As summarised in *Paciocco v Australia and New Zealand Banking Group Ltd*: "[t]he unintended consequence of lucidity is sometimes rigidity."[67]

The Revival of Equity — *Extravagance and Unconscionability*

Over time, courts started to loosen the over-prescriptive structure of the *Dunlop* rules by recognising the prominence of the doctrine's equitable undertones. Obiter statements made in the High Court of Australia indicated a turning point for judicial perception of the penalty doctrine. These statements enunciated that the focus should lie on unconscionability, rather than the dogmatic test of compensatory loss.[68] Still, the first *Dunlop* factor — inquiring into whether a sum demonstrates extravagance and unconscionability — attracted the most modern judicial rhetoric.

It seems as though courts place pseudo-conclusive weight on this factor when deciding whether a clause is penal. This is presumably due to the natural nexus between unconscionability and holding one in terrorem. But, what *is* extravagance and proportionality in this context?

Lord Parmoor in *Dunlop* compared the £5 payable by New Garage to a hypothetical one-million pound penalty payable on the breach of a £50 construction contract.[69] His Lordship expressed that the latter sum was extravagant, meaning it was unconsionable. This indicates that the determination lies with a bona fide assessment of conscionable conduct, rather than one of some mechanical accuracy. For example, in *General Finance Acceptance Ltd v Melrose* a formula for calculating damages in the case of hirers' default was held to be unenforceable on the grounds that the sum it produced was significantly larger than the sum that would have been received by the owner had the agreement simply run its course.[70]

64 *Cooden Engineering Co Ltd*, above n 26, at 98.
65 *AMEV-UDC Finance Ltd*, above n 16, at 190.
66 At 190.
67 *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28, (2016) 333 ALR 569 at [152].
68 *AMEV-UDC Finance Ltd v Austin*, above n 16, at 197–198.
69 *Dunlop*, above n 2, at 101.
70 *General Finance Acceptance Ltd v Melrose* [1988] 1 NZLR 465 (HC) at 470. See also *Jobson v Johnson* [1989] 1 WLR 1026 (CA). In this case a clause enforcing the repurchase of shares below market-value was held to be penal due to the difference in price.

Conversely, a clause providing for the transfer of shares to one party upon breach was not penal, because that party provided the property and the clause simply restored them to the position they had been in prior to the failure of performance.[71] These instances are markedly consistent with the overarching rationale of the doctrine — that only cases of extreme punitive or coercive effect ought to be deemed *unfair* to invoke the operation of the doctrine. This clearly demonstrates the delicate balance that courts must strike between upholding the equitable notions of the doctrine and retaining some level of mechanical proportionality valuation.

A compelling example of this mechanical-equitable dichotomy is demonstrated in *Murray v Leisureplay plc*, a case concerning an employment contract which allowed for a year's worth of salary upon wrongful termination. The English Court of Appeal reached a unanimous conclusion that the provision was punitive, but were split on the reasoning.[72] Arden LJ demonstrated a preference for a conventional approach which compared liquidated damages to damages that would have been awarded under common law principles to evidence a punitive nature.[73]

On the other hand Buxton LJ (Clarke LJ agreeing) considered the conventional test to be too rigid and inflexible, advocating an assessment based on extravagance and unconscionability.[74] This entails that there may no longer be a need to calculate the "greatest loss that could conceivably be proved to have followed from the breach".[75] There is merit in this stance, because it mitigates the issue of subjectivity in calculating compensatory damages by different courts and different judges. It also allows for a holistic approach which better reflects the rudimentary *aim* of the penalty doctrine, which was founded to protect parties from terrorising clauses.

The Current Position in New Zealand

In line with the above developments, New Zealand courts have (rather unsystematically) shifted from a highly mechanical approach[76] to recognising that the penalty rule is grounded in equity, and that equitable relief exists, first and foremost, to prevent *oppression*.[77] Nonetheless, the law on penalties remains in a state of confusion. Courts steadfastly adhere to a technical application, which is at odds with the flexibility demanded by an equitable approach. As the United Kingdom Supreme Court stated:[78]

> The penalty rule … is an ancient, haphazardly constructed edifice which has not weathered well, and which in the opinion of some should simply be demolished … The test for distinguishing penal from other principles is unclear.

71 *Amaltal Corp Ltd v Maruha (NZ) Corp Ltd* [2004] 2 NZLR 614 (CA) at [61].
72 *Murray v Leisureplay plc* [2005] EWCA Civ 963, [2005] IRLR 946.
73 At [29].
74 At [114]
75 *Dunlop*, above n 2, at 87.
76 *Turner v Superannuation & Mutual Savings Ltd* [1987] 1 NZLR 218 (HC) at 225.
77 *Amaltal Corp Ltd*, above n 71, at [59].
78 *Makdessi*, above n 11, at [3].

A Legitimate Interests Test? The Decisions in *Makdessi* and *ParkingEye*

In 2015, the United Kingdom Supreme Court handed down a landmark judgment concerning the law on penalties, radically narrowing the operation of the penalty doctrine's identification test. The Supreme Court heard two factually dissimilar appeals alongside one another. The first, *ParkingEye Ltd v Beavis*, concerned a simple consumer fee of £85 charged for overstaying in a retail carpark. Mr Beavis challenged the fee, claiming it was unenforceable as a penalty.[79]

Conversely, the second case, *Cavendish Square Holding BV v Makdessi*, was more factually complex, concerning a contract for a restrictive covenant-in-trade between two arms-length, sophisticated and commercial parties.[80] In substance, the contract was one for the sale of shares in Mr Makdessi's successful marketing company. It contained a basic non-compete provision enforced on Makdessi, activated upon sale of the shares. A breach of these restraints would invoke either clause 5.1, which abrogated Makdessi's right to receive payments due; or clause 5.6, which required Makdessi to sell Cavendish his remaining shares at the "Defaulting Shareholding Option Price" based on straight asset value (thereby ignoring any goodwill value). Upon breaching his non-compete restraint, Makdessi agreed to forego remaining debts, but refused to comply with the price reduction provision, claiming it was a non-enforceable penalty.

1 Criticism of Dunlop*'s Subsequent Application*

Lord Neuberger and Lord Sumption began their analysis of the law on penalties with a heavy-handed criticism of the English penalty rules:[81]

> … the law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions … 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.

"Over-literal" here alludes to the fact that the four-pronged test put forward by Lord Dunedin has been interpreted as a pseudo-code.[82] It has been uncomfortably bent and skewed to fit each and every case at hand. This was never the tone that the *Dunlop* judgment intended to portray. Rather, Lord Dunedin expressly stated that the four tests were intended to be helpful considerations, not steadfast rules.[83] Consequently, the overarching and forefront consideration was whether the impugned provision was "extravagant or unconscionable".[84] The more factually-complex the case, the

79 At [93].
80 At [46].
81 At [31].
82 At [22] and [31].
83 *Dunlop,* above n 2, at 87–88.
84 At 87.

less helpful the tests became, requiring the Court to place more reliance on whether there was extravagance or unconscionability.

2 A Commercial Justification Test Rejected

The failure of judges to properly construe the *Dunlop* principle created an obdurate uncertainty in the law. There have been attempts to take a circumstance-focused approach to circumvent the technical rigours of the identification test, one of which has been "commercial justification".[85]

To illustrate, the Supreme Court refers to the judgment of Colman J in *Lordsvale Finance plc v Bank of Zambia*, where an inflated interest rate (chargeable upon default) was considered to be valid on the grounds that the increase was commercially justifiable.[86] A similar view was taken in *Murray v Leisureplay plc*. In that case Arden LJ stated that, if there was "some" justification for the pecuniary divergence between the sum agreed in contract and at common law, it would point towards it being an enforceable liquidated damages provision.[87] The Supreme Court did not take a favourable approach to the commercial justification argument. This was because an oppressive deterrence could easily be commercially justified and, thus, could not provide adequate causal evidence that the impugned provision was not intended to be *in terrorem*.[88]

3 The Supreme Court's Legitimate Interests *Test*

Ameliorating the impracticality of the above approach, their Lordships advised that the justification for pre-agreed damages provisions is not limited to compensation upon breach. Rather it extends to wider socioeconomic considerations. In doing so, they approved of Lord Atkinson's dicta in *Dunlop*, which questioned the nature and extent of the innocent party's *interest* in the performance of the primary obligation.[89] The underlying reason for this is that the law will not enforce a remedy which has an adverse effect (on the breaching party) that outweighs the legitimate interest of the innocent party. As famously stated by Lord Reid in *White and Carter (Councils) Ltd v McGregor*, an innocent party that has no interest in performing a repudiated contract may be denied specific performance.[90] After all, the purpose of the law "is not to punish wrongdoing but to satisfy the expectations of the party entitled to performance".[91]

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85 *Makdessi,* above n 11, at [25].

86 *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752 (HL). See also *Makdessi*, above n 11, at [26].

87 *Murray*, above n 72, at [52].

88 At [28].

89 At [23].

90 *White and Carter (Councils) Ltd v McGregor* [1962] AC 413 (HL) at 431.

91 *Co-operative Insurance Society Ltd v Argyll Stores (Holdings) Ltd* [1998] AC 1 (HL) at 15 as cited in *Paciocco*, above n 67, at [254].

Adopting this reasoning, the Supreme Court fashioned a test which protected the legitimate interests of the innocent party:[92]

> The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.

This test dissolves the relevance of the traditional definitions, which rely on concepts such as "extravagance", "unconscionability", and "genuine pre-estimate of loss".[93] These concepts, according to their Lordships, are abhorrently artificial and have caused a gross misapplication of the penalty rule.[94] John Burrows, Jeremy Finn and Stephen Todd suggest that the legitimate interests reasoning may bring clarity, as it shifts focus away from contractual construction and onto the *conduct* of the parties.[95] In practical terms, this means that intangible and incalculable assets (such as goodwill and restraints of trade) can be more readily-protected if the protection of a legitimate interest is evidenced as the purpose of the impugned provision. Thus, even though there may be a complete mismatch between the loss suffered and amount triggered under breach of contract, the difference can be augmented by reference to some legitimate interest. Consequently, deterrence is permissible because such a provision will aim to *deter* breach in order to *protect* the interest underlying the primary obligation.

(a) Legitimate Interest

In order to establish the Supreme Court's delineation of a *legitimate interest*, it is helpful to look to the outcome of the facts. The majority in *ParkingEye* did not hold the fee to be a penalty, even though the £85 could not be linked to any monetary accounting figure that would make it a genuine pre-estimate of loss. Instead, their Lordships looked to the legitimate interest being protected — the availability of parking spaces in a busy retail shopping complex.[96] While this outcome is coherent and logical, it exposes the inherent weakness of an interests test: the burden of proving the existence of a legitimate interest falls on the party seeking to enforce the damages provision. Rebutting that evidence may be near impossible and this can have a paralysing effect on the party with considerably less bargaining power.

The same outcome was reached on the facts of *Makdessi*, on the grounds that Cavendish had a legitimate interest in protecting their company's goodwill. This interest would be threatened if the sellers breached their non-compete provisions. The Court held that, even though the provisions had no relationship whatsoever with a measure of loss attributable

92 *Makdessi*, above n 11, at [32].
93 *Dunlop*, above n 2, at 87, discussed in *Makdessi*, above n 11, at [22].
94 *Makdessi*, above n 11, at [31].
95 John Burrows, Jeremy Finn and Stephen Todd *Law of Contract in New Zealand* (5th ed, LexisNexis, Wellington, 2016) at 857.
96 *Makdessi*, above n 11, at [99].

to breach, the *interest* that Cavendish had in enforcing compliance of the restrictive covenants extended far "beyond the recovery of that loss".[97] That interest was goodwill — a sense of loyalty which, when diminished, resulted in an unquantifiable business risk to Cavendish and which both parties recognised during negotiations. In essence, clauses 5.1 and 5.6 operated to reflect the price Cavendish would pay had he not secured that loyalty.[98] While the clauses had a *deterrent* effect, they were in no way *punitive* because they carried a "legitimate function which had nothing to do with punishment and everything to do with achieving Cavendish's commercial objective in acquiring the business".[99]

These two factually divergent appeals highlight the contextually-driven analysis that must be undertaken to ascertain the existence of a legitimate interest. The High Court of Australia, applying *Makdessi* in the 2016 case *Paciocco v Australia and New Zealand Banking Group Ltd*, broadened this enquiry. The Court called for a specific analysis of the *entire* commercial context from which the interest to be protected arises.[100] This best reflects the very purpose of the legitimate interests test, paying homage to Lord Atkinson's century-old recognition of interest-protection in *Dunlop*. In unbuckling the technical rigour of the *Dunlop* test, the "legitimate interests" consideration allows for a more comprehensive analysis which better fits modern contract practice and the hyper-interdependent nature of trade, law and economics.

(b) Out of All Proportion

It is uncontested that the *legitimate interests* test tremendously expands the operation of the penalty doctrine. This naturally creates a serious inroad into the sanctity of contractual certainty, risking the recognition of interests beyond the objective contemplation of the parties. The proportionality metric abates the intensity of the legitimate interests test by imposing peripheral boundaries on the ways that interests are to be protected. The metric is tested once throughout the judgment. On the facts of *ParkingEye*, the Supreme Court upheld the trial Judge's finding that the £85 fee was not out of all proportion to ParkingEye's interests, as it was "neither extravagant nor unconscionable".[101] Lord Hodge championed this approach, stating that it would prevent the enforcement of extreme pre-agreed damages clauses.[102]

In my opinion, this is the correct proportionality threshold: once a legitimate interest is identified, the causality between the interest and the sum payable must be founded on the doctrine's equitable origins. In doing so, the *legitimate interests* test upholds the doctrine's equitable rigour, but

97 At [75].
98 At [81].
99 At [82]. See also *Wilaci Pty Ltd v Torchlight Fund No 1 LP (in rec)*, above n 19, at [97]. The Court of Appeal discusses how the legitimate interests test permits the objective of deterrence.
100 *Paciocco,* above n 67, at [166].
101 *Makdessi*, above n 11, at [100].
102 At [255] and [257].

expands it to fit modern commercial practice. This allows the doctrine to encompass a broader range of interests, while confining its operation to the grounds of rationality and conscionability.

4 The Relevance of Bargaining Power

The Supreme Court spends a considerable length of their judgment alluding to the importance of bargaining power. This is because equality in bargaining indicates that the parties are in the best position to judge the legitimate consequences of breach. This provides a robust justification for the encroachment into contractual freedom caused by the penalty doctrine.[103] Therefore, the economic efficiency argument discussed in Part II is discredited by the existence of unequal bargaining power as a result of the inefficiencies created by information asymmetry. After all, the likelihood of oppression is greater when one party is unable to properly protect their legitimate interests.[104] Thus, unequal bargaining power is a pertinent influence in implying unconscionable conduct.

However, it is important to note that bargaining power is merely an indicative factor. This is what the Judicial Committee of the Privy Council warned in *Philips Hong Kong Ltd v The Attorney General of Hong Kong*, where it expressed that the discretionary use of idiosyncratic hypotheticals (such as bargaining power) could not subsume the substantive apparatuses of the identification test.[105]

Consequences of *ParkingEye* and *Makdessi*

The practical impact of the Supreme Court's decision is an instantaneous narrowing of the penalty doctrine's operation. By allowing a broader range of interests to justify the imposition of a pre-agreed damages clause, more liquidated damages clauses will be upheld. An operative illustration of this is time-bar clauses in construction clauses, mentioned earlier in this article in the context of the scope rule. The legitimate interests test effectively ensures that time-bar clauses are safe from classification as penalties, as they operate to protect the financial and operative interests of the contractor. Likewise, fees charged by financial institutions are likely to evade the penalty doctrine, insofar as they can be shown to causally protect an interest of the institution's practice.[106]

Narrowing a doctrine traditionally considered to be in stark contention with the freedom of contract has the obvious effect of protecting that freedom. An approach which enlarges the pool of interests that a pre-agreed damages clause can reasonably be seen to protect substantially

103 At [35], [167] and [262].

104 PS Atiyah *The Rise and Fall of Freedom of Contract* (Oxford University Press, Oxford, 1979) at ch 22 as cited in *AMEV-UDC Finance Ltd*, above n 16, at 194.

105 *Philips Hong Kong Ltd*, above n 9, at 57–59.

106 See, for example, *Paciocco*, above n 67, at [167]. The Court held that a late-payment fee legitimately protected the bank's interest in protecting their circulating capital value.

diminishes the latitude for judicial intervention. In effect, this approach shifts the balance of power back to party autonomy. As highlighted by the Court of Appeal, such a shift is particularly welcome where the contracting parties are commercially astute and the transaction is balanced on equal bargaining power.[107]

Additionally, the Supreme Court has succeeded in advocating for a more liberal view of the penalty doctrine by shifting the analysis away from a formula-driven predisposition and towards a substantive, *purposive* enquiry. This evidences a modern ideology that is concerned with the oppressive — not compensatory — nature of a provision.[108]

Conclusion: Identification Rules

The identification rules are tasked with drawing a functional line between clauses held to be reasonable and legitimate, and those held to be onerous and unenforceable. The manner by which they do this has changed over time, starting with the orthodoxy of *Dunlop*. The test in *Dunlop*, misinterpreted by subsequent decisions, became a highly mechanised test, infatuated with calculating a compensatory sum upon loss. Over time, the austerity of this test came to the forefront of judicial consideration. *Makdessi* revived Lord Atkinson's forgotten dicta in *Dunlop*, mitigating the inequities presented by the technical approach.

The legitimate interests test allows courts to consider a broader range of eventualities that a liquidated damages clause may protect. It does not eliminate the operation of the *Dunlop* test; it simply paints a gloss over it and encourages a flexible, but substance-based, analysis for complicated circumstances. Such circumstances are increasingly common. Most modern contracts of sale, trade and supply contain liquidated damages provisions intended to deter breach in the hope of protecting some *interest*. There is no public policy reason justifying the inhibition of these consensually-agreed obligations. Hence, *Makdessi* successfully redefines the constraints on the penalty doctrine by shifting the identification rules further in line with modern commercial practice.

V THE CASE FOR ABOLITION

The doctrine of penalties creates the most substantial departure from the steadfast principles of contractual freedom and certainty that are said to uphold the sanctity of contract. For this reason, the doctrine has been subject

107 *Wilaci Pty Ltd*, above n 19, at [91]. Note that this decision was *not* a statement of the New Zealand position on penalties, as the contract was governed by the law of New South Wales. See [41] and [88]. Therefore, the New Zealand Court of Appeal simply applied Australian law, which had already accepted the *Makdessi* legitimate interests test. See *Paciocco*, above n 67.

108 Nick Tall "Cavendish Square and the 'Modern Approach' to Contractual Penalties" (2013) 24 Ent LR 146.

to considerable debate between abolitionists and proponents. Abolitionists argue that there are no viable justifications for the existence of the doctrine.[109]

There is merit in the view that party autonomy ought to trump notions of fairness. As contended by Peel, the fact that a contract is fully negotiated by two parties is enough to justify the enforcement of any agreed damages.[110]

Nevertheless, it is unlikely that modern societal discourse, devoted in many respects to consumer-protection and fairness, will embrace the abolition of the doctrine. There is an argument made by abolitionists that all necessary protection ought to be left to remedial legislation.[111]

This view, while ostensibly rational, is unreasonable when viewed alongside the protections available. In New Zealand, consideration "contingent upon the occurrence or non-occurrence" of an event under contract is expressly excluded from being classified as an "unfair contract term".[112] Similarly, the provisions in the Consumer Rights Act 2015 (UK), which stipulate that an unfair term is "not binding on the consumer", are expressly limited to consumer contracts.[113]

The distinction between *consumer* and *non-consumer* is arbitrary when one considers small businesses which share the characteristics of consumers that ought to deem them protective status. To illustrate this fallacy, Lord Hodge offers the examples of a large retail chain and a small supplier; and a main contractor and a sub-contractor.[114]

The Supreme Court in *Makdessi* offered compelling reasons for preserving the doctrine. Fundamentally, their Lordships were persuaded by the fact that the penalty doctrine was a steadfast feature of contract law across various international jurisdictions — reflecting the public policy concern trigged by a fee enforced disproportional to loss.[115] Additionally, English and Scottish Law Commissions had advocated for the expansion, rather than the abolition, of the doctrine.[116] They argue that any shortfalls of the penalty doctrine ought to be ameliorated by altering its operation, rather than abolished entirely. For these reasons, the doctrine, in its constrained form, is welcomed in the modern law of contract.

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109 William Day "A Pyrrhic victory for the doctrine against penalties: *Makdessi v Cavendish Square Holding BV*" [2016] 2 JBL 115.

110 Edwin Peel "Unjustified Penalties or an Unjustified Rule Against Penalties?" (2014) 130 LQR 365 at 370.

111 Edwin Peel "The Rule Against Penalties" (2013) 129 LQR 152 at 156–157 as cited in Burrows, Finn and Todd, above n 95, at 859.

112 Fair Trading Act 1986, s 46K.

113 The Consumer Rights Act 2015 (UK), ss 61 and 62.

114 *Makdessi*, above n 11, at [262].

115 At [164]. Lord Hodge commented that the injustices created by inherent imbalances in bargaining power (prevalent in today's market) were one of the compelling justifications for the doctrine. At [262].

116 At [38].

VI CONCLUSION

The penalty doctrine exists to protect parties from onerous obligations by striking down clauses that parties agree upon as ostensible *liquidated damages* clauses. This creates an obvious inroad into the freedom of contract, resulting in a historically narrow application of the doctrine. For over a century, the doctrine has fallen privy to circular criticism and amelioration as judges and practitioners have grappled with the underlying policy considerations and tensions of the doctrine.

The penalty doctrine is comprised of scope and identification rules. The scope rules define which circumstances trigger the operation of the penalty doctrine. By creating a conjectural barrier, the scope rules include only those circumstances which can be justifiably and rationally demarcated as penalties. The identification rules then assess whether the obligations enforced upon the incidence of those eventualities are indeed penal, as evidenced by the nature and degree of the obligation at hand. Over time, both of these rules became subject to hyper-mechanical analysis due to the doctrine's inherently abrogative stance on the freedom of contract. Because of the injustices they presented, several judges and academics have attempted to reformulate these rules. This challenge was recently taken by the highest courts in Australia and the United Kingdom.

Consequently, the Australian scope rules are now defined in terms of *failed primary stipulations*, extending the circumstances upon which the doctrine may operate. The direct and intended consequence of the High Court's decision is a substance-based analysis to ascertain collateral stipulations that secure satisfaction of primary obligations. While this analysis mitigates the incongruities presented by the breach rule, and encourages a flexible interpretation, the *Andrews* approach is unsatisfactorily justified and lacks practical applicability.

In contrast, the English position has been narrowed. The Supreme Court has qualified the "genuine pre-estimate" of loss test[117] to include, where circumstances warrant it, the justification of protecting some legitimate interest. This step is welcomed for two reasons. First, it encourages a flexible, substance-based approach that looks to the purpose of the interest being protected. This enables courts to better ascertain whether something is intended to be punitive or not. Secondly, it reflects modern contract practice, which often contains obligations payable on the occurrence of some contingency as a means to protect some commercial (or other) interest. This application is universal between the commercial and consumer sphere, as evidenced by the Supreme Court reaching similar decisions in two factually divergent appeals.

The doctrine of penalties has a comfortable place in the modern law of contract. It accords with the long-held social value in preventing oppression within the private market. However, its operation ought to be

117 *Dunlop*, above n 2, at 87.

subject to reasonable restraints, so as to uphold the autonomy of contract, which, too, is a foundational value of the free market. Therefore, I submit that the *Andrews* approach extends the doctrine too-haphazardly beyond the justifications that any contemporary policy consideration can provide.

On the other hand, the *Makdessi* "legitimate interests" test provides a certain, yet flexible gloss on the identification test. This test successfully mitigates the issues predominant in the law and strikes a delicate balance between condemning oppression and protecting contractual freedom.[118]

118 *Makdessi*, above n 11, at [32].