

*A Restatement of Relief Against Contractual Penalties (II): A framework for applying the Australian and English approaches*

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**Abstract:** This article provides an analytical restatement of the law of penalties in Australia and England. It demonstrates that in applying the penalties doctrine, a three-stage framework can be adopted. The *first* stage is to ask whether the impugned contractual clause attracts the operation of the penalties doctrine (this was the issue considered by the High Court of Australia in *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205). If the penalties doctrine is applicable the *second* stage is to consider whether the impugned clause is punitive in character (this was the issue subsequently considered by the High Court in *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28, (2016) 333 ALR 569). If the impugned clause is punitive the *final* stage of analysis is to consider the consequences that should flow from a finding that a clause is a penalty. By providing a restatement of the Australian and English approaches at each stage of inquiry, the key convergences and divergences between the two jurisdictions become clear. The key divergences exist at the first and third stage of the inquiry. In Australia, unlike England, a breach of contract is not required to enliven the penalties doctrine. Rather, it suffices under Australian law that A's contractual right to a fixed remedy exists to secure the happening of some other contractual stipulation (being either a contractual duty or, in rare circumstances, a non-promissory condition). The second key divergence is the consequence of a finding that a clause is a penalty. In Australia, the penalties doctrine provides for a *pro tanto* enforcement of A's right to a fixed remedy so that it is not punitive in operation. English law has staunchly rejected that such an approach is possible. However, there is one significant convergence. Both Australia and England have recently adopted a deferential 'legitimate interest' standard at the second stage of inquiry in order to assess whether an impugned clause is punitive in character.

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## INTRODUCTION

In Part I of this article,<sup>2</sup> I set out two approaches to the penalties doctrine in view of the decisions by the highest courts of Australia and the United Kingdom in *Andrews*,<sup>3</sup> *Paciocco*,<sup>4</sup> *Cavendish*<sup>5</sup> and *ParkingEye*.<sup>6</sup> It was argued that the Australian or ‘equitable’ rule as stated in *Andrews* concerns fixed sum clauses that are characterised as being in the nature of security rights. This rule prevents rights or interests taken or retained by A by way of security against B from being enjoyed beyond the function or purpose of security, by preventing such rights from being exercised in a manner that would impose an unjustifiable detriment or punishment on B. This evaluation is made in light of how the law attributes value to the underlying secured stipulation or obligation as at the time of entry into the contract.<sup>7</sup> Whereas the English<sup>8</sup> or ‘common law’ rule, as stated in *Cavendish*, regulates the parties’ ability to determine the quantum of a secondary remedial obligation that arises upon breach of a primary contractual obligation. The English rule prevents fixed sum clauses which derogate too far from a legally imposed remedial regime available for a breach of contract. While there is overlap between these two rationales, which is unsurprising given that the rules share a common history, they remain distinct.

The purpose of writing a Part II to this article is to bridge the important gap between theory and practice. This article looks more closely at directly applicable legal rules in order to understand how the Australian ‘equitable’ and English ‘common law’ penalties doctrines function. It is demonstrated that in applying the penalties doctrine in both Australia and England, the approach adopted in the cases can be broken down into three stages of inquiry.<sup>9</sup>

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<sup>2</sup> Part I appeared in the previous edition of this journal: insert *Journal of Equity* citation. [tba].

<sup>3</sup> *Andrews v Australia and New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205.

<sup>4</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* [2016] HCA 28, (2016) 333 ALR 569.

<sup>5</sup> *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67, [2016] AC 1172. The appeals in *Cavendish* and *ParkingEye* were heard conjointly and have the same neutral and report citation. Unless the context suggests otherwise the decisions will be referred to collectively as *Cavendish*.

<sup>6</sup> *ParkingEye Ltd v Beavis* [2015] UKSC 67, [2016] AC 1172.

<sup>7</sup> The issue concerning ‘time of assessment’ being a continuing distinction between relief against penalties and relief against penalties (see below text at n 127). Hence why Part I of this article referred to the relief against penalties as a *species* of law within the wider genus relating to security rights.

<sup>8</sup> Meaning the common law in England and Wales. For convenience, referred to throughout this paper as the law of ‘England’.

<sup>9</sup> The first two stages of inquiry are crisply set out in *Sydney Constructions & Developments Pty Ltd v Reynolds Private Wealth Pty Ltd* [2016] NSWSC 1104, (2016) 115 ACSR 513 [46] (Barrett AJA). See further, in *Andrews* (n 3) [9], [15] (French CJ, Gummow, Crennan, Kiefel and Bell JJ); *Magnin v Creevey* [2017] NSWSC 375 [11] (Harrison J); and *Australia Capital Financial Management Pty Ltd v Linfield Developments Pty Ltd*; *Guan v Linfield Developments Pty Ltd* [2017] NSWCA 99 [357] (Ward JA with whom McColl and Gleeson JJA agreed). In the English context see *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) [41] (Timothy Fancourt QC).

The *first* or ‘anterior’<sup>10</sup> stage is to ask whether the impugned clause attracts the operation of the penalties doctrine. If the penalties doctrine is applicable the *second* stage of inquiry is to consider whether the impugned clause is punitive in character.<sup>11</sup> If the impugned clause is punitive the final stage of analysis is to consider the consequences that should flow from a finding that a clause is a penalty. Importantly, given that the English law and Australian rules against penalties have different underlying rationales, it should come as no surprise that (despite some key convergences) the application and scope of the two rules illustrates some key divergences in the law. Accordingly, in order to identify these points of difference, this article seeks to provide a restatement of these legal rules in light of the decisions in *Andrews*, *Paciocco*, *ParkingEye* and *Cavendish* and the subsequent jurisprudence applying and interpreting the general principles set out in these landmark cases.

The analysis adopted here is in four parts. Parts one to three set out how the penalties doctrine functions in practice. Each part corresponds to one stage of the three-stage inquiry as to whether a clause is punitive in nature by contrasting the Australian and English approaches. Part four of this article considers to what extent should there be room in the Australian context for separate equitable and common law penalty doctrines to coexist. Five key conclusions are reached. First, the essential attributes of how the two rules function synthesise together to fit the two conceptions for the penalties rule put forward in Part I of this article. Second, although the High Court in *Andrews* expanded the scope of what types of clause can be captured by the penalties doctrine, the subsequent jurisprudence has illustrated that this approach has conceptual limits. Third, due to a split in the Supreme Court’s reasoning in *Cavendish*, two different approaches as to when the English approach to penalties is engaged have emerged in the cases. This is a key point to take away from *Cavendish*, as the adoption of a narrow approach as to when the penalties doctrine is engaged has further reduced the scope of the doctrine in England. Fourth, both the Australian rule and English rule have adopted functionally similar deferential ‘legitimate interest’ standards in order to assess whether an impugned clause is punitive in character. Finally, I argue that the best understanding of Australian law is that it ought to be seen as consisting of a unified rule against penalties (albeit *originating* as an equitable rule) and not as consisting of two distinct rules (being separate rules at common law and in equity which are mutually independent and both potentially applicable on the same set of facts).<sup>12</sup>

## I

### ANTERIOR STAGE OF ANALYSIS: DOES THE IMPUGNED CLAUSE ATTRACT THE OPERATION OF THE PENALTIES DOCTRINE?

- i. *Restatement of the Australian Penalties Doctrine: Threshold test — is the fixed sum a security right?*

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<sup>10</sup> *Andrews* (n 3) [15] (French CJ, Gummow, Crennan, Kiefel and Bell JJ).

<sup>11</sup> This was the issue considered in *Paciocco High Court of Australia* (n 4).

<sup>12</sup> Since this article was accepted for publication the opposite view on the issue of fusion was taken in the otherwise excellent decision of Ward JA (with whom McColl and Gleeson JJA agreed) in *Australia Capital Financial Management Pty Ltd* (n 9) [359]–[360].

Before an impugned contractual clause is assessed to see whether it is punitive in character, the penalties doctrine must first be engaged. Post-*Andrews*, the salient question to determine whether the Australian penalties doctrine is engaged is to ask whether or not A's right to a fixed sum remedy is imposed to secure either the performance of, or happening of, another 'contractual stipulation'. This other contractual stipulation which the fixed sum secures could, and will almost universally, be a contractual duty which B owes to A and which, if B fails to perform, would constitute a breach of contract. Thus nothing decided in *Andrews* upsets the well-settled principles that the penalties doctrine attaches to remedial or collateral rights that secure the performance of a *duty*. But the Court in *Andrews* held that although a contractual clause operating in the nature of a security right can, of course, function to secure performance of B's contractual duty to A, as a matter of legal history and logic, there is no reason why such a right cannot function to secure the happening or fulfilment of a non-promissory contractual provision.<sup>13</sup> Thus if A's right operates as a security then the doctrine is engaged. If not, the parties are left to the terms of their bargain and the penalties doctrine has no work to do.

The question whether A has a collateral right, the purpose of which is to secure performance of a related primary stipulation, is a question of *construction* to be determined at the time of entry into the contract.<sup>14</sup> This means that the question, whether an impugned contractual clause is a penalty, goes beyond the interpretative attribution of linguistic meaning to the contractual text. This point was captured in *Paciocco*, where the question of whether an impugned clause was a penalty was 'a question of construction', and that 'construction' in this context refers to 'something beyond the attribution of legal meaning' and it encompasses the ultimate 'legal characterisation' of the rights in question.<sup>15</sup> The purpose of this section is to provide guidance for ascertaining whether the Australian penalties doctrine is engaged by asking how one assesses whether A's contractual right is collateral (in the sense of a security).<sup>16</sup>

The starting point is naturally to interpret the impugned clause and the contract in question. It

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<sup>13</sup> Cross reference *Journal of Equity* Article I at [tba] p 11. The rejoinder to this approach being that any wider application of the penalties doctrine is unwelcome as it detracts impermissibly from the parties powers to create consent-based obligations.

<sup>14</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50, (2015) 236 FCR 199 [95], [200] (Allsop CJ); and *Mineralogy Pty Ltd v Sino Iron Pty Ltd (No 6)* [2015] FCA 825, (2015) 329 ALR 1 [471]–[478] (Edelman J); and *Australia Capital Financial Management Pty Ltd* (n 9) [329]–[331], [336], [371] (Ward JA).

<sup>15</sup> *Paciocco High Court of Australia* (n 4) [31] (Kiefel J with whom French CJ agreed), [146] (Gageler J).

<sup>16</sup> The fact that the High Court is yet to engage in a detailed practical application of the threshold test for when the penalties doctrine is engaged has led to academic criticism of the *Andrews* formulation on the basis that: 'the distinction between collateral and alternative [primary] stipulations is not easy to draw': Katy Barnett and Sirko Harder, *Remedies in Australian Private Law* (CUP 2014) 306. A similar point is also made in Richard Manly, 'Breach No Longer Necessary: The High Court's Reconsideration of the Penalty Doctrine' (2013) 41 ABLR 314, 331–36.

is trite law that an objective theory of interpretation of written instruments permeates<sup>17</sup> the general law.<sup>18</sup> The expression ‘general law’ here includes both equity<sup>19</sup> and the common law. At a broad level of generality, the orthodox approach to interpreting constitutions, contracts, statutes, trusts and security documents is the same: a search for the *objective* meaning to be attributed to the instrument. So applied to the law of contract, on this objective approach, the impugned contractual obligations or stipulations should be interpreted in accordance with how a reasonable person in the parties’ position would be taken to have understood the relevant contract, read as a whole, in the circumstances<sup>20</sup> and context in which that contract was entered into (that context including the purpose and object of the transaction).<sup>21</sup>

However, as outlined in Part I of this article in the previous edition of this journal, the rationale underpinning the penalties doctrine no longer turns,<sup>22</sup> as it did in the 19<sup>th</sup> and early 20<sup>th</sup> centuries, on an interpretive-based presumption that looks to the parties’ objective intentions to wholly determine this question (although it is possible that Australian law may ultimately redevelop in this way).<sup>23</sup> Rather, the central reason why equity limits the exercise of A’s legal right as against B is to prevent B from being subject to an unjustifiable detriment

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<sup>17</sup> This proposition is correct insofar as we are concerned with the interpretation and construction of written instruments. However, where fraud is involved, for example in the context of a sham trust, the court may arguably engage in a wider inquiry that considers evidence as to a parties’ state of mind.

<sup>18</sup> *Byrnes v Kendle* [2011] HCA 26, (2011) 243 CLR 253 [59] (Gummow and Hayne JJ), [93]–[118] (Heydon and Crennan JJ); *Cusack v London Borough of Harrow* [2013] UKSC 40, [2013] 1 WLR 2022 [58]–[59] (Lord Neuberger with whom Lord Sumption and Lord Hughes agreed).

<sup>19</sup> *Parkin v Thorold* (1851) 61 ER 239, 2 Sim NS 1, 6 (Lord Cranworth VC); *Tilley v Thomas* (1867) LR 3 Ch App 61, 67 (Lord Cairns); *Solomons v Halloran* (1906) 7 SR (NSW) 32, 42–4 (Street J). Such an approach is wholly consistent with the High Court’s recent emphasis on there being a uniform law of interpretation: *Byrnes* (n 18) [17] (French CJ); [93]–[118] (Heydon and Crennan JJ). See also ‘The Maxims of Equity’ in John McGhee (ed), *Snell’s Equity* (33rd ed, Sweet & Maxwell 2015) [5-013]: ‘The equitable concern with objective intention rather than mere form lies at the root of the equitable doctrines governing precatory words, mortgages, penalties and forfeitures’.

<sup>20</sup> See *Western Export Services v Jireh International Pty Ltd* [2011] HCA 45, (2011) 282 ALR 604 [2]–[5] (Gummow, Heydon and Hayne JJ). There is controversy concerning the extent to which contextual surrounding circumstances are available, in the absence of ambiguity, to aid contractual interpretation. English courts take a broader view whereas Australian courts have traditionally favoured a more restrictive approach. See *Stratton Finance Pty Limited v Webb* [2014] FCAFC 110, (2014) 314 ALR 166 [36]–[40] (Allsop CJ, Siopis and Flick JJ).

<sup>21</sup> *Toll (FGCT) Pty Ltd v Alphapharm Pty Ltd* [2004] HCA 52, (2004) 219 CLR 165 [40] (Gleeson CJ, Gummow, Hayne, Callinan and Heydon JJ). *Byrnes* (n 18) [98] (Heydon and Crennan JJ); *Electricity Generation Corporation v Woodside Energy Ltd* [2014] HCA 7; (2014) 251 CLR 640 [35] (French CJ, Hayne, Crennan and Kiefel JJ); *Mount Bruce Mining Pty Limited v Wright Prospecting Pty Limited* [2015] HCA 37, (2015) 256 CLR 104 [46]–[47] (French CJ, Nettle and Gordon JJ).

<sup>22</sup> The move away from focusing on the party’s intentions can be clearly seen in *Webster v Bosanquet* [1912] AC 394 (PC) 398 (Lord Mersey).

<sup>23</sup> Cross reference *Journal of Equity* Article I at [tba]. This approach is still maintained post-*Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited* [1915] AC 79 (HL) in Maurice L Gwyer and William R Anson, *Principles of the English Law of Contract and of Agency in its Relation to Contract* (16th ed, OUP 1923) 332, stating that the guidelines that constitute the rule against penalties are ‘no more than presumptions as to the intentions of the parties’. For a clear overview of the pre-*Dunlop* position see *Pye v British Automobile Syndicate* [1906] 1 KB 425, 429 (Bigham J).

in light of how the law values B's underlying breach of contract or the failure of a contractual stipulation. The linguistic meaning of the parties' rights and obligations is therefore only the starting point for analysis. Once the contract has been *interpreted*, it then needs to be *construed* to ascertain whether the rights and obligations created by the parties fit the set legal criteria for whether the penalties doctrine is engaged: that A's right to a fixed sum, as a matter of substance, is characterised as existing to ensure that either B performs a contractual obligation or that a non-promissory contractual stipulation is fulfilled.

Indeed, whether the court is construing a contract, penal clause, licence, lease, trust or security instrument, the labels used by the parties to describe the legal effect of the impugned provisions are simply not determinative.<sup>24</sup> Relevantly, as in the context of security rights, just because a provision (ie a penalty or security right) is drafted on its face to suggest that the right is intended to be enforceable outright (ie without limitation) as opposed to enforceable by way of security is *not* determinative of the proper legal characterisation of that right. As the High Court highlighted in *Andrews*<sup>25</sup> in order to properly characterise whether a contractual stipulation operates as a penalty, it is essential to consider the substance of the legal effect of the rights created by the impugned clauses rather than merely focus on form.<sup>26</sup> Thus it is open to the contracting parties to attach whatever label they see fit to a fixed sum remedy. However, it is up to the court to determine whether or not the label affixed to the impugned right is accurate in light of externally imposed legal principles: is the impugned right nonetheless properly understood as being a collateral right? Or is the impugned right independent and not in the nature of a collateral right? This process involves the court construing the relevant agreement as a constituent whole,<sup>27</sup> which requires the express legal form of the contractual arrangement to be non-determinative and the actual substance of what the parties have agreed, including the underlying purpose, logic and coherence of the transaction, to inform the inquiry.

While the penalties doctrine enables the court to impose external principles on to the parties' contract in order to reach a legal characterisation that ultimately differs from the linguistic meaning of A's right to a fixed sum, there are conceptual limits to how far the court can construe an agreement in order to characterise A's right as being a security right. As the High Court observed in *Andrews*, the penalties doctrine is clearly not engaged where A's right

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<sup>24</sup> See in *Dunlop* (n 23) 86 (Lord Dunedin); *Re Spectrum Plus* [2005] UKHL 41, [2005] 2 AC 680 (HL) [116]–[117] (Lord Scott). *Paciocco High Court of Australia* (n 4) [31] (Kiefel J); [146] (Gageler J); [243] (Keane J). See too Lionel Smith, 'Relief Against Forfeiture: A Restatement' (2001) 60 CLJ 178, 179; and Sarah Worthington 'Common Law Values: The Role of Party Autonomy in Private Law' in Andrew Robertson and Michael Tilbury (eds) *The Common Law of Obligations: Divergences and Unity* (Hart Publishing 2016) 308.

<sup>25</sup> See too *Re Universal Management* [1983] NZLR 462, 470 (Cooke J).

<sup>26</sup> *Andrews* (n 3) [10]–[13] (French CJ, Gummow, Crennan, Kiefel and Bell JJ). For a similar approach see *M&J Polymers Ltd v Imerys Minerals Ltd* (2008) 1 Lloyds Rep 541, [41] (Burton J), discussed in Ben McFarlane, 'Penalties and Forfeiture' in John McGhee (ed), *Snell's Equity* (33rd edn, Sweet & Maxwell 2015) [13-007]; and *Cavendish* (n 5) [15] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>27</sup> *FAI General Insurance Company Limited v Australian Hospital Care Pty Ltd* [2001] HCA 38, (2001) 204 CLR 641, [33] (McHugh, Gummow and Hayne JJ).

against B does not secure performance of an obligation or the fulfilment of a stipulation, but simply constitutes a fee levied on B when A confers on B some further right or benefit (also described as being a fee levied by A on B by virtue of there being an ‘alternative’ primary stipulation or a fee for a further ‘accommodation’ or ‘service’).<sup>28</sup> This is because where the fee in question is levied for the provision of a further contractual right or benefit, that fee cannot be seen as merely being a ‘collateral’ right existing only to ensure the performance or fulfilment of some other contractual stipulation. Rather, the fee constitutes the fully enforceable consideration for that further right or benefit.<sup>29</sup>

Take, for instance, the following example (based on *Metro-Goldwyn Mayer Pty Ltd v Greenham*<sup>30</sup> and used by the High Court in *Andrews*): A and B enter into a contract under which B is conferred a right to screen A’s film on a single occasion for the fixed sum of \$Y. The contract then contains a further stipulation that for each additional occasion that B screens the film, B is required to pay A an increased fixed fee of four times that of the original fee per screening (Y4). In this example, the fee of Y4 for each additional screening constitutes a fee levied by A on B in exchange for a *new* contractual right or benefit to screen the film as B was otherwise not at liberty against A to do so<sup>31</sup>. Accordingly, the right to the increased fee would not engage the penalties doctrine because it does not operate as a security right.

In the *Paciocco* litigation, the fact that the Bank (A) levied various fees against the consumer (B) for the conferral of a new right or benefit was precisely why all but one type of impugned bank fees were incapable of engaging the operation of the penalties doctrine. Both Gordon J at first instance and the Full Court of the Federal Court of Australia (Allsop CJ, Besanko and Middleton JJ) characterised all the fees set out in the examples below as fees for the conferral of a new right or benefit. None of these fees were subject to the ultimate appeal to the High Court of Australia<sup>32</sup> and it is submitted that the reasoning of Gordon J and Full Court was sound given the underlying rationale for the Australian penalties doctrine. While there were a series of separate bank fees challenged in the *Paciocco* litigation, all of these fees ultimately fell into four categories which raised common legal issues. Three of the categories will be considered in this part of the article because they all turn on the threshold issue of whether the penalties doctrine is engaged. These three types of fee are discussed in detail below but can be broadly classified as: (i) honour and dishonour fees; (ii) non-payment fees; and (iii) overlimit fees. The fourth and final category of fees were late payment fees on credit card accounts, which were the subject of the ultimate appeal to the High Court in *Paciocco* and

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<sup>28</sup> *Andrews* (n 3) [80]–[92] (French CJ, Gummow, Crennan, Kiefel and Bell JJ); and *Paciocco Full Court of the Federal Court* (n 14) [199] (Allsop CJ).

<sup>29</sup> See too the discussion in *McFarlane* (n 26) [13-009].

<sup>30</sup> [1966] 2 NSW 717.

<sup>31</sup> Although, as B was under a duty against A not to show the film unless B had a licence to do so there was no discussion in *Andrews* as to whether the impugned fee could be construed as existing to secure this duty not to infringe A’s intellectual property rights over the film in question.

<sup>32</sup> *Paciocco High Court of Australia* (n 4) [2] (French CJ).

were held to be valid as they were not punitive in nature. Therefore late payment fees on credit card accounts will be considered in part two of this article.

*Example 1: Honour and dishonour fees.*<sup>33</sup> Under the terms of a savings account, A charges B the fixed sum of \$35 to either honour or dishonour a transaction when B attempts to overdraw his account. B, a university student and poor saver, has \$50 in his account with A. When B is out doing grocery shopping at C's shop the transaction results in B needing to pay C the sum of \$90. B attempts to use an electronic transfer at the point of sale from his account with A to make the \$90 payment for the groceries into C's account. As B does not have sufficient funds in his account, A can now elect either to honour or dishonour the transaction and can accordingly charge B the fixed sum of \$35 for doing so. The reason why the sum of \$35 is not a penalty in the *Andrews* sense is that it cannot be characterised as a security right. The savings account operates as a chose in action which B has against A. That is, B has a right to the sum of \$50 because at some stage he deposited a sum of money with A and, accordingly, A owes him a corresponding debt. However, the mere fact that A owes B a debt does not, without more, extend to a right for B to receive a provision of credit from A. So when B attempted a transaction which would have resulted in him overdrawing his account by \$40, he requested a new right or benefit from A. That is, B requested that A loan him the additional sum of \$40 in order for B to complete his \$90 transaction with C. As the fixed sum of \$35 is charged by A for either (i) considering and rejecting B's request (in the case where the transaction is dishonoured); or (ii) considering B's request and allowing B to overdraw his account (in the case where the transaction is honoured), A's right to that fixed sum does not operate as a right to secure the performance of another right or stipulation, but was properly characterised as being a fee, albeit a high fee, for a *further* accommodation, right or benefit to which B was not otherwise entitled.

The fact that A may choose to automate the process by which it decides to accept or reject B's payment request does not change the underlying applicable legal rules. You can ask to borrow \$50 from me. We can agree in advance that I can charge you a fixed sum of \$10 for considering any requests that you make of me for a loan. We could further agree that the outcome of your request could be based on a coin toss or whether Australia beats England in the forthcoming Ashes series. But the imposition of such a decision-making framework to ascertain whether or not you receive a small loan cannot transform your payment for a new right or benefit into a security right (ie a right that secures the happening of some other pre-existing primary duty or stipulation).

*Example 2: Non-payment fees.*<sup>34</sup> Under the terms of a savings account, A charges B a fixed sum of \$35 when B attempts to overdraw her savings account by virtue of a periodical direct debit payment. For example, where a football club (C) debits B's account each month in order to extract B's ongoing membership fees but there are now insufficient funds in B's account to make her required monthly payment to her club. The same conclusion is reached in this example as in the case of a dishonour fee. The \$35 fee is charged by A as a consequence of B issuing an informal payment instruction to A and for A considering whether or not to process

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<sup>33</sup> *Paciocco Full Court of the Federal Court* (n 14) [215]–[231], [240]–[244] (Allsop CJ).

<sup>34</sup> *Paciocco v Australia and New Zealand Banking Group Ltd* [2014] FCA 35, (2014) 309 ALR 249 [272] (Gordon J), although these observations of the Court were simply *obiter dicta*.

that instruction. If A honours B's instruction, it would have the effect of either: (i) overdrawing B's account (thereby creating a loan from A to B) or, (ii) if B had a credit facility the credit limit would be exceeded (thereby conferring on B the further benefit of a right to additional credit).

*Example 3: Overlimit fees.*<sup>35</sup> A has provided B with a credit card account with a credit limit of \$5000. The terms of the account provide that A can charge B a \$35 fee for any transaction which will result in B exceeding her credit limit. This fee is conceptually similar to the honour fee discussed above. The fee of \$35, without more, cannot be characterised as a right that exists merely to secure B's performance of a stipulation or obligation. The better characterisation of the fixed sum is that it constitutes a fee levied by A in exchange for B receiving a further benefit or accommodation upon B's informal request for further credit (ie a *further* loan). Those accommodations and benefits being, respectively: (i) A considering the informal credit increase request; and (ii) B having her credit limit extended.

There are two important observations to draw from the above examples regarding how the *Andrews* formulation operates in practice. *First*, in applying the penalties doctrine, courts do not attempt to 'balance' whether a contract or transaction was, in global terms, substantively fair by assessing whether adequate consideration exists to justify the inclusion of a penal clause.<sup>36</sup> Rather, at this threshold stage of inquiry the court is concerned with whether A's right against B exists to secure either B's performance of an obligation or the fulfillment of a non-promissory stipulation. *Second*, it appears wholly possible to draft around the post-*Andrews* formulation of when the penalties doctrine is engaged. The impugned fees from the *Paciocco* litigation set out above serve as a series of practical examples of what the High Court in *Andrews* termed 'alternative primary stipulations'. That is, circumstances where A's right to a fixed sum is a fee which constitutes the consideration for a further contractual right or benefit. It is not conceptually possible for such fees to attract the operation of the equitable penalties doctrine, as they do not operate as security rights.<sup>37</sup> Thus it might be possible to recast a *potential* penal provision as constituting a fee levied by A on B to give B some new contractual right or benefit. For example, altering the underlying substance of a credit card agreement to make a late payment credit card fee levied by A as being the consideration for conferring on B a *new* right to continue using the account, rather than simply being a fee levied for late payment.<sup>38</sup> By making the fee the price for A's conferral of a new right or benefit on B, the penalties doctrine would be avoided because the impugned fee would not operate *as a security*, but would constitute a legitimate fee for a further contractual right or benefit. There is nothing wrong in principle with allowing the parties, if they so wish, to choose a second, or indeed a third, fourth etc... primary stipulation.

ii. *Restatement of the English Penalties Doctrine: Threshold test — is the fixed sum a secondary right?*

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<sup>35</sup> *Paciocco Full Court of the Federal Court* (n 14) [232]–[235], [237]–[239] (Allsop CJ).

<sup>36</sup> See also *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71, (2005) 224 CLR 656 [37]–[38] (Gleeson CJ, Gummow, Kirby Hayne, Callinan and Heydon JJ).

<sup>37</sup> *Andrews* (n 3) [79]–[82] (French CJ, Gummow, Crennan, Kiefel and Bell JJ).

<sup>38</sup> See Alan Tyree, 'Fees and Penalties' (2014) 25 JBFLP 43, 46.

The operation of the ‘common law’ or English approach to the rule against penalties is, at least at first blush, somewhat more straightforward than the Australian rule. As outlined in Part I of this article,<sup>39</sup> the English rule is best understood as being rationalised on the basis that it is a rule of ‘public policy’ designed to regulate the parties’ ability to determine the quantum of a sanction or remedy that arises upon breach of a primary contractual obligation.<sup>40</sup> This rule prevents fixed sum clauses which derogate too far from the remedy available for a breach of contract. Accordingly, for the English penalties doctrine to be engaged, the hook on which A’s right to a fixed sum as against B must operate is the breach of a contractual obligation.<sup>41</sup> A breach of contract is required because A’s right to a fixed sum cannot derogate too far from the remedial regime imposed by the general law unless that regime is engaged in the first place. How then does the court decide whether an impugned clause is a ‘secondary right’ which attracts the operation of the penalties doctrine? This is the question which is answered in this section.

Two approaches to the identification of secondary rights can be discerned from the various strands of reasoning in *Cavendish* and the subsequent English and Scots cases.<sup>42</sup> The first, or narrow, approach is to ask whether a clause hinging on B’s breach of contract serves as a functional substitute or equivalent to a court order for contractual damages.<sup>43</sup> The second, or broader, approach is to ask whether the clause hinging on B’s breach of contract provides a remedy or a sanction for that breach.<sup>44</sup> Asking the narrower question of whether an impugned clause performs the same function as a court order for contractual damages considerably reduces the scope of the penalties doctrine when contrasted with the question of whether the clause provides a sanction or remedy on breach of contract. Put simply, the remedy of damages (a money award) for breach of contract is a narrower concept than any sanction or remedy for breach of contract that the parties may choose in their contract (e.g. common

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<sup>39</sup> Cross reference *Journal of Equity* Article I at [tba].

<sup>40</sup> This explains the breach of contract requirement to enliven the common law rule: See Robert Stevens, ‘Rights Restricting Remedies’ in Andrew Robertson and Michael Tilbury (eds), *Divergences in Private Law* (Hart Publishing 2016) 171–7.

<sup>41</sup> See *In re B (Children) (Removal from Jurisdiction: Enforcement of Contract Order)* [2016] 1 WLR 2326 [65] (McFarlane LJ), where it was questionably (given the history of the rule) held that the penalties doctrine would not apply to a charge over real property that was realisable on breach of a court imposed order because the breach of that order would not constitute a breach of contract.

<sup>42</sup> To this end, the view that primary and secondary rights distinction is unworkable put forward in Carmine Conte, ‘The penalty rule revisited’ (2016) 132 LQR 382, 386, seems to be an overstatement.

<sup>43</sup> *Cavendish* (n 5) [14], [76] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed). The cases that seem to map more closely to this approach are *Richards v IP Solutions Group Ltd* [2016] EWHC 1835 (QB) [83]–[85] (May J); *Edgeworth Capital (Luxembourg) SARL v Ramblas Investments BV* [2016] EWCA Civ 412 [7] (Moore-Bick LJ with whom King and Sales LJ agreed); *Hayfin Opal Luxco 3 SARL v Windermere VII CMBS plc* [2016] EWHC 782 (Ch) [132] (Snowden J); and *Brown’s Bay Resort Ltd v Pozzoni (Antigua and Barbuda)* [2016] UKPC 10 [9] (Lord Hodge).

<sup>44</sup> *Cavendish* (n 5) [280] (Lord Hodge); [291] (Lord Clarke); [292] (Lord Toulson). This approach seems to map more closely with the Scots decision of the Court of Session (Inner House, Extra Division) in *Gray v Braid Group (Holdings) Ltd* [2016] CSIH 68 [81]–[82] (Lord Menzies), [106] (Lord Brodie); and *Vivienne Westwood* (n 9) [46]–[49] (Timothy Fancourt QC).

contractual provisions providing for the forced transfer of shares or the withholding of a portion of a purchase price payment do not function like an award of damages).

The narrow and broad approaches to determine whether an impugned clause is a ‘secondary right’ are derived from a split in the reasoning on this point in *Cavendish*. Although the Supreme Court unanimously held that the impugned clauses in *Cavendish* were not penalties, the Court split on this important threshold question of whether or not the impugned clauses attracted the scrutiny of the penalties doctrine in the first place thus providing no clear majority on this issue. The reason why this split in judicial opinion is controversial and worthy of detailed comment is that the impugned clauses in *Cavendish* clearly hinged on B’s breach of contract. Further, the narrow and broad approaches appear to be creating some potential inconsistencies in the post-*Cavendish* jurisprudence. For example, there has been a potential divergence as to whether bad leaver provisions in a company’s articles of association are primary or secondary obligations.<sup>45</sup> In short, such provisions enable a company (A) to compulsorily acquire an employee’s (B) shares in A at a rate below either market value or subscription value on B’s breach of her employment contract.

Given that the common law penalties doctrine polices the remedy available for breach of contract, why then did at least three members of the Court in *Cavendish* adopt a ‘narrow approach’ to the concept of secondary obligations to hold that the penalties doctrine did not apply to a clause fixing detrimental financial consequences on B, in favour of A, in circumstances where B breached the contract? Before engaging with this question it is worth setting out the relevant facts of *Cavendish*. Although the agreement in *Cavendish* facilitated a fairly complex commercial transaction, the facts can be briefly stated.

The story begins with one company (A)<sup>46</sup> wishing to acquire a majority stake in a market-leading advertising and marketing company (C),<sup>47</sup> which was based in the Middle East. After extensive negotiations<sup>48</sup> where large commercial law firms represented both sides, A arranged to purchase a significant number of shares in C from C’s founder (B)<sup>49</sup> which would give A a majority stake in C. For present purposes it is enough to say that A was required to make three types of payment to B for the acquisition.<sup>50</sup> The first payment was for the sum of USD 34m on completion of the agreement. The second payment was for the sum of USD 31.5m and was to be paid into escrow and released to B in instalments once a required corporate

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<sup>45</sup> *Richards* (n 43) [84]–[85] (May J), it was held that these bad leaver provisions were primary obligations. In *Gray* (n 44) [81]–[82] (Lord Menzies); [106] (Lord Brodie), it was held that similar provisions were secondary obligations.

<sup>46</sup> While the structure is immaterial for present purposes, it is worth noting that by way of a novation to the agreement the corporate entity that was purchasing the shares was changed.

<sup>47</sup> C was actually the holding company for a group of subsidiary companies that operated in concert.

<sup>48</sup> *Cavendish* (n 5) [47], [66] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>49</sup> On the facts there was also a second seller and each seller was entitled to a proportion of the shares in the company but this fact was immaterial to the reasoning see *Cavendish* (n 5) [48] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>50</sup> *Cavendish* (n 5) [48] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

restructuring of C and its subsidiaries took place. A made these two payments once due and they were not in issue.<sup>51</sup> However, A was also obliged to make two further ‘deferred payments’<sup>52</sup> at a later date for the share acquisition to B. These deferred payments were to be calculated according to a formula<sup>53</sup> that took into account C’s actual reported future after-tax profits subject to a maximum cap that the sums paid for the shares could not exceed a combined total of USD 147.5m.<sup>54</sup> However, it was common ground that a large portion of the value of C was tied up in goodwill,<sup>55</sup> including the ongoing business relationships that C had with its clients and senior employees. Accordingly, restrictive covenants were inserted into the share sale agreement which provided that B could not engage in certain activities that could potentially undermine the value and long term viability of C.<sup>56</sup> These restrictions placed B under obligations not to compete with C in certain markets and prevented B from attempting to solicit clients and senior employees away from C. More specifically, the restrictions also placed B under obligations to divest any shareholding in, and not to be involved in the operations of, certain competitor companies.<sup>57</sup>

It turned out that after the initial sale and transfer of shares had taken place, B had breached the restrictive covenants. B had, in breach of the share sale agreement, retained an unpaid non-executive role on the board of a competitor company pending the appointment of a new chief executive officer.<sup>58</sup> The central issues in *Cavendish* turned on the consequences of B breaching the restrictive covenants. The contract provided for two consequences. The first was that a clause (clause 5.1) provided that if B breached the restrictive covenants then B was no longer entitled to any outstanding deferred payments for the sale of his shares to A.<sup>59</sup> On the facts this would mean that B would lose his right to both of the deferred payments which would have been worth up to USD 44m.<sup>60</sup> The second consequence was that another clause (clause 5.6) provided that if B breached the restrictive covenants A would be given a contractual power to purchase all of B’s remaining shares in C at a set price calculated below market value.<sup>61</sup> The price at which A would be able to purchase the shares under the option

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<sup>51</sup> *Cavendish* (n 5) [58] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>52</sup> One of the deferred payments was styled an ‘interim payment’ the other a ‘final payment’.

<sup>53</sup> *Cavendish* (n 5) [48] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>54</sup> *Cavendish* (n 5) [49] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>55</sup> *Cavendish* (n 5) [66] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>56</sup> *Cavendish* (n 5) [51]–[52] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>57</sup> *Cavendish* (n 5) [54] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>58</sup> See *Cavendish* (n 5) [61]–[62] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed). B admitted these breaches of the covenants. Broader allegations were made which B denied but the Court was not required to explore this issue any further.

<sup>59</sup> *Cavendish* (n 5) [55] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [121] (Lord Mance).

<sup>60</sup> *Cavendish* (n 5) [67] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>61</sup> *Cavendish* (n 5) [55] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

would be below market value because the purchase price was to be calculated on the basis of C's net tangible assets with no component of goodwill to be included in the calculation of the price.<sup>62</sup>

Once A discovered B's breach of the restrictive covenants the next part of the story was predictable.<sup>63</sup> A sought declarations that it was no longer obliged under the share sale agreement to make the two further deferred payments to B by operation of clause 5.1.<sup>64</sup> In addition, A also exercised its call option under clause 5.6 to purchase B's remaining shares in C at the reduced price. In response, B argued that both clause 5.1 and clause 5.6 were penalties and that, accordingly, he was not required to transfer to A his remaining shares in C and that he was still entitled to the deferred payments for the previous sale of his shares. The arguments raised required the Court to consider each part of the three-stage inquiry as to whether the penalties doctrine was applicable.

The Supreme Court in *Cavendish* was unanimous in its broad conclusion that neither clause 5.1 nor clause 5.6 was a penalty. As noted above, the members of the Court reached this conclusion for different reasons. The first split was on the threshold issue of whether the impugned clauses attracted the operation of the penalties doctrine.<sup>65</sup> The three justices who held that clause 5.1 did not attract the operation of the penalties doctrine were Lord Neuberger and Lord Sumption (with whom, on this issue, Lord Carnwath agreed). Although the impugned clause extinguished B's right to the deferred payments if B breached any of the restrictive covenants, their Lordships held that the clause was part of the parties' 'primary obligations' and therefore did not attract the operation of the penalties doctrine. The clause was characterised as part of the parties' 'primary obligations' as it only effected an adjustment of the consideration payable by A to B. This price adjustment was said to reflect what A would pay for B's shares in C if the goodwill in C was put at risk by any breach of a restrictive covenant. Put another way, B would only earn the deferred payments if he 'behaved himself' and didn't risk the value of C's goodwill by breaching the restrictive

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<sup>62</sup> *Cavendish* (n 5) [68] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>63</sup> *Cavendish* (n 5) [62] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [118] (Lord Mance). For completeness it is worth noting that C (the company) also sued B for breach of contract and settled with B for the sum of USD 500,000. As the Court observed it was accepted that any loss that A had indirectly suffered to a reduction in the value of C for the breaches in question would have been offset by this payment.

<sup>64</sup> *Cavendish* (n 5) [63]–[64] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>65</sup> *Vivienne Westwood* (n 9) [40] (Timothy Fancourt QC): "three of the Justices [in *Cavendish*] held that the clause in question was a price adjustment clause that was in no sense a secondary provision and was therefore not a penalty. Another three Justices held that there was a strong argument that the penalty jurisdiction was not engaged at all but decided the case on the basis that the specified consequences were not exorbitant or unconscionable in all the circumstances. The seventh Justice (Lord Mance) only expressed a concluded view on the latter issue, giving his reasons for reaching the same conclusion."

covenants.<sup>66</sup> Thus the clause was not operating as a functional equivalent to a court order for damages.<sup>67</sup> As their Lordships observed, clause 5.1 was:<sup>68</sup>

plainly not a liquidated damages clause. It is not concerned with regulating the measure of compensation for breach of the restrictive covenants. It is not a contractual alternative to damages at law. Indeed in principle a claim for common law damages remains open in addition, if any could be proved. The clause is in reality a price adjustment clause. Although the occasion for its operation is a breach of contract, it is in no sense a secondary provision. ... Clause 5.1 belongs [...] among the provisions which determine [A's] primary obligations, ie those which fix the price, the manner in which the price is calculated and the conditions on which different parts of the price are payable. Its effect is that [B] earn[s] the consideration for [his] shares not only by transferring them to [A], but by observing the restrictive covenants.

Their Lordships reached the same conclusion with respect to the call option in favour of A that was enlivened if B breached the restrictive covenants (contained in clause 5.6).<sup>69</sup> They preferred to characterise the call option as being part of the primary rights and obligations contained in the contract exercisable on a certain event, and that it was immaterial that the relevant event that triggered the option was B's breach of contract.<sup>70</sup> The 'event' triggering the option here being B's breach of the restrictive covenants designed to protect the goodwill in C. Thus the option afforded A a power with which it could swiftly terminate any residual commercial interest that B had in C. Their Lordships considered that the fact that B was forced to sell his shares in C to A below market value at a price excluding goodwill was immaterial. This was because the reduced price was said to reflect the consideration A would be willing to pay for the shares should B's loyalty come into question.<sup>71</sup>

With respect to their Lordships, the line of reasoning that the impugned clauses were conditional 'primary rights' because they did not operate as a substitute to an award of common law damages is unsatisfactory. It is artificial to characterise the clauses as simply effecting a 'price adjustment' for the potential loss of goodwill in C. This is because the impugned clauses provided for the same price adjustment irrespective of whether or not any goodwill in C was actually lost as a result of B's breach of contract.<sup>72</sup>

Accordingly, both clauses appear wholly remedial in nature: they provide A with a specified form of relief, and subject B to the corresponding sanction. The form of relief is engaged if B

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<sup>66</sup> *Cavendish* (n 5) [73] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed), a clause that forms part of the consideration to ensure a standard of performance is not a penalty.

<sup>67</sup> *Cavendish* (n 5) [74] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>68</sup> *Cavendish* (n 5) [74] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>69</sup> *Cavendish* (n 5) [79]–[83] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>70</sup> *Cavendish* (n 5) [83] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>71</sup> *Cavendish* (n 5) [81] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>72</sup> See *Talal El Makdessi v Cavendish Square Holdings* [2013] EWCA Civ 1539, [2013] 2 CLC 968 [84] (Christopher Clarke LJ with whom Patten and Tomlinson LJJ agreed).

violates A's contractual rights created under the share sale agreement. Once B commits a wrong by breaching the restrictive covenants then the impugned clauses respond to this event by: (i) extinguishing A's obligation to make significant payments to B; and (ii) conferring on A a call option which is priced on objectively generous terms. If the penalties doctrine is to be understood as applying to 'secondary rights' that provide relief or a sanction for a civil wrong, in this context the wrong being a breach of contract, then it is unclear why the penalties doctrine did not apply to the impugned clauses. Indeed, it is not to the point to observe, as their Lordships did, that the impugned clauses do not provide for a function similar to compensatory or common law damages. This is because it is circumstances where a clause does something fundamentally different from, or repugnant to, the general law's remedial regime which the penalties doctrine is seeking to prevent.<sup>73</sup> Put simply, there does not appear to be any material difference between the following clauses: (i) clause one — which 'adjusts consideration' in effect lowering the price paid by A to B by a fixed sum on B's breach of contract which is, apparently, outside of the scope of the penalties doctrine when applying the narrow approach to the classification of 'secondary rights', and (ii) clause two — which requires B to pay A a fixed sum of money on B's breach of contract which appears to be inside the scope of the doctrine.<sup>74</sup> Indeed, it is for this reason that the need for caution in directly, and uncritically, applying the reasoning of Lord Neuberger and Lord Sumption to different factual patterns has already been expressed at first instance.<sup>75</sup>

Although Lord Hodge saw some force in Lord Neuberger and Lord Sumption's conclusion that the impugned clauses in *Cavendish* were primary obligations, ultimately his Lordship<sup>76</sup> (with whom Lords Toulson and Clarke relevantly agreed)<sup>77</sup> decided the case on the basis that the penalties doctrine was engaged as the impugned clauses were characterised as providing a form of sanction or remedy for breach of contract (although their Lordships ultimately upheld the clauses on the second stage of inquiry: as the clauses were not punitive in nature, discussed further below). Their Lordships were therefore prepared to adopt a broader approach towards whether a clause is a secondary right.<sup>78</sup> Given the underlying rationale for the English penalties doctrine there is much to be said in favour of this approach. The core idea behind a secondary obligation is that it responds to wrongdoing by providing a remedy or sanction.<sup>79</sup> An award of damages for wrongdoing clearly does not exhaust the full panoply of potential secondary rights. Accordingly, it is unfortunate that the narrower test for whether an impugned clause is a secondary right posited by Lord Neuberger and Lord Sumption

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<sup>73</sup> Cross reference *Journal of Equity* Article I at [tba].

<sup>74</sup> Although note that the Court in *Cavendish* did provide dicta that the penalties doctrine may apply to clauses that do hinge on breach of a contract but are then dressed up as being *Cavendish*-style price adjustments and therefore do not look like contractual damages. *Cavendish* (n 5) [15], [32] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed) [243], [258] (Lord Hodge).

<sup>75</sup> *Vivienne Westwood* (n 9) [46], [49] (Timothy Fancourt QC), holding that a clause 'adjusting rent' by entitling A to back rent and future rent at an increased rate if B breached any material term of the lease was a 'secondary obligation' and thus attracted the operation of the penalties doctrine.

<sup>76</sup> *Cavendish* (n 5) [270], [280] (Lord Hodge).

<sup>77</sup> *Cavendish* (n 5) [291] (Lord Clarke); [292] (Lord Toulson).

<sup>79</sup> Cross reference *Journal of Equity* Article I at [tba] p 20.

appears to be, at least at the present moment, the favoured approach in the post-*Cavendish* jurisprudence.<sup>80</sup> This is a key point of principle to take away from *Cavendish*. While the adoption in *Cavendish* of a more deferential standard (discussed below) as to whether a clause is punitive has, more obviously, reduced the number of clauses that would now be considered penal. It cannot be underestimated that the narrow approach as to when the penalties doctrine is engaged has limited the scope of the doctrine, thereby reducing the range of impugned clauses that attract judicial scrutiny in the first instance. While some may welcome the further reduction in scope of the penalties doctrine, it is important that any limitations on the application of the doctrine are both coherent and capable of being applied consistently.

Finally, by way of contrast to the decision in *Cavendish*, in *ParkingEye* the Supreme Court was unanimous in its conclusion that the impugned fee engaged the penalties doctrine. The facts of *ParkingEye* are relatively simple.<sup>81</sup> A firm (A) was contracted by the owner of a retail park (C) to manage the car park related to C's premises. During the course of A's management of the car park, A levied a charge of £85 on motorists (B) if B overstayed an otherwise free of charge two hour parking limit. The details of the £85<sup>82</sup> charge were made clearly visible by some 20 signs that were described as 'large, prominent and legible, so that any reasonable user of the car park would be aware of their existence and nature'.<sup>83</sup> B left his vehicle in the car park for just under three hours and was accordingly issued with a notice requiring him to pay to A the sum of £85. B refused to pay the sum in question and so A commenced proceedings to claim its £85. B resisted A's claim on the basis that, *inter alia*, the fee constituted a penalty. It was common ground between the parties that in making use of the car park, B entered into a contract with A under which B agreed to leave the car park within two hours.<sup>84</sup> Failure to do so would constitute a breach of contract, in respect of which B agreed to pay the fixed sum of £85 to A. The Court held that the fee 'plainly engaged'<sup>85</sup> the penalties doctrine as it could only be regarded as existing as 'a charge for contravening the terms of the contract'.<sup>86</sup> Accordingly, as the fee engaged the penalties doctrine, the Court considered whether or not it was punitive in nature.

## II

### SECOND STAGE OF ANALYSIS: IS THE CLAUSE PUNITIVE?

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<sup>80</sup> This is perhaps unsurprising given their Lordships wrote the leading judgment and provided a clear holding on this issue: see the authorities outlined above (n 43).

<sup>81</sup> *ParkingEye* (n 6) [89]–[92] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [188] (Lord Mance) .

<sup>82</sup> The fee was reduced to the sum of £50 if paid early.

<sup>83</sup> *ParkingEye* (n 6) [90] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>84</sup> *ParkingEye* (n 6) [94] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>85</sup> *ParkingEye* (n 6) [99] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [193] (Lord Mance).

<sup>86</sup> *ParkingEye* (n 6) [94] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

i. *Restatement of the Australian Penalties Doctrine: Application of the Legitimate Interest Standard in Equity*

Once the penalties doctrine is engaged the next stage of the inquiry is to consider whether the impugned clause is punitive in character. A contentious issue in the law of penalties that was resolved by the High Court of Australia in *Paciocco* was the status of pre-*Andrews* jurisprudence for determining whether or not a clause was punitive. In *Andrews*, the Court observed that its reformulation for when the penalties doctrine was engaged concerned the threshold issue of when a clause was a *prima facie* penalty. As the Court observed, its reformulation of the penalties doctrine concerned the ‘anterior stage of analysis — identification of those criteria for when the penalties doctrine is engaged’.<sup>87</sup> The resolution of the issue as to the proper anterior stage of inquiry raised the question of what is the proper posterior analysis once the penalties doctrine is *prima facie* applicable? The answer to this question was provided in *Paciocco* in the following terms: if A’s right to a fixed sum is characterised, at the time of entry into the contract, as existing to facilitate or protect A’s legitimate or commercial interests it is wholly enforceable.<sup>88</sup> That is to say, the purpose of this external norm is to elucidate the extent to which A’s right is legitimate. Thus this standard can be satisfied notwithstanding A’s right to the fixed sum not being a genuine pre-estimate of loss that A would suffer from a breach of contract, or failure of a contractual stipulation, on the application of the guidelines set out by Lord Dunedin in *Dunlop*.<sup>89</sup> Here a clear convergence between English and Australian law can be seen as a similar test for whether or not a contractual clause is punitive had been adopted by the Supreme Court in *Cavendish*.

Returning to the substantive reasoning in the *Paciocco* litigation, as Allsop CJ (with whom Besanko and Middleton JJ agreed) observed in the Full Court of the Federal Court, ‘[t]he

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<sup>87</sup> *Andrews* (n 3) [15] (French CJ, Gummow, Crennan, Kiefel and Bell JJ).

<sup>88</sup> *Paciocco Full Court of the Federal Court* (n 14) [99]–[103] (Allsop CJ). McFarlane (n 26) [13.013]; and Nicholas A Tiverios, ‘Doctrinal approaches to the law of penalties: A post-*Andrews* intention-based defence of relief against fixed contractual penalties’ in Simone Degeling, James Edelman and James Goudkamp (eds), *Contract in Commercial Law* (Lawbook 2016) 489. Although, Nettle J in *Paciocco High Court of Australia* (n 4) [322] dissented on the application of these principles: his Honour applying the *Dunlop* principles in *Paciocco* but remaining open to applying the legitimate interest standard in ‘more complex types of cases’.

<sup>89</sup> *Dunlop* (n 23) 86–8 (Lord Dunedin) paraphrased by Nettle J in *Paciocco High Court of Australia* (n 4) [317] as follows: “(1) whether the contract describes the payment as a penalty or liquidated damages is not decisive; (2) the essence of a penalty is a payment “*in terrorem*” (which in this context means to deter the offending party from committing the breach), whereas the essence of liquidated damages is a genuine pre-estimate of damage; (3) the question is one of “construction” (more accurately, of characterisation) of the terms of the contract having regard to the inherent circumstances of the contract at the time the contract was made; (4)(a) the agreed sum will be held to be a penalty if it is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach; (4)(b) the agreed sum may be held to be a penalty where the breach consists only in not paying a sum of money and the stipulated sum is greater than the sum which ought to have been paid; (4)(c) there is a presumption that a single lump sum is a penalty if it is payable on the occurrence of one or more of several events of which some may occasion serious damage and others do not; and (4)(d) where the consequences of breach make the precise pre-estimate of damage almost impossible, it is more probable that an agreed sum is a penalty than where the damage is capable of precise estimation”. See *Ringrow*, above n 36, at [32] per Gleeson CJ, Gummow, Kirby Hayne, Callinan and Heydon JJ.

object of and purpose of the doctrine of penalties is vindicated if one considers whether the agreed sum is commensurate with the interest protected by the bargain'.<sup>90</sup> His Honour's formulation proved influential in the High Court.<sup>91</sup> As Kiefel J (with whom French CJ agreed)<sup>92</sup> said, the appropriate test was to consider:<sup>93</sup>

whether a provision for the payment of a sum of money on default is out of all proportion to the interests of the party which it is the purpose of the provision to protect. This interest may be of a business or financial nature.

Similarly, Keane J too noted that the critical issue in ascertaining whether an impugned fixed sum clause was punitive and thus enforceable only by way of security was to consider whether the sum was protective of A's legitimate interests in the performance of the bargain.<sup>94</sup> Likewise, Gageler J, paraphrasing the decision of Wilson J in *O'Dea v Allstates Leasing System (WA) Pty Ltd*,<sup>95</sup> framed the inquiry as whether the impugned stipulation:<sup>96</sup>

can be considered to be a 'genuine pre-estimate of [A's] ... probable or possible interest in [B's] due performance of the principal obligation ... or "whether it is a penalty inserted 'merely to secure the enjoyment of a collateral object.

In *Paciocco* the existence of legitimate interests was the reason why late payment fees on credit card accounts were characterised as not existing *merely* to secure performance of a primary obligation and therefore the fees were fully enforceable.<sup>97</sup> As a simplified example,<sup>98</sup> a Bank (A) provides a consumer (B) with a credit card account. The terms of the account

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<sup>90</sup> *Paciocco Full Court of the Federal Court* (n 14) [103] (Allsop CJ). See also at [137], [147], [163]–[165], [176]–[170], [177] (Allsop CJ).

<sup>91</sup> The reasoning of Allsop CJ also proved influential in the reasoning of Supreme Court in *Cavendish* (n 5) see text at (n 102).

<sup>92</sup> *Paciocco High Court of Australia* (n 4) [2] (French CJ).

<sup>93</sup> *Paciocco High Court of Australia* (n 4) [29], [57], [58] (Kiefel J). There has been a renewed interest in the aspects of the decision in *Dunlop* (n 23) 88–89 (Lord Dunedin), 91 (Lord Atkinson); 103 (Lord Parmoor), which focused not just on A's potential loss on failure of the secure stipulation but rather on A's commercial or legitimate interests in the performance of the contract. See also Tiverios (n 88) 465–7.

<sup>94</sup> *Paciocco High Court of Australia* (n 4) [270] (Keane J).

<sup>95</sup> [1983] HCA 3, (1983) 152 CLR 359, 383 (Wilson J).

<sup>96</sup> *Paciocco High Court of Australia* (n 4) [157] (Gageler J). See at [165], framing the inquiry this way allows identification of whether the clause functions beyond having a punitive operation.

<sup>97</sup> *Paciocco High Court of Australia* (n 4) [58], [69] (Kiefel J); [141]–[143], [172]–[177] (Gageler J); [271]–[279] (Keane J). See too *Paciocco Full Court of the Federal Court* (n 14) [163]–[165], [176]–[170], [177] (Allsop CJ), his Honour also referred to the difficulty of assessing damages that would result from B's breach of contract: at [183]. Similar reasoning, focusing on, provisioning costs and regulatory capital costs, was adopted in upholding a like clause in *Arab Bank Australia Ltd v Sayde Developments Pty Ltd* [2016] NSWCA 328 [23], [26], [29], [90]–[95] (McDougall J with whom Gleeson JA and Sackville AJA agreed).

<sup>98</sup> *Paciocco High Court of Australia* (n 4) [11]–[12] (Kiefel J).

oblige B to make minimum monthly repayments to A on a set date. The terms of the account further provide that A can charge B the sum of \$35<sup>99</sup> if she fails to make her obliged repayment on time. Here the late payment fee was justifiable on the basis that, properly characterised, it served multiple legitimate interests, being: (i) preserving the value of the book debts owed to A in global terms by discouraging a default because a borrower in default has a greater credit risk than before default;<sup>100</sup> (ii) preserving A's capital as A is required under prudential regulations to hold a sum of 'regulatory capital', which increases when A's assets become impaired, resulting in such capital becoming unavailable to earn normal banking returns; (iii) the operational costs associated with chasing payment from bad debtors (e.g. the costs of A hiring staff in order to contact borrowers in B's position).

As the Australian test at this stage of inquiry is similar to that at English law, the outcome of the decisions in *Cavendish* and *ParkingEye* will be outlined before commenting on the implications of the new test for whether a clause is punitive in operation.

ii. *Restatement of the English Penalties Doctrine: Application of the Legitimate Interest Standard at Common Law*

Post-*Cavendish* a right to a fixed sum is clearly enforceable despite the clause not being a genuine pre-estimate of loss on the application of the classic *Dunlop* formulation for whether a clause is punitive in character.<sup>101</sup> As Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) said, the true test for whether the penalties doctrine is engaged requires consideration of 'unconscionability' and 'exorbitance' by reference to the following external norm:<sup>102</sup>

whether the impugned provision is a secondary obligation which imposes a detriment on [B] out of all proportion to any legitimate interest of [A] in the enforcement of the primary obligation.

The test posited by Lord Hodge (with whom Lord Clarke agreed) was functionally the same.<sup>103</sup>

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<sup>99</sup> Note that A had a contractual power to set the fee from time to time. Accordingly, the fee was in the sum of \$20 for a portion of the relevant period. Although this fact was not material to the outcome in the case: *Paciocco High Court of Australia* (n 4) [12] (Kiefel J); [82] (Gageler J).

<sup>100</sup> See further the similar conclusions reached in the cases discussed by Lord Mance in *Cavendish* (n 5) [146]–[148].

<sup>101</sup> Although the approach adopted in *Cavendish* can be seen as an extension of the more deferential test that allowed a non-compensatory fixed sum clause to be enforced provided there was a 'commercial justification' for its imposition: set out by Coleman J in *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752, 764; and see too *Murray v Leisureplay Plc* [2005] IRLR 946.

<sup>102</sup> *Cavendish* (n 5) [22], [28], [31]–[32] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>103</sup> *Cavendish* (n 5) [255] (Lord Hodge).

the correct test for a penalty is whether the sum or remedy stipulated as a consequence of [B's] breach of contract is exorbitant or unconscionable when regard is had to [A's] interest in the performance of the contract.

Similarly, Lord Mance observed that '[A's] commercial interests may justify the imposition upon [B's] breach of contract of a financial burden which cannot either be related directly to loss caused by the breach or justified by reference to the impossibility of assessing such loss'.<sup>104</sup>

In *Cavendish*, both clause 5.1 (concerning A's ability to withhold payments otherwise due to B on B's breach of a restrictive covenant) and clause 5.6 (concerning A's power to acquire B's remaining shares in C on B's breach of a restrictive covenant) were held to be commensurate with A's legitimate interests. The Court unanimously held that clause 5.1 was not a penalty as it served a 'legitimate interest', as the fee was not out of all proportion to achieving the principal purposes of:<sup>105</sup> (i) ensuring the maintenance of the value of goodwill in C, which was particularly important because a 'large proportion' of C's value was attributable to goodwill and because interpersonal relationships were central to the long-term viability and competitiveness of any advertising company operating in the markets in which C competes; (ii) protecting the value of the shares in C which B had already sold to A; (iii) deterring B from engaging in even a minor breach of the restrictive covenants, as even a minor breach could have a significant financial impact on the value of A's shareholding, as the Court observed: B's loyalty was indivisible, once it was lost the prejudice that could be caused to the value of the shares in C was considerable.<sup>106</sup> Two further interests were identified to support the validity of clause 5.6 (the forced transfer of shareholding provisions), being:<sup>107</sup> (i) the need for the parties quickly to decouple their business relationship once that relationship had broken down due to a breach of the restrictive covenants; and (ii) given that the English penalties doctrine wholly voids clauses, the Court expressed its concern that wholly voiding a contractual power to acquire shares would considerably alter the overall structure of the parties' bargain.

Finally, the Court in *Cavendish* emphasised that the bargaining position of the parties was a relevant contextual factor in deciding whether a fixed remedy clause was commensurate with the interests which the clause sought to protect. The Court observed that where the impugned clause was agreed upon by sophisticated parties acting on legal advice it would be appropriate to afford greater deference to party autonomy. Thus the Court observed that the impugned clauses had been agreed by parties that were 'sophisticated, successful and experienced

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<sup>104</sup> *Cavendish* (n 5) [145], [152] (Lord Mance).

<sup>105</sup> See *Cavendish* (n 5) [75] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [180]–[181] (Lord Mance); [270]–[279] (Lord Hodge). Although not cited in *Cavendish* the same conclusion was reached, and similar reasoning employed, in the somewhat analogous case of *Reynolds v Bridge* (1856) 6 El & Bl 528, 119 ER 961. Although decided under the interpretive-based approach, the sum of £2000 in favour of A to secure B's performance of restrictive covenants in the sale of a medical practice conducted as a partnership between A and B was held to be fully enforceable.

<sup>106</sup> Note the court rejected the submissions that this would result in overcompensation.

<sup>107</sup> See *Cavendish* (n 5) [81]–[82] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [185] (Lord Mance); [281]–[282] (Lord Hodge).

commercial people bargaining on equal terms over a long period with expert legal advice'.<sup>108</sup> Although it is hard to know what weight to ascribe to the parties' bargaining position,<sup>109</sup> or indeed whether such factors were essential to the reasoning in *Cavendish*, the bargaining position of the parties has nonetheless been widely used as a contextual factor informing the application of the legitimate interest standard in the post-*Cavendish* jurisprudence.<sup>110</sup> However, it is important not to overstate the importance of the parties' bargaining position in determining the proper characterisation of an impugned clause. It still remains possible for a clause to be punitive notwithstanding that two commercial, and well-advised, parties have agreed it.<sup>111</sup>

Consistently with the outcome in *Cavendish*, the impugned fee in *ParkingEye* was also held to be commensurate with A's legitimate interests. In *ParkingEye*, A levied a £85 charge on B if B overstayed a free of charge two hour parking limit. It was common ground between the parties that in making use of the car park, B entered into a contract with A under which B agree to leave the car park within two hours. Failure to do so would constitute a breach of contract, in respect of which B agreed to pay the fixed sum of £85 to A. The Court held that the fee was not punitive in nature as it had served a 'legitimate interest', as the fee was characterised as having the principal purposes of: (i) deterring motorists from abusing the car park by staying beyond the period of free parking and thus facilitating a turnover of potential consumers for the attached retail premises; and (ii) enabling A (the parking services provider) to properly administer the free parking scheme (which included a profit motive).<sup>112</sup>

### iii. *A brief comment on the legitimate interest standard*

At this second stage of the three-stage analysis as to whether an impugned clause is a penalty, a convergence between English and Australian law can be seen. Thus there is still some utility in engaging in a comparative analysis of cases on this point between the two jurisdictions. The clearest way of contrasting the tests set out in *Cavendish* and *Paciocco* with the earlier test in *Dunlop* is as follows. The two tests create different external norms under which an impugned clause can be assessed to determine whether or not the clause is punitive in character. The earlier *Dunlop* guidelines can be seen as imposing a stricter standard of judicial scrutiny: the role of the court is to compare the sum fixed by a clause with the consequence which would flow from a hypothetical breach of contract at the time of entry into the contract (or a hypothetical failure of a secured stipulation applying *Andrews*). The new *Cavendish* and *Paciocco* tests can be seen as overriding this earlier test with a weaker

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<sup>108</sup> *Cavendish* (n 5) [75] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [152], [181] (Lord Mance); [282] (Lord Hodge).

<sup>109</sup> An observation also noted in Andrew Summers, 'Unresolved issues in the law on penalties' [2017] LMCLQ 95, 115.

<sup>110</sup> *Richards* (n 43) [85] (May J); *Gray* (n 44) [107]–[108] (Lord Brodie); [124] (Lord Malcolm); *First Personal Services Limited v Halfords Limited* [2016] EWHC 3220 (Ch) [162] (Jeremy Cousins QC); *In re B (Children)* (n 41) [66] (McFarlane LJ).

<sup>111</sup> See *Vivienne Westwood* (n 9) [65] (Timothy Fancourt QC).

<sup>112</sup> *ParkingEye* (n 6) [98]–[99] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [197]–[198] (Lord Mance); [286] (Lord Hodge).

form of judicial scrutiny: the role of the court is to assess whether the sum fixed by the clause is out of all proportion with A's legitimate interests in the enforcement of the related primary obligation (and also the fulfilment or performance of a secured stipulation in Australia). Put simply, this weaker form of judicial scrutiny imposes a 'high hurdle'<sup>113</sup> on those asserting that a clause is a penalty.

The more deferential standard of judicial scrutiny set out in *Cavendish* and *Paciocco* is justifiable on the basis that the Court should in general be reluctant to limit the parties' powers to set the terms of consensually created rights and obligations.<sup>114</sup> Ultimately, this deference acknowledges that any injustice that B suffers from the operation of a fixed remedy is, in part, a result of those consent-based obligations that would have not come into existence in the first place without B's prior assent. That is, any injustice in this context is an injustice that has been voluntarily assumed by B. Further, greater deference to party autonomy acknowledges that the enforcement of a fixed remedy clause has an inherent utility for both A and B in limiting A's need to engage in uncertain and expensive arbitration or litigation to vindicate her rights.<sup>115</sup> Although this deferential standard will result in fewer clauses infringing the penalties doctrine, subsequent jurisprudence has illustrated that the deferential standard can still bite.<sup>116</sup> Indeed, a residual benefit in retaining the penalties doctrine, albeit in a more limited form, is that maintaining the spectre of a potential legal challenge to a purported penalty clause may continue to help facilitate reasonable pre-contractual behaviour.<sup>117</sup> That is, the continuing existence of the weaker form rule will ensure a base-level modicum of pre-contractual reasonableness and cooperation in assessing the amount B ought to pay to A should the event which gives rise to the fixed remedy materialise. Finally, what is the relationship between the *Dunlop* test and the *Cavendish/Paciocco* test? Although

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<sup>113</sup> *Paciocco Full Court of the Federal Court* (n 14) [400] (Middleton J). See too *Australia Capital Financial Management Pty Ltd* (n 9) [345] (Ward JA).

<sup>114</sup> See *Cavendish*, (n 5) [33], [35] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); *Gray* (n 44) [107] (Lord Brodie); *Phillips Hong Kong v A-G of Hong Kong* (1993) 61 BLR 41 (PC) 59 (Lord Woolf); *Arab Bank Australia* (n 97) [105] (McDougall J with whom Gleeson JA and Sackville AJA agreed). For a powerful moral defence of party autonomy in contract see Jeremy Bentham, *Defence of Usury*, Bk 1 (4th edn, Payne and Foss 1818) [5]. See too the influential, and famous, defence of the policy of freedom of contract in *Printing and Numerical Registering Company v Sampson* (1874-75) LR 19 Eq 462, 465 (Sir George Jessel MR).

<sup>115</sup> *Paciocco High Court of Australia* (n 4) [284] (Keane J). Hugh Beale, 'Damages' in Hugh Beale (ed), *Chitty on Contracts: Volume 1 General Principles* (31st ed, Sweet & Maxwell 2012) [26-171].

<sup>116</sup> *First Personal Services* (n 110) [163] (Jeremy Cousins QC); *Hayfin* (n 43) [140] (Snowden J); and *Vivienne Westwood* (n 9) [65] (Timothy Fancourt QC). See too the dissenting judgment of Lord Menzies in *Gray* (n 44) [87].

<sup>117</sup> A similar point, albeit in the context of potential challenges to the remuneration of court appointed officers, is made in Nicholas A Tiverios, 'Raiders of the secured asset: The doctrinal rationalisation for the liquidator's lien or charge over a secured asset post-Stewart v Atco' (2015) 23 ILJ 101, 114. See too Elisabeth Peden and J W Carter, 'A Good Faith Perspective on Liquidated Damages' in Charles E F Rickett (ed), *Justifying Private Law Remedies* (Hart Publishing 2008) 152: 'the rules which make up the law of penalties have been formulated to ensure that only honest-estimations are effective to liquidate damages'. See also Chris Rossiter, *Penalties and Forfeiture: Judicial Review of Contractual Penalties and Relief against Forfeiture of Proprietary Interests* (Lawbook 1992) 13 'where the penalty was inserted simply as means of securing performance of the covenant, there being no attempt on the part of the parties to assess the real damage. Equity relieved against the penalty'.

Lord Neuberger and Lord Sumption suggested that the principles set out by Lord Dunedin in *Dunlop* might still be relevant in deciding simple penalties cases or as a fall back position,<sup>118</sup> it is telling that the norm for whether a clause is penal as applied and set out in *Cavendish* and *Paciocco* has been the universal approach applied in the subsequent jurisprudence in both jurisdictions.<sup>119</sup>

There are two further important observations to take from the reformulation of the test for whether or not a clause is punitive in character. The first observation is that both in Australia and in England, the question of whether a clause is a penalty is a question of construction to be determined wholly at the time of entry into the contract.<sup>120</sup> However, a ‘legitimate interest’ test engages with broader social and economical considerations than a ‘commercial justification’ test or by adopting the *Dunlop* approach of contrasting the sum in a fixed remedy clause to the likely loss flowing from the related breach of contract or failure of a contractual stipulation.<sup>121</sup> While there is no conceptual difficulty with A’s right existing to further broader social and economic considerations, it remains to be seen to what extent there are limitations on a party relying on a particular interest to support the validity of a fixed sum remedy. Or put another way, how does a court determine what interests are legitimate or illegitimate? The High Court in *Paciocco* took a broad approach to the identification of A’s legitimate interests, accepting A’s evidence as to the objectively discernable ‘inherent circumstances’ persisting at the time the contract was entered into.<sup>122</sup> Looking at the ‘inherent circumstances’ at the time of entry into the contract appears somewhat broader than, for example, requiring the interests to be within the contemplation of the reasonable person in the position of the parties at the time the contract was entered into. It would be difficult to argue that all of the legitimate interests relied upon by A in *Paciocco* were ascertainable to a reasonable consumer in B’s position at the time of entry into the contract. Considering that the evidentiary and persuasive onus is on B<sup>123</sup> to demonstrate that a clause is a penalty, the combination of the legitimate interest test and onus will create a significant procedural barrier to B successfully arguing that an impugned clause is punitive in character.

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<sup>118</sup> *Cavendish* (n 5) [31]–[32] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>119</sup> *Richards* (n 43) [85] (May J); *Hayfin*, (n 43) [133]–[135] (Snowden J); *Browns Bay Resort* (n 43) [9] (Lord Hodge); *Gray* (n 44) [84] (Lord Menzies); [108] (Lord Brodie); [123]–[125] (Lord Malcolm); *First Personal Services* (n 110) [161]–[162] (Jeremy Cousins QC); *Pencil Hill Ltd v US Citta Di Palermo SpA* (HC, 19 January 2016) para 24–25 (Bird J). *Sydney Constructions* (n 9) [45]–[52] (Barrett AJA); *Wu v Ling* [2016] NSWCA 322 [1] (Leeming JA); [21] (Payne JA); [117]–[123] (Bergin CJ in Eq); *Arab Bank Australia* (n 97) [69]–[112] (McDougall J); *Vivienne Westwood* (n 9) [54]–[65] (Timothy Fancourt QC); *Magnin* (n 9) [10]–[12] (Harrison J); *Australia Capital Financial Management Pty Ltd* (n 9) [311], [336], [339], [358], [371] (Ward JA).

<sup>120</sup> The Court did not allow evidence of the post-contract conduct to influence whether or not a clause is a penalty when applying the legitimate interest standard.

<sup>121</sup> See *Cavendish* (n 5) [28]–[29] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [152] (Lord Mance); [249] (Lord Hodge); and *Australia Capital Financial Management Pty Ltd* (n 9) [369] (Ward JA).

<sup>122</sup> *Paciocco High Court of Australia* (n 4) [31], [66] (Kiefel J); [148] (Gageler J); [273] (Keane J).

<sup>123</sup> *Paciocco High Court of Australia* (n 4) [167] (Gageler J); *Magnin* (n 119) [10] (Harrison J); and *Australia Capital Financial Management Pty Ltd* (n 9) [357] (Ward JA).

A more principled approach may be to require any legitimate interests ultimately relied upon by A to be ascertainable by a reasonable person in the position of the parties at the time the contract was entered into. This approach would make sure that any such interests are indeed the ‘legitimate’ reasons why the impugned clause was inserted into the bargain, thus making sure that the interests relied upon are indeed legitimate and are not merely *ex post facto* concoctions created by legal advisors in the process of drafting pleadings and submissions. Put simply, on this approach, the legitimate interests must be discernable to a reasonable person in the parties’ or B’s position at the time of entry into the contract. This would seem to fit more closely with the approach in *Cavendish* where the Court placed an emphasis on the factual matrix underpinning the contract and the common ground between the parties,<sup>124</sup> and even in *ParkingEye* the Court emphasised the references in the relevant signage at the carpark setting out the contractual terms that notified B that a ‘Parking Maximisation Scheme’<sup>125</sup> was in place. As Lord Neuberger and Lord Sumption said:<sup>126</sup>

the penal character of a clause depends on its purpose, which is ordinarily an inference from its effect. ... this is a question of construction, to which evidence of the commercial background is of course relevant in the ordinary way.

Thus small potential differences between discerning what interests are legitimate may illustrate a subtle divergence between the application of the legitimate interest standard in Australia and England.

The second observation is that both *Cavendish*<sup>127</sup> and *Paciocco*,<sup>128</sup> and subsequent jurisprudence<sup>129</sup> in both jurisdictions, reinforce the impermissibility of A adducing, or relying on, relevant *ex post facto* evidence to justify the existence of the impugned clause. Any legitimate interest on which A seeks to rely must have existed at the time A and B entered into the relevant bargain and not: (i) at the time of B’s breach of contract; (ii) when the secured stipulation failed (in Australia only); or (iii) at the time when the curial process is

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<sup>124</sup> See *Cavendish* (n 5) [28] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed).

<sup>125</sup> *ParkingEye* (n 6) [91] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [197] (Lord Mance). Although on this construction based approach it can be queried to what extent in *ParkingEye* could B reasonably be assumed to know about the business structure underpinning the carpark.

<sup>126</sup> *Cavendish* (n 5) [28] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed). See too at [99] ‘[t]his conclusion is reinforced when one bears in mind that the question whether a contractual provision is a penalty turns on the construction of the contract, which cannot normally turn on facts not recorded in the contract unless they are known, or could reasonably be known, to both parties’; and [272] (Lord Hodge).

<sup>127</sup> *Cavendish* (n 5) [9], [28], [99] (Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed); [243] (Lord Hodge).

<sup>128</sup> *Paciocco High Court of Australia* (n 4) [31], [66] (Kiefel J); [146] (Gageler J); [273] (Keane J).

<sup>129</sup> *Wu* (n 119) [120] (Bergin CJ in Eq with whom Leeming and Payne JJA agreed); *Gray* (n 44) [112] (Lord Brodie); [125] (Malcolm); *Hayfin* (n 43) [137] (Snowden J); *Arab Bank Australia* (n 97) [81], [87] (McDougall J with whom Gleeson JA and Sackville AJA agreed); and *Australia Capital Financial Management Pty Ltd* (n 9) [329]–[331], [336], [371] (Ward JA).

engaged to enforce the clause in question. This approach to discerning legitimate interests makes clear conceptual sense on the English approach. This is because on the common law approach a penal clause is wholly void. The parties thus ought to know where they stand at the point of time that contractual relations have been entered: is the clause void or enforceable? It would be an odd result if the changing tides of A's legitimate interests once a contract has been entered had the result of an impugned clause constantly shifting between validity and invalidity. For example, if the 'time of entry' approach is taken seriously, the outcome in *Cavendish* on the penalties question would not have been different if an external event, which was not covered by the restrictive covenants (e.g. a moral scandal effecting B's business standing in the Middle East), had already destroyed most of the goodwill in the company *after* the contract had been entered into but *before* the relevant breach of the restrictive covenant occurred. In such circumstances the interests protected by the impugned clauses (being the goodwill), would have been non-existent by the time B breached the contract. Yet the agreed contractual remedies hinging on this breach would have still been wholly enforceable on a strict application of the test adopted by the Court.

In contrast to the current English approach, several academics have argued that under a more 'equitable' approach to penalties, the court should depart from an inquiry that focuses solely on whether a clause is penal at the time of entry into the contract. Rather, it is suggested that the court ought to consider circumstances arising after contractual relations have been created to determine whether or not a clause is punitive in character, thus facilitating an *ex post facto* inquiry.<sup>130</sup> More specifically, on this approach, the focus ought to be on those circumstances existing at the time A seeks to enforce her legal right against B in order to determine whether the impugned clause is punitive in character given the circumstances of the case. The impetus for adopting this approach appears to be a perceived need to further reconcile the modern rule against penalties with (i) the related principles concerning relief against forfeiture which allow for *ex post facto* evidence,<sup>131</sup> and (ii) the more ancient Chancery authorities that granted relief from a penalty because A's right against B was enlivened by B's *subsequent* misfortune. Namely, A's right against B is enlivened because of B's *ex post facto* mistake, accident or hardship (these cases were discussed in Part I of this article).<sup>132</sup> Australian law has, thus far, eschewed a return to a 'time of enforcement' assessment as to whether a clause is punitive.

A 'time of enforcement' or *ex post facto* approach to determining whether a clause is punitive was not adopted by the High Court in *Paciocco* nor has it been accepted in subsequent jurisprudence.<sup>133</sup> Indeed, *ex post facto* evidence at this stage of inquiry has been a point of

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<sup>130</sup> Rossiter (n 117) 153–4; and McFarlane (n 26) [13-002], where it is noted that “there is no obvious doctrinal or policy reason for maintaining English law’s clear distinction between penalties and forfeiture jurisdictions”. This approach does have a basis in legal history: cross reference *Journal of Equity* Article I at [tba] p 7.

<sup>131</sup> As discussed in *Australia Capital Financial Management Pty Ltd* (n 9) [325]–[331] (Ward JA).

<sup>132</sup> Insert cross reference to Part I. [tba]

<sup>133</sup> See above, n 129.

error for first instance judges.<sup>134</sup> Thus Australian law, like that in England, still considers whether the clause is punitive in character solely at the time of entry into the contract. Although relief against penalties and relief against forfeiture are closely related,<sup>135</sup> there remains a ‘real distinction’ between the doctrines.<sup>136</sup> As Ward JA, echoing Hoffmann LJ,<sup>137</sup> recently observed in *Australia Capital Financial Management Pty Ltd*:<sup>138</sup>

The penalties doctrine requires characterisation of an impugned stipulation by reference to the circumstances as *at the time of entry* into the contract ... but the forfeiture doctrine focuses upon the nature of the forfeiture which occurs *ex hypothesi after* the time of entry into the contract.

The continuing characterisation of a penalty at the ‘time of entry’ into the contract is a welcome outcome of *Paciocco* and the subsequent jurisprudence for two brief reasons. The *first* reason, as set out in Part I of this article,<sup>139</sup> is that there is no perfectly consistent historical theorisation for why the Lord Chancellor gave relief against a penalty. Different rationales for the penalties doctrine have existed at different points in time in English and Australian legal history. Put simply, legal history does not compel Australian courts to maintain a residual jurisdiction to relieve against an otherwise valid clause simply on the basis of B’s subsequent misfortune as adjudged at the time A seeks to enforce her legal rights. The *second* reason is that, as noted above, the parties and their legal advisors ought to know where A and B stand at the point of time they enter into the contract. The whole point of a valid fixed remedy clause is to plan for what ought to happen in the event that the relevant secured stipulation fails. Thus the utility of all fixed remedies would be undermined if circumstances wholly external and unforeseeable to A, such as B’s subsequent misfortune, limited A’s ability to enforce her otherwise justifiable fixed sum clause against B.

### III

#### THIRD STAGE OF ANALYSIS: REMEDIAL CONSEQUENCES

##### i. *Restatement of the Australian Penalties Doctrine: Remedial Consequences of a Finding that a Clause is Penal*

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<sup>134</sup> See for example, in the United Kingdom (albeit a Scots law context), *Gray* (n 44), the Court split on the application of the legitimate interest test, Lord Menzies (dissenting) [84] took into account factors *after* the contract had been entered into. Namely the increased value of certain shares. Whereas Lord Brodie [111] and Lord Malcolm [125] expressly rejected this approach to hold that the impugned clause was valid. In Australia, see *Arab Bank Australia* (n 97) [81], [87] (McDougall J with whom Gleeson JA and Sackville AJA agreed).

<sup>135</sup> Indeed, this is why these two doctrines were described as being species of law in the same genus in Part I of this Article. The two doctrines are closely related but remain distinct.

<sup>136</sup> *Australia Capital Financial Management Pty Ltd* (n 9) [325]–[331] (Ward JA).

<sup>137</sup> *Else (1982) Ltd v Parkland Holdings Ltd* [1994] 1 BCLC 130 (CA) 144 (Hoffmann LJ).

<sup>138</sup> *Australia Capital Financial Management Pty Ltd* (n 9) [326] (Ward JA) citations omitted.

<sup>139</sup> Insert cross reference to Part I. [tba]

As the High Court observed in *Andrews*, because the penalties doctrine is engaged where A has a right against B that secures the occurrence of a primary stipulation or obligation, it is axiomatic that in order for A's exercise of a punitive security right to be restrained, it must be possible for B to provide for the satisfaction of the secured stipulation.<sup>140</sup> B can achieve this in one of two ways. Importantly, both modes of satisfaction are illustrative of B 'making good' on the *original* or *primary* intent of the parties' bargain: the *performance* of the underlying secured primary stipulation or obligation. The *first* mode of satisfaction is the actual performance, or the closest thing to actual performance, of the primary stipulation or obligation (specific relief such as an injunction or decree of specific performance). The *second*, and more common, mode of performance is payment by B to A for the loss or prejudice suffered by A as a result of the failure of the primary stipulation (including interest and any related costs of recovery thereby returning A to the position she would have been had the primary stipulation been performed or fulfilled).

In *Andrews* the High Court emphasised that a monetary payment by B to A for the failure of the primary stipulation will be compensatory: the court will only relieve B from a penalty where it is possible to award A compensation for the prejudice suffered by the occurrence or non-occurrence of the primary stipulation. In short, because the obligation to pay damages is a monetised form of the primary stipulation, A cannot enforce a right intended to function as a mere security for performance of the primary stipulation beyond the compensatory amount without a contradiction arising. Presumably there would be only limited circumstances in which a court could not fix a sum to compensate A for the failure of a primary stipulation, as the judicial trend over the past century has been to expand the types of losses that are recoverable under the general law.<sup>141</sup> Importantly, at this stage of the inquiry it is clear that *ex post facto* evidence from the time of entry into the contract will be relevant for either assessing: (i) the monetary value of A's secured contractual right *at the time performance was due*; or (ii) the loss or prejudice suffered by A for the failure of the primary stipulation or obligation.

As a final caveat, it should be noted that a security rights analysis of the penalties doctrine should not exclusively depend on the compensatory principle to value the 'secured' stipulation or obligation. Indeed some care must be made in referring to the expression that the availability of compensation in penalties cases is the equity on which the court intervenes. This caution is required for two reasons. First, equity and the common law do not always value a breach of obligation (including the breach of a contractual obligation)<sup>142</sup> in compensatory terms.<sup>143</sup> For example, it would be unlikely that relief would be granted from

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<sup>140</sup> *Andrews* (n 3) [40]–[44] (French CJ, Gummow, Crennan, Kiefel and Bell JJ). See too *Paciocco High Court of Australia* (n 4) [23] (Kiefel J with whom French CJ agreed).

<sup>141</sup> See JD Heydon, MJ Leeming and PG Turner, *Meagher, Gummow & Lehane's Equity: Doctrines & Remedies* (5th ed, LexisNexis Butterworths 2015) [18-160].

<sup>142</sup> Cross reference *Journal of Equity* Article I at [tba].

<sup>143</sup> A good example being a trustee's liability to restore a trust fund *in specie* for a misapplication of trust funds rather than require a trustee to compensate the trust for the consequential loss suffered by the misapplication: see *Agricultural Land Management Ltd v Jackson [No 2]* (2014) 48 WAR 1, [339] [347]–[348] (Edelman J) *contra* the position adopted in *AIB Group (UK) plc v Mark Redler & Co Solicitors* [2015] AC 1503, for a discussion of these conflicting cases see Nicholas A Tiverios and C

the enforcement of a profit-stripping fixed remedy clause in a company director's (B) employment contract designed to secure the performance of B's duties of trust and confidence simply on the grounds that compensation for loss was paid by B to A for such a breach. Second, care should be taken in giving an overly literal reading to references in old Chancery penalties cases to 'compensation'. Such statements are derived from a period when the law of remedies was under-theorised and generally a question of fact to be determined by a jury.<sup>144</sup>

ii. *Restatement of the English Penalties Doctrine; Remedial Consequence of a Finding that a Clause is Penal*

The remedial consequence of applying the English approach if a clause is found to be a penalty is that the clause is void and the parties are left to the remedial regime available at general law. It should be noted that this was a clear policy choice made by the Supreme Court in *Cavendish* to further develop English law in this direction.<sup>145</sup> That is because the penalties doctrine in England historically scaled down the strict operation of penalty clauses at common law by applying equitable principles.<sup>146</sup> Indeed, Australia is not an outlier in allowing for a *pro tanto* application of a penal clause. Other jurisdictions without dualist legal systems or an equitable rule against penalties typically allow for a *pro tanto* scaling down of penal clauses. For example, Scots law<sup>147</sup> and many civilian jurisdictions,<sup>148</sup> allow for a penalty clause to have a scaled down operation. Further, it is arguable that the Australian approach of scaling down the operation of a penalty clause interferes less with the parties' powers to create mutually binding rights and obligations. This is because a 'scaling down' approach at least attempts to give some limited effect to what the parties have actually agreed rather than rendering it void.

Finally, there is one emerging trend in the English cases which is worth noting: by expressly removing the possibility of giving a penalty clause a *pro tanto* application courts are reluctant

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McKay, 'Orthodoxy lost: The (ir)relevance of causation in quantifying breach of trust claims' (2016) 90 ALJ 231. See also James Edelman, 'In Defence of Exemplary Damages' James Edelman, 'In Defence of Exemplary Damages' in Charles E F Rickett (ed), *Justifying Private Law Remedies* (Hart Publishing 2008) 225.

<sup>144</sup> Andrew Burrows, 'Damages and Rights' in Donal Nolan and Andrew Robertson (eds) *Rights and Private Law* (Hart Publishing, 2011) 276. This was because the quantum of a damages award was historically an issue for the jury to determine. See further, John H Baker, *Oxford History of the Laws of England: Volume VI 1483–1558* (OUP, 2003–2012) 41; and William Blackstone, *Commentaries on the Law of England* (Vol II) (1766) 438: damages are described as 'given to a man by a jury, as a compensation and satisfaction for some injury sustained'. For an express example of judicial concern resulting in the imposition of limits on the otherwise unprincipled manner in which a jury may arrive to the quantum of damages (albeit in the context of Lord Campbell's Act) see *Blake v Midland Railway Co* (1852) 18 QB 93, 96–7.

<sup>145</sup> In doing so rejecting contrary authority: see, *Jobson v Johnson* [1989] 1 WLR 1026 (CA).

<sup>146</sup> Cross reference *Journal of Equity* Article I at [tba].

<sup>147</sup> See *Gray* (n 44)[89] (Lord Menzies).

<sup>148</sup> For example, French law, Swiss law, German law and Dutch law. See, *Pencil Hill* (n 119) para 9 (Bird J); *Ordonnance n° 2016-131 du 10 février 2016 portant réforme du droit des contrats, du régime général et de la preuve des obligations*; § 339–341 BGB, Arts 6.91–6.94.

to hold that a clause is a penalty.<sup>149</sup> English courts have a binary choice: the clause is valid or void. Thus there appears to be a noticeable reticence in some cases, particularly in complex cases (such as compulsory share sale provisions), to wholly invalidate such a clause, as to do so would alter too much the overall structure of the parties' bargain. On the one hand, this may be seen as a positive development. From a functionalist perspective, designing the penalties doctrine to present only a binary choice to the curial decision-maker may ensure greater judicial restraint in applying the doctrine. Naturally, any judge will want to be certain of the proper legal characterisation of a contractual term before wholly invalidating it. On the other hand, a binary choice reduces the ability of the penalties doctrine to respond to many species of agreed contractual sanctions and remedies. For example, if a contractual clause forcing B to transfer shares to A was held to be invalid on the English approach, the parties are left to the general law remedial regime. However, that regime has no remedy that is the functional equivalent of a compulsory share sale. Therefore, the risk is that an 'all or nothing' approach will encourage judges to reason backwards, holding that an otherwise punitive clause is valid out of a concern that the general law remedial regime would otherwise be inadequate given the circumstances of the case.

#### IV

#### FUSION: TWO RULES IN AUSTRALIA OR A UNIFIED RULE?

##### i. *Questions and potential conflicts*

Several important questions remain open in Australia. First, post-*Andrews*, does a common law rule still exist in the Australian law of penalties? If so, do the equitable and common law rules coexist or constitute a single unified rule? If a dualist approach remains then a number of further questions will arise. For example, does the rejection of the breach requirement in *Andrews* also apply at common law? Is a clause void under the Australian common law approach or can it be given a *pro tanto* application? If a clause is void at common law does the equitable rule have any work to do? Could equitable principles which enable relief to be tailored in specific circumstances result in different answers being given at common law and in equity (e.g. undue delay or unclean hands)? Further, a dualist approach could create uncertainty as to whether a lower court or tribunal, with a limited statutory-based equitable jurisdiction, has the power to apply a purely equitable rule.<sup>150</sup> The initial authorities applying *Andrews* conflict as to whether the decision created a unified<sup>151</sup> penalties doctrine with equitable origins or whether the decision simply delineated between a restated equitable doctrine leaving a separate common law rule intact.<sup>152</sup> *Paciocco* did nothing expressly to

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<sup>149</sup> See above text to n 107. *Richards* (n 43) [84]–[85] (May J); *Edgeworth Capital* (n 43) [7] (Moore-Bick LJ with whom Sales and King LJJ agreed).

<sup>150</sup> E.g. *Bushby v Dixon Holmes du Pont Pty Ltd* [2010] NSWSC 234; (2010) 78 NSWLR 111, where this issue was discussed in the context of estoppel.

<sup>151</sup> See *Mineralogy* (n 14) [470] (Edelman J).

<sup>152</sup> See the first instance decision of Gordon J from the remitted *Andrews* litigation: *Paciocco Trial* (n 34) [11]–[17] (Gordon J). See also *Paciocco Full Court of the Federal Court* (n 14) [19] (Allsop CJ). This approach was not expressly disapproved by the High Court. Since this paper was accepted for

resolve this conflict. It appears implicit at times that the High Court is suggesting the existence of two discrete legal rules.<sup>153</sup> At other times the Court's reasoning appears to set out general norms as to whether a clause is punitive without distinguishing between two separate rules.

ii. *Justifying a unified Australian approach to penalties*

It is submitted that a unified rule against penalties constitutes the best understanding of the High Court's decision in *Andrews* and the present state of the law. I make this claim notwithstanding the otherwise excellent decision of Ward JA in *Australia Capital Financial Management Pty Ltd*<sup>154</sup> suggesting the opposite. Four premises support the conclusion that Australian law ought to be understood of consisting of a single rule against penalties. First, in *Andrews* the High Court staunchly rejected the proposition<sup>155</sup> that the penalties doctrine in Australia is a conceptually distinct rule of common law and not equity.<sup>156</sup> As the Court observed:<sup>157</sup>

The litigation in *Dunlop*, where in the one court, and in the same proceeding, legal and equitable remedies were sought by the plaintiff and the defendant raised the penalty doctrine in its defence, *illustrates the place of the penalty doctrine in a court where there is a unified administration of law and equity but equitable doctrines retain their identity.*

As Edelman J later observed in *Mineralogy*,<sup>158</sup> the High Court's approach signifies a single rule against penalties albeit with equitable origins. This understanding of *Andrews* is consistent with the uncontroversial views that while it is possible for legal rules to shed their historical labels,<sup>159</sup> and while it is also possible for legal principles not wholly to be slaves to history,<sup>160</sup> in a system of case law governed by precedent history forms a body of knowledge or epistemology which can help lawyers account, both descriptively and normatively, for

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publication as bifurcated approach was envisioned in *Australia Capital Financial Management Pty Ltd* (n 9) [359]–[360] (Ward JA).

<sup>153</sup> See *Paciocco High Court of Australia* (n 4) [2] (French CJ); [125] (Gageler J); [253] (Keane J).

<sup>154</sup> See at (n 9) [359]–[360].

<sup>155</sup> Which had been accepted by the Court of Appeal of the Supreme Court of New South Wales in *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* [2008] NSWCA 310; (2008) 257 ALR 292 [99], [134] (Allsop P with whom Giles and Ipp JJA agreed).

<sup>156</sup> *Andrews* (n 3) [63], [77]–[78] (French CJ, Gummow, Crennan, Kiefel and Bell JJ). Although this was well considered *obiter dicta*. The rejoinder to this argument is that elsewhere in *Andrews* (see at [68]) the High Court emphasised that the implementation of the Judicature system was procedural.

<sup>157</sup> *Andrews* (n 3) [77] (French CJ, Gummow, Crennan, Kiefel and Bell JJ) emphasis added.

<sup>158</sup> (n 14) [470].

<sup>159</sup> F W Maitland, *Equity: A Course of Lectures* (published 1909, rev edn, CUP 1936) 20.

<sup>160</sup> A prominent recent Australian example being the decision in *PGA v The Queen* [2012] HCA 2; (2012) 245 CLR 355.

what the law *is*.<sup>161</sup> Accordingly, in *Andrews*, the Court approached the issues before it cognisant of the historical development of the penalties doctrine: the doctrine, like all other legal rules, has a particular historiography that assists in accounting for its key features. Emphasising the doctrine's equitable origins serves to remind lawyers of that historiography but it does not presuppose the need for two legal rules. The key point of engaging in this historical approach was the rejection of treating the doctrine as being a blank slate when *Dunlop* was decided in 1915. Indeed, as outlined in Part I of this article, the Court's reformulation of the penalties doctrine in *Andrews* was not simply based on pre-Judicature 'equitable' decisions made by the Lord Chancellor. Rather, the Court's reasoning also took into account key decisions of the Common Law Courts sitting at Westminster Hall in its reformulation of the doctrine.<sup>162</sup>

The *second* reason why *Andrews* is best understood as creating a unified penalty doctrine is that the cases decided after *Paciocco* appeared to be adopting a clear trend toward applying a unified approach.<sup>163</sup> If these cases, including *Paciocco* itself, were applying a bifurcated approach then it would have been necessary for the courts to consider, once holding that an impugned clause was not a penalty, whether that characterisation of the clause would have been any different at common law or in equity as the case may be. However, it must be conceded that this argument is considerably weaker in light of the recent contrary decision of the Court of Appeal of the Supreme Court of New South Wales in *Australia Capital Financial Management Pty*.<sup>164</sup>

The *third* reason is that, if *Andrews* is read as entrenching two distinct rules against penalties, then contracts will need to be read and enforced in a complex and bifurcated manner.<sup>165</sup> This would require switching between equitable and legal spectacles when reading one instrument in order to make sense of the parties' rights and obligations. Writing in *Snell's Equity on Andrews*, Professor McFarlane has correctly observed that a bifurcated approach of applying

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<sup>161</sup> See, for example, Lionel Smith, 'Fusion and Tradition' in Simone Degeling and James Edelman (eds) *Equity in Commercial Law* (Lawbook Co 2005) 38; Stephen Smith, *Contract Theory* (OUP 2004) 7–49; Anthony Mason, 'Fusion' in Simone Degeling and James Edelman (eds) *Equity in Commercial Law* (Lawbook Co, 2005) 12; and Edmund Burke, *Reflections on the Revolution in France* (published 1790, Everyman's Library 1964) 92. Burke provides: 'the science of jurisprudence, the pride of the human intellect, which, with all its defects, redundancies, and errors, is the collected reason of ages, combining the principles of original justice with the infinite variety of human concerns, as a heap of old exploded errors...' emphasis added.

<sup>162</sup> For example, *Reynolds* (n 105) was decided in the Court of King's Bench. Also, *Astley v Weldon* (1801) 2 Bos & Pul 346; 126 ER 1318; and *Kemble v Farren* (1829) 6 Bing 141; 130 ER 1234, were decided in the Court of Common Pleas. Indeed, the analysis of decisions from the courts of 'common law' and 'equity' are blended in *Gwyer and Anson* (n 23) 330–332.

<sup>163</sup> *Sydney Constructions* (n 119) [45]–[52] (Barrett AJA); *Wu* (n 119) [1] (Leeming JA); [21] (Payne JA); [117]–[123] (Bergin CJ in Eq); *Arab Bank Australia* (n 97) [69]–[112] (McDougall J); and *Magnin* (n 119) [10]–[12] (Harrison J).

<sup>164</sup> *Australia Capital Financial Management Pty Ltd* (n 9) [359]–[360] (Ward JA).

<sup>165</sup> See also *Tiverios* (n 88) 462.

conceptually distinct ‘common law’ and ‘equitable’ penalties doctrines to the same fixed sum clause.<sup>166</sup>

may seem to make the law unnecessarily complex, and it could instead be argued that there is only one penalties doctrine, originating in equity, and that some previous decisions, rather than setting out the boundaries of a distinctly common law doctrine, instead adopted an unduly narrow view of [the penalty doctrine’s] operation.

Put simply, given the overlap between the two approaches to the penalties doctrine discussed in this article, as a matter of efficiency the retention of both rules appears somewhat unnecessary. Practitioners and judges should be slow to decry the problems pertaining to access to justice and the rising costs of litigation one day and then incrementally, and for no clear benefit, proceed to make the law a little more complex the next day. A dualist approach to penalties in Australia would simply mean extra work drafting agreements, extra work providing legal advice, extra work preparing a case for trial and extra time spent in advocacy, writing a judgment, and extra time spent interpreting the content of that judgment.

The final reason why *Andrews* is best understood as creating a unified rule is based on the considerable overlap which the two rules have.<sup>167</sup> This is unsurprising given that any common law rule is merely the progeny of the equitable rule. Put simply, the High Court’s conception of a ‘collateral’ right in *Andrews* can still capture a clause that hinges on a breach of a contractual duty as discussed in *Cavendish*. Similar tests for whether a clause is punitive in character have nonetheless been developed in Australia and England. And while the Supreme Court in *Cavendish* suggested that on a ‘common law’ approach a punitive clause must be void and not given a *pro tanto* operation, as discussed above,<sup>168</sup> this was simply a policy choice made by the Court. Indeed, while unfortunately envisaging the existence of a bifurcated approach to penalties in Australia, Ward JA in *Australia Capital Financial Management Pty Ltd*, nonetheless correctly concluded that the legal principles directly applicable on each approach would ‘not relevantly differ depending upon whether the penalties doctrine is engaged at law or in equity’.<sup>169</sup>

In short, while there are contexts where duality in the law may be welcome, the penalties doctrine is not one of them. Anti-fusionists concerns regarding the need to preserve the unique equitable characteristics of the doctrine are unfounded. This is because the equitable origins of the doctrine were at the forefront of the High Court’s reformulation of the rule in *Andrews* and *Paciocco*. Indeed, as the recent landmark cases in this area discussed this article make clear, it is a truism that the general judge made law continues to develop notwithstanding the enactment of the Judicature Acts 1873–5. Given this starting point, it would be an oddity if the only forms of legal development that were strictly forbidden were

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<sup>166</sup> McFarlane (n 26) [13-007].

<sup>167</sup> Cross reference *Journal of Equity* Article I at [tba].

<sup>168</sup> See above text to (n 145).

<sup>169</sup> *Australia Capital Financial Management Pty Ltd* (n 9) [362] (Ward JA). And see too at [376] “Thus if the impugned stipulation were to have been properly characterised as penal it would be ‘unenforceable at common law’ [and not void as under the English approach] except (assuming that compensation is available) to the extent that equity would permit ‘scaling’”.

the unification of two legal rules that share a common origin. In these circumstances, and as a matter of coherence,<sup>170</sup> there is no reason to create a new category of case where any minor or subtle difference at common law and in equity could result in different answers being given to the same question (whereby such differences could serve to potentially create an incoherent and fractured body of penalties case law).<sup>171</sup>

## CONCLUSION

Part I of this article, which appeared in the previous edition of this journal,<sup>172</sup> set out two underlying approaches to the penalties doctrine in view of recent decisions by the highest courts of Australia and the United Kingdom. The Australian rule concerns fixed sum clauses that are characterised as being in the nature of security rights. This rule prevents rights or interests to a fixed sum taken or retained by A by way of security against B from being enjoyed beyond the function or purpose of security, by restricting such rights from being exercised in a manner that would impose an unjustifiable detriment or punishment on B. This evaluation is made in light of how the law attributes value to the underlying secured stipulation or obligation at the time of entry into the contract. Whereas the English rule regulates the parties' ability to determine the quantum of the secondary obligation that arises upon breach of a primary contractual obligation. While there is overlap between these two approaches, they remain distinct. From this starting point, this article has bridged the important gap between theory and practice, looking more closely at directly applicable legal rules in order to understand how the Australian and English penalties doctrines function in concrete cases.

It has been demonstrated that in applying the penalties doctrine in both Australia and England, a three-stage framework can be applied. The *first* or 'anterior' stage is to ask whether the impugned clause attracts the operation of the penalties doctrine. If the penalties doctrine is applicable the *second* stage is to consider whether the impugned clause is punitive. If the impugned clause is punitive in character the *third* stage is to consider the consequences that should flow from a finding that a clause is a penalty. By providing an analytical restatement of the Australian and English approaches at each stage of inquiry, the key convergences and divergences between the two jurisdictions become evident. The key divergences exist at the first and third stage of the inquiry. In Australia, unlike England, a breach of contract is not required to enliven the penalties doctrine. Rather, it suffices that A's contractual right to a fixed remedy exists to secure the happening of some other contractual stipulation. The second key divergence is the consequence of a finding that a clause is a penalty. In Australia, equity provides for a *pro tanto* enforcement of A's legal right to a fixed remedy so that it is not punitive in operation. English law has staunchly rejected that such an

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<sup>170</sup> *Miller v Miller* [2011] HCA 9; (2011) 242 CLR 446; and *Equuscorp Pty Ltd v Haxton* [2011] HCA 9; (2012) 246 CLR 498.

<sup>171</sup> Andrew Burrows, 'We Do This at Common Law But That in Equity' (2002) 22 OJLS 1, 5. The rejoinder to this argument would be that the differences in the rationales underpinning the equitable and common law rules suffice to independently justify, and also to keep, both rules.

<sup>172</sup> Part 1 appeared in the previous edition of this journal: insert *Journal of Equity* citation. [tba].

approach is possible. However, post-*Cavendish* and *Paciocco* there has been one significant convergence in the law. Both Australia and England have adopted a deferential ‘legitimate interest’ standard at the second stage of inquiry: assessing whether an impugned clause is punitive in character.

In light of this analytical restatement, three important observations can be drawn from *Andrews*, *Paciocco*, *ParkingEye*, *Cavendish* and the subsequent jurisprudence applying these leading authorities. *First*, although the High Court in *Andrews* expanded the scope of what types of clause can be captured by the Australian penalties doctrine, the subsequent jurisprudence has illustrated more clearly that this approach has conceptual limits. Namely, a right, as a matter of substance, cannot function as a security where the right constitutes the fully enforceable consideration for a further contractual right or benefit. *Second*, due to a split in reasoning in *Cavendish*, two approaches as to when the English approach to penalties is engaged have emerged in the English jurisprudence. This is an essential point to take away from *Cavendish*, as the adoption of a narrow approach for determining when the doctrine is engaged has further reduced the range of clauses that are capable of attracting the operation of the penalties doctrine in England. Finally, the best understanding of the Australian law of penalties is that it ought to be seen as consisting of a unified rule (albeit recognising that the rule has equitable origins). This approach means rejecting the idea that the Australian penalties doctrine consists of distinct ‘common law’ and ‘equitable’ rules each of which could potentially be separately applicable on the same set of facts.