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A Restatement of Relief Against Contractual Penalties (I): Underlying principles in Equity and at Common Law

Nicholas A Tiverios¹

The rule preventing a contracting party from enforcing a penalty clause has been the subject of recent decisions of the highest courts of the United Kingdom and Australia, which has led to a number of significant divergences in the law. This article outlines two potential rationales that can explain the distinct approaches to the law of penalties adopted in England and Australia. It is argued that the Australian or 'equitable' rule against penalties 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 way of security from being enjoyed beyond the function or purpose of security in light of how the law attributes value to the underlying secured stipulation or obligation (thereby preventing the imposition of an unjustifiable detriment or punishment on a contracting party). Whereas the English or 'common law' rule regulates the parties' ability to determine the quantum of the secondary obligation that arises upon breach of a primary contractual obligation. The English rule prevents fixed sum clauses which derogate too far from the default remedy 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.

INTRODUCTION

The rule preventing a contracting party from enforcing a 'penalty' clause² has been the subject of recent decisions of the highest courts of the United Kingdom and Australia, which has led to a number of significant divergences in the law. In the conjoined appeals in *Cavendish Square Holding BV v Makdessi*³ and *ParkingEye Ltd v Beavis*⁴ the Supreme Court

¹ Teaching Fellow, University College London; Barrister and Solicitor, Supreme Court of the ACT and High Court of Australia. My thanks to Ben McFarlane, Charles Mitchell, Clare McKay and the two anonymous referees for their suggestions. The usual caveats apply.

² Such a clause can be broadly defined, with a degree of circularity, as a clause in which the parties to the contract have stipulated a fixed or agreed remedy that will be payable if a certain event happens, but where a court is unwilling to enforce the clause on the basis that it constitutes a 'penalty' on the defaulting party.

³ [2015] UKSC 67; [2016] AC 1172 at [12] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed. 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*.

⁴ [2015] UKSC 67; [2016] AC 1172.

of the United Kingdom held that the rule against penalties is a distinct rule of common law and not, as in Australia, a rule of equity. The result is that the rule against penalties, as applied in England and Wales,⁵ only applies where a contracting party ('B') has to pay a 'penal' fixed⁶ sum to another party ('A') in circumstances where B's liability to pay the fixed sum hinges on her breaching a contractual obligation. However, the Supreme Court reformulated the test applicable to determine whether or not a right to a fixed sum was 'penal' in character. The Court held that a non-compensatory fixed sum clause⁷ would not be penal provided there is a legitimate interest for A's imposition of the fixed sum.⁸ Where a contractual term requires payment of such a fixed sum and fails this test, the consequence is that the term is void and imposes no duty to pay the sum, so that the parties are left to seek a remedy pursuant to general law principles governing relief for breach of contract.⁹

The approach taken by the Supreme Court in *Cavendish* marked a conscious decision not to follow the approach developed by the High Court of Australia in *Andrews v Australia and New Zealand Banking Group Ltd*.¹⁰ In *Andrews* the High Court unanimously held that the rule against penalties derives from equitable origins, with the result that the operation of the penalties doctrine does not, as in England, hinge upon breach of a contractual obligation.¹¹ Some four years later, and after the Supreme Court's decision in *Cavendish*, the High Court of Australia in *Paciocco v Australia and New Zealand Banking Group Ltd*¹² clarified the test to be applied in determining whether the enforcement of a fixed sum clause in a contract was penal. The test endorsed by the High Court is described in functionally similar terms to that adopted by the Supreme Court in *Cavendish*, as it too requires the court to consider whether A has a legitimate interest in the enforcement of the fixed sum as against B.¹³ However, an

⁵ For convenience referred to throughout this paper as the law of 'England'. The fusion of the two jurisdictions begins with the Statute of Wales (1284), see: J Gillingham 'Conquests, Catastrophe and Recovery, 1066-c.1485' in J Clark (ed) *A Word by Itself: A History of the British Isles*, William Heinemann, London, 2010, p 187.

⁶ For convenience this paper uses the terms 'fixed sum' or 'fixed remedy' throughout.

⁷ Meaning a clause which imposes a fixed sum that is more than a genuine pre-estimate of loss on breach of contract.

⁸ *Cavendish*, above n 3, at [32] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; [152] per Lord Mance; [255] per Lord Hodge; [293] per Lord Toulson. Although note that the test requires the impugned clause to impose a fixed sum that is 'out of all proportion' to A's legitimate interests.

⁹ *Cavendish*, above n 3, at [84]–[87] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; [230], [283] per Lord Hodge.

¹⁰ [2012] HCA 30; (2012) 247 CLR 205. Indeed, prior to the hearing of *Cavendish* the Supreme Court asked for submissions from the parties on the law of Commonwealth countries applicable to the penalties doctrine.

¹¹ *Andrews*, above n 10, at [10] per French CJ, Gummow, Crennan, Kiefel and Bell JJ.

¹² [2016] HCA 28; (2016) 90 ALJR 835.

¹³ *Paciocco High Court of Australia*, above n 12, at [29] per Kiefel J with whom French CJ agreed; [164] per Gageler J; [270] per Keane J. The 'legitimate interest' standard adopted in *Cavendish* can be seen in the judgment of Allsop CJ in the intermediate appeal in the *Paciocco* litigation: *Paciocco v Australia and New Zealand Banking Group Ltd* [2015] FCAFC 50; (2015) 321 ALR 584 at [103].

important difference, both practically and philosophically, between the Australian and English approaches is the *consequence* of a term requiring payment of a fixed sum failing this test. In Australia, A's right to the fixed sum is not void as it is under the English approach. Rather, A's right to the fixed sum is preserved at common law but equity *disables* or *scales down* A's ability to enforce her strict legal right to the fixed sum as against B.¹⁴

The developments in the law outlined above are significant. In the United Kingdom the English developments have been described as effecting a 'radical adjustment'¹⁵ or 'overhaul'¹⁶ of the existing law. Similarly, developments in Australia have been described as repositioning the entirety of the law of penalties.¹⁷ Accordingly, this article seeks to provide a critical analysis of the recent developments in the law of penalties. This is achieved in three parts. Parts one and two consider the diverging underlying rationales for the rule against penalties in equity and at common law. Part three of this article considers some of the strengths and weaknesses of the two approaches.

There is no reason to be obfuscatory about the conclusion to which this article ultimately leads. The central thesis is that divergences in the law of penalties between Australia and England illustrate differences between possible rationalisations of the doctrine. Post-*Andrews*, the 'equitable' penalties doctrine in Australia ought to be seen as the functional equivalent of a specific application of equity's general doctrine to provide relief against forfeiture.¹⁸ Or, put another way, the penalties doctrine ought to be understood as a species of law within the wider genus of the law relating to security rights. For the 'equitable' doctrine of penalties as enunciated in *Andrews* to be enlivened, there must be a collateral right (the penalty) which, applying the principles of contractual construction, operates as a security right to ensure performance of a related primary contractual¹⁹ stipulation (or obligation).²⁰ Where the

¹⁴ *Paciocco High Court of Australia*, above n 12, at [248] per Keane J: '[a]n ancillary or security provision could not be enforced in equity at all to the extent it went beyond the substance of the transaction'.

¹⁵ Scottish Law Commission, *Review of Contract Law: Discussion Paper on Penalty Clauses*, Discussion Paper 162, Edinburgh, 2016, at [3.61] see also at [1.7].

¹⁶ *First Personal Services Limited v Halfords Limited* [2016] EWHC 3220 (Ch) at [161] per Jeremy Cousins QC.

¹⁷ JW Carter and others, 'Contractual Penalties: Resurrecting the Equitable Jurisdiction' (2013) 30 *Journal of Contract Law* 99. See too *Cavendish*, above n 3, at [42], although this was, somewhat perplexingly given the thesis set out in this paper, not a view shared by Gageler J see *Paciocco High Court of Australia*, above n 12, at [122].

¹⁸ This view of the penalties doctrine is consistent with the historical development of the rule: *Forestry Commission of NSW v Stefanetto* (1976) 133 CLR 507 at 519 per Mason J. See also Sir Anthony Mason, 'Themes and Prospects' in PD Finn (ed) *Essays in Equity*, The Law Book Co., Sydney, 1985, p 248.

¹⁹ Although the focus of this paper is on contractual rights, given the reasoning of the High Court in *Andrews* the Australian penalties doctrine should apply to all manner of consensually created obligations that include rights that function in the nature of a security. This point was correctly alluded to by Kiefel J in *Paciocco High Court of Australia*, above n 12, at [24].

collateral right is characterised as being in the nature of a security right, the court will restrain the exercise of that collateral right to ensure that it is only enforced to the extent necessary to secure performance of the related primary stipulation (or the stipulation's monetised equivalent). As partial enforcement of the secondary 'security' right may be all that is required to achieve performance of the 'secured' primary stipulation, the court may provide for a scaled down or *pro tanto* enforcement of the collateral right. In contrast, the 'common law' penalties doctrine in England, as applied in *Cavendish*, is not about restraining the enforcement of collateral or security rights. The penalties doctrine in England is best understood as a common law rule²¹ of public policy. The doctrine preserves the state's exclusive jurisdiction to impose a remedy for breach of contract by making void a right to a fixed sum remedy that stultifies too far the general remedial policies that underlie the law of contract. Thus once the penalties doctrine applies to void a contractual right to a fixed remedy, the state can still impose an appropriate sanction for a breach of contract. There is overlap between these two rationales but they do remain distinct.

I

EQUITY — RIGHTS TO FIXED SUMS TAKEN BY WAY OF SECURITY

i. *Andrews* — the equitable approach in Australia

The High Court of Australia's unanimous judgment in *Andrews* changed the accepted understanding of the Australian law of penalties. The issues raised in the *Andrews* litigation (ultimately resolved by the subsequent decisions of the High Court of Australia and Full Court of the Federal Court of Australia in the *Paciocco* litigation)²² involved an unsuccessful class action brought by bank customers ('B') against a bank ('A') claiming, *inter alia*,²³ that various bank fees²⁴ levied on personal, business and credit card accounts constituted penalties. As most of these bank fees were levied by A on B in circumstances where B was not in breach of a contractual obligation, an important preliminary issue arose after the class action was commenced: could the penalties doctrine apply in circumstances absent a breach

²⁰ Unless the context suggests otherwise this paper tends to use the broader term 'stipulation' throughout to capture both obligations and 'non-promissory' stipulations.

²¹ This approach is strongly defended in *JW Carter and others*, above n 17.

²² *Paciocco High Court of Australia*, above n 12; and *Paciocco Full Court of the Federal Court*, above, n 13.

²³ B also made unsuccessful statutory claims against A based on consumer protection statutes which are beyond the scope of this paper, see *Paciocco High Court of Australia*, above n 12, at [2] per French CJ.

²⁴ While there were a series of separate bank fees which were unsuccessfully challenged in the *Paciocco* litigation, all of these fees ultimately fell into four categories which raised common legal issues. These fees can be broadly classified as: (i) fees imposed by A for honouring a transaction from B's savings account where B had insufficient funds to make the transaction in question (honour fees); (ii) fees imposed by A for dishonouring a transaction from B's savings account where B had insufficient funds to make the transaction in question (dishonour fees); (iii) fees imposed by A on B when B failed to make obliged minimum monthly credit card payments (late payment fees); and (iv) fees imposed by A on B when B exceeded an agreed limit on a credit card facility (over limit fees).

of contract? Or, put another way, were the fees that A levied on B in circumstances where B was not in breach of contract capable of attracting the operation of the penalties doctrine? At the time *Andrews* was argued it was the general prevailing wisdom in both Australia²⁵ and England²⁶ that a breach of contract was required to engage the penalties doctrine. This remains the prevailing wisdom in England.²⁷ Not so in Australia.

The High Court in *Andrews* unanimously held that the operation of the penalties doctrine does not hinge upon breach of a contractual obligation. Rather, the court set out a reformulated test for when the penalties doctrine is engaged in the following general terms:²⁸

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

The High Court did not cut its reformulation of the law of penalties out of whole cloth. Rather, the reformulation was tailored in response to a particular²⁹ broad historical view of the penalties jurisprudence. Indeed, it is worth noting that the High Court's reformulation is not wholly unique to the modern law of penalties. A functionally similar approach to *Andrews* that required A's right to a fixed sum to be in the nature of a collateral security right in order for the penalties doctrine to be engaged has been previously advocated in Australia. Although not cited in *Andrews*, Gavan Duffy J³⁰ in the Court of Appeal of the Supreme Court of

²⁵ *Interstar Wholesale Finance Pty Ltd v Integral Home Loans Pty Ltd* [2008] NSWCA 310; (2008) 257 ALR 292 at [99], [134] per Allsop P with whom Giles and Ipp JJA agreed.

²⁶ *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 WLR 399 (HL) at 402–4 per Lord Roskill with whom Lord Diplock, Lord Elwyn-Jones, Lord Kieth of Kinkel and Lord Brightman agreed.

²⁷ *Cavendish*, above n 3, at [12] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed.

²⁸ *Andrews*, above n 10, at [10] per French CJ, Gummow, Crennan, Kiefel and Bell JJ (footnotes omitted).

²⁹ For academic support of this historical approach see Ben McFarlane, 'Penalties and Forfeiture' in John McGhee (ed), *Snell's Equity*, 33rd edn, Sweet & Maxwell, London, 2015 at [13-001]-[13-003]; and NA Tiverios, 'Doctrinal approaches to the law of penalties: A post-Andrews intention-based defence of relief against fixed contractual penalties' in J Edelman, J Goudkamp and S Degeling (eds), *Contract in Commercial Law*, Lawbook Co., Sydney, 2016, p 457. However, the opposite view: that a breach of contract was, as a matter of historical analysis, always required to enliven the penalties doctrine was taken in *Cavendish*, above n 3, at [42] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; and RL Gilbert, 'The Minimum Hire Provision in Hire-Purchase Agreements Part II' (1938) 12 *Australian Law Journal* 198 at 198: '[h]istorically and logically, at any rate, the relief against penalties was developed and administered only where the 'penalty' was incurred, or made payable, upon some breach of contract'.

³⁰ Son of the former Chief Justice of Australia Sir Frank Gavan Duffy.

Victoria, in the unreported 1937 case of *Universal Guarantee v Jarvis*,³¹ purportedly adopted an approach towards the law of penalties similar to the reformulation set out in *Andrews*. On this approach, for the penalties doctrine to be engaged it required A's right to a fixed remedy be 'collateral for securing performance of some other object (which was the case upon which the equitable doctrines would operate)'.³²

Returning to the substantive reasoning in *Andrews*, the Court provided two clear historical justifications for its reformulation of the penalties doctrine. Both of these justifications map closely to the arguments put forward by CJ Rossiter in favour of the continuing existence of the equitable rule against penalties.³³ The *first* historical justification provided by the Court in *Andrews* was that the modern penalties doctrine developed from the Lord Chancellor's jurisdiction to relieve against penalties and forfeitures, which predated the emergence of *assumpsit* for nonfeasance³⁴ and the modern law of contract.³⁵ Put shortly, the history of the doctrine was anchored in equity preventing the unconscionable enforcement of obligations. The archetypal example was the prevention of the unconscionable enforcement of obligations created under bonds³⁶ (specifically conditional bonds) where relief did not depend upon a

³¹ Although the case is unreported see the discussion in RL Gilbert 'The Minimum Hire Provision in Hire-Purchase Agreements Part I' (1938) 12 *Australian Law Journal* 139 at 140–4; and JD Phillips, 'Universal Guarantee Pty Ltd v Carlyle' (1957) 1 *Melbourne University Law Review* 94 at 96.

³² Gilbert, above n 31, at 143.

³³ CJ Rossiter, *Penalties and Forfeiture*, Law Book Co., Sydney, 1992, pp 148–9. This text was cited in the judgment in *Andrews* but not in support of these two propositions.

³⁴ This development apparently arose by 1500, although there is no identifiable case: See the famous dictum of Fyneux CJ at Gray's Inn (1499) in JH Baker, *Baker and Milsom Sources of English Legal History: Private Law to 1750*, 2nd ed, Oxford University Press, Oxford, 2010, p 442.

³⁵ *Post-Waltham Carrier* (1321) in Baker, above n 34, p 319, the writ of covenant was not available to enforce parol agreements. Thus the common law was left to develop a complete doctrine of contract on its 'second attempt'. This saw modern contract law develop out of *assumpsit* in the wake of *Slade's case* (1602) 4 Co Rep 92b, 76 ER 1074; the best report of *Slade* is in Baker, above n 34, p 460. The late development of the English law of contract for this reason was also noted by Peter Birks, *Unjust Enrichment*, 2nd ed, Oxford University Press, Oxford, 2005, pp 285–6; and Peter Birks, *The Roman Law of Obligations* (Descheemaeker (ed)), Oxford University Press, Oxford, 2014, p 58.

³⁶ See AWB Simpson, 'The Penal Bond with Conditional Defeasance' (1966) 82 *LQR* 392, at 416–18. The bond was the central instrument of commercial life in the medieval and early modern periods. A simple bond is a unilateral promise contained in a deed binding its maker to do something (for example, pay a fixed sum or perform an act) by a set date. A conditional bond is the same as a simple bond, aside from it being accompanied by a condition (termed a condition of defeasance) that, if satisfied, extinguished the primary obligation of the bond. For example, A lends £20 to B. In doing so A makes B execute a deed obliging B to pay A the sum of £40 (the penalty) by date X subject to a condition of defeasance (normally written on the back of the bond) that B pay A the sum of £25 by date X–1. The conditional bond was not merely a device for money lending, but could also be used to ensure the performance of non-monetary stipulations. For example, A and B agreed that B would deliver to A a set quantity of red bricks by date X for the sum of £50. This agreement could be recorded as a mere condition of defeasance on the back of a bond which otherwise stated that B would pay A the sum of £90 (the penalty) on date X+1. The common law's approach to bonds was historically plaintiff friendly. In the context of the conditional bond, common law courts until the mid 1670s allowed the full enforcement of the primary obligation and, although the defendant could plead the existence of performance of the conditional defeasance, performance had to be strict. The common law position with respect to simple bonds was that the mere production of the simple bond proved the

breach of contract. The Court reasoned that considering the common law (c.1670s³⁷) and statute³⁸ with the enactment of the statutes of William (1696–7)³⁹ and Anne (1705)⁴⁰ followed equity in providing relief against the unconscionable enforcement of bonds, it also followed that limiting relief in equity to cases where there is a breach of contract was inconsistent with the doctrine's historical origins and development.⁴¹ The *second* historical justification provided by the Court was that the creation and expansion of common law and statutory jurisdictions to relieve against penalties did not abolish the related equitable jurisdiction (so that the penalties doctrine became exclusively a rule of common law). Such developments may have decreased the necessity for equitable relief from penalties, but these developments did not result in the equitable rule becoming wholly obsolete.⁴² As a supplement to this second justification, Rossiter's earlier observation is noteworthy: as a matter of consistency and coherency in the law, an equitable penalties rule should still exist. Rossiter argued that because there has been no discernable trend towards restricting equity's jurisdiction to provide relief against forfeiture in light of statutory developments, no such argument should be maintained regarding the continuing existence of the equitable penalties doctrine. In

existence of the primary obligation (that is, the debt owing) and, due to the common law's reticence towards parol evidence, it was not open to the defendant to enter a plea that they had performed the primary obligation. The common law's rigidity led to defendants in common law bond cases becoming Chancery's plaintiffs. Simpson identifies three periods of development. *First*, during the reign of Edward IV (1442–83), Chancery provided relief in cases where the debtor had performed an obligation contained in a simple bond but had failed to take the necessary steps to gain a release. *Second*, during the reign of Elizabeth I (1558–1603), Chancery expanded the circumstances in which a defendant could be afforded relief on a conditional bond to circumstances where the defendant had suffered an accident or extremity or had only made a trifling default, provided the defendant compensated the plaintiff for any loss suffered. *Finally*, after the Restoration (1660), Chancery moved beyond the traditional grounds of relief involving accident, hardship and fraud and would grant relief to a defendant on a conditional bond if, within a short time from non-performance, he paid to the plaintiff the compensation for the failure of any conditional defeasance, interest and any legal costs. For a similar overview see Rossiter, above n 33, pp 5–20.

³⁷ AWB Simpson, *A History of the Common Law of Contract: The Rise of the Action of Assumpsit*, Clarendon Press, Oxford, 1987, p 122.

³⁸ Simpson, above n 37, pp 118–23.

³⁹ Administration of Justice Act 1696 (8 & 9 Will 3 c 11). The Statute of William permitted judgment to be entered for a plaintiff but relevantly limited the plaintiff's actual recovery (ie the *execution* of the judgment was limited) to the quantum of assessed damages (the judgment for the full sum would continue to stand as security for ongoing obligations which B owed to A). See *Collins v Collins* (1759) 2 Burr 820, 97 ER 579; and *Murray v Earl of Stair* (1823) 2 B & C 82.

⁴⁰ The Administration of Justice Act 1705 (4 & 5 Anne c 16). The Statute of Anne conferred on the court a power to discharge an obligor on a bond who brought into court: (a) the principal sum; (b) interest; and (c) the obligee's costs that were due on the money bond. AWB Simpson described the broad effect of these statutes as reconciling the position in the Chancery and common law courts: See Simpson, above n 37, pp 118–23. For the differences between these statutes (and the types of bonds which fell under each) see *Andrews v Australia and New Zealand Banking Group Ltd* [2011] FCA 1376; (2011) 211 FCR 53 at [22]–[25] per Gordon J.

⁴¹ *Andrews*, above n 10, at [40]–[45] per French CJ, Gummow, Crennan, Kiefel and Bell JJ.

⁴² *Andrews*, above n 10, at [61]–[63] per French CJ, Gummow, Crennan, Kiefel and Bell JJ. A point made by Lord Thurlow LC in *Codd v Wooden* (1790) 3 Bro CC 731; 29 ER 415, see too Rossiter, above n 33, pp 12, 149.

making this argument Rossiter expressly points to the fact that the creation of particular remedial statutory regimes providing for forms of relief against forfeiture has not resulted in the equitable principles against forfeiture becoming wholly redundant.⁴³ Accordingly, he called for the law of penalties to be treated in a like manner. Put simply, a particular legal rule, in this case the equitable penalties doctrine, should not be presumed to have been abolished merely because new legal rules operate in similar factual circumstances to those in which the original rule applied.

The typical, albeit not universal,⁴⁴ criticism of the High Court's reformulation in *Andrews* is that the reasoning relies too much on legal history and fails to provide a clear positive rationale⁴⁵ for reformulating, and even for retaining, the rule against penalties. Indeed, Professor Peel has gone so far as to criticise *Andrews* as being a history lesson which simply begs the question: why have a penalties doctrine at all?⁴⁶ This is no easy question to answer. Indeed, the question 'what is the underlying rationale for the penalties doctrine?' has proved elusive, with the case law and academic literature often treating the doctrine as a *sui generis* rule, an 'artefact of legal history'⁴⁷ with no clear conceptual basis.⁴⁸ These fundamental difficulties concerning the nature and scope of the penalties doctrine are centuries old and perhaps result from the multiplicity of reasons as to why equity would provide relief from a penalty.⁴⁹ Indeed, many of these original reasons for relief mapped, and then extended beyond, the traditional grounds of equitable intervention, being derived from a protean foundational concept in equity that a legal right should not be enforced to take advantage of accident, mistake, hardship or to perpetuate fraud.⁵⁰

⁴³ Rossiter, above n 33, p 149. A similar argument was accepted in *Cavendish*, the Court rejected the argument that statutory control of unfair terms has made the common law doctrine against penalties redundant.

⁴⁴ See Paul Davies and PG Turner, 'Relief Against Penalties Without a Breach of Contract' (2013) 72 *CLJ* 20; and McFarlane, above n 29.

⁴⁵ Carter and others, above n 17, at 128.

⁴⁶ Edwin Peel, 'The Rule Against Penalties' (2013) 129 *LQR* 152.

⁴⁷ Jonathan Morgan, *Great Debates in Contract Law*, 2nd ed, Palgrave Macmillan, London, 2015, p 234.

⁴⁸ See further *AMEV-UDC Finance Ltd v Austin* [1986] HCA 63; (1986) 162 CLR 170 at 183 per Mason and Wilson JJ. See *Cavendish*, above n 3, at [3] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed. Nine potential rationales for the penalties doctrine are set out and assessed in Tiverios, above n 29, pp 465–475, being: (i) equity's limitations on the enforcement of security rights; (ii) prevention of clauses that deter certain behaviours; (iii) preserving substantive fairness; (iv) prevention of clauses that punish; (v) behavioural economics; (vi) preserving liberty of action; (vii) protecting the state's role in imposing a remedy for breach or contract/preserving the compensatory principle of contractual damages; (viii) economic efficiency; and (ix) preventing perverse contractual incentives.

⁴⁹ See above text in n 36.

⁵⁰ See, eg, FW Maitland, *Equity: A Course of Lectures*, Cambridge University Press, Cambridge, 1909, revised ed 1936, pp 12–3 and see further Rossiter, above n 33, pp 1–26; Simpson, above n 37, pp 118–25 and WMC Gummow, 'Forfeiture and Certainty: The High Court and the House of Lords' in PD Finn (ed) *Essays in Equity*, The Law Book Co, Sydney, 1985, p 34.

In an essay annexed to the English translation of *Pothier on the Law of Obligations*, William D Evans, after a succinct summary of the relevant Chancery jurisprudence on penalties, made two pertinent observations. Evans' first observation was that it was hard to find a coherent and consistent application of the penalties doctrine:⁵¹

it is obviously no easy matter to determine, in what cases the sanction, intended by the parties to enforce the performance of their engagements, shall or shall not be permitted to take effect.

Evans' prophetic second observation was that courts tend to fail to clearly outline a positive rationale for the penalties doctrine, preferring to engage with an uncritical application of existing precedent:⁵²

[it] is easier to follow precedent than to investigate principles, and there is often a timidity in deviating from even those precedents which are most at variance with principles.

The point is that not all legal rules, let alone the entire history of a legal doctrine, are capable of easily fitting into a single bright line classification.⁵³ This truism is particularly apt for a doctrine such as relief against penalties which has developed into its modern forms over the course of centuries, and where there was a multiplicity of reasons why the Lord Chancellor historically would grant relief from a penalty. The purpose of the remainder of this article is to attempt to elucidate the underlying principles that are essential to understanding how the 'equitable' and 'common law' penalty doctrines operate in light of the decisions in *Andrews*, *Paciocco* and *Cavendish* and the subsequent jurisprudence applying the principles set out in these landmark cases. However, as legal history has played a significant role in the reformulation of the penalties doctrine in both England and Australia, the history of relief against penalties will still be considered to the extent required to make sense of the current rules.

ii. *Rationalising the equitable rule* — security rights or interests

At a high level of generality, it is submitted that the analytical link between the High Court's reasoning in *Andrews* and *Paciocco* and a clear rationale for the penalties doctrine rests on appreciating how a right to a fixed sum remedy is characterised. It is essential to appreciate the primary reason why the *Andrews* formulation does not depend on a breach of contract: the Court took the view that the characterisation of a fixed sum remedy as a security to ensure the happening of some other event was the essential hook on which the Lord Chancellor's jurisdiction to relieve against penalties operated in the post-Restoration (1660) jurisprudence. As Edelman J has outlined, the conscious emphasis in the *Andrews* formulation on the Roman origins of the term 'stipulation' (or '*stipulatio*') is best understood as referring to a *security* stipulation on the basis, *inter alia*, of the common use of a *stipulatio* as a unilateral contract

⁵¹ WD Evans, *Pothier on the Law of Obligations*, Vol II, A Strahan, London, 1806, p 98.

⁵² Evans, above n 51, p 109.

⁵³ Oliver Wendell Holmes, *The Common Law*, John Harvard Library, 1881, revised ed 2009, pp 1–2; and Stephen Waddams, *Dimensions of Private Law: Categories and Concepts of Anglo-American Legal Reasoning*, Cambridge University Press, Cambridge, 2003, p 2.

binding a third party guarantor to secure a sum owed by a principal debtor.⁵⁴ Thus in the context of the law of contract, the equitable penalties doctrine concerns contractual rights or interests that are characterised as existing to secure the performance or fulfilment of another contractual obligation or stipulation. As Baggallay LJ observed in *Protector Endowment Loan and Annuity Co v Grice*,⁵⁵ the penalties doctrine does not apply to an impugned clause ‘where the intent [of the clause] is not simply to secure a sum of money, or the enjoyment of a collateral object’.⁵⁶

It is submitted that the central holding of the High Court in *Andrews* is that the penalties doctrine applies in circumstances where A’s right to a fixed sum is characterised as existing to secure the performance of some other contractual ‘requirement’ or ‘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. This captures the orthodox understanding of the penalties doctrine, being remedial rights that secure the performance of a *duty*. But the Court 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, there is no logical reason why such a right cannot function to secure the happening or fulfilment of a non-promissory contractual provision.⁵⁷ Thus the other contractual stipulation which A’s right to the fixed sum secures could also be a non-promissory contingency,⁵⁸ the failure or happening of which would not constitute a breach of contract. The High Court’s conception of security rights existing to secure the fulfilment of a non-promissory condition does not simply represent a conceptual possibility, but is reflected in Chancery authorities where relief against a penalty was granted for the failure of a non-promissory condition.⁵⁹

⁵⁴ *Andrews*, above n 10, at [37] per French CJ, Gummow, Crennan, Kiefel and Bell JJ; and *Mineralogy Pty Ltd v Sino Iron Pty Ltd (No 6)* [2015] FCA 825; 329 ALR 1 at [482]–[485] per Edelman J. For an outline of this particular application of *stipulatio* in Roman law see, Birks, above n 35, pp 62–3.

⁵⁵ (1880) 5 QBD 592 (CA).

⁵⁶ *Grice*, above n 55, at 595.

⁵⁷ McFarlane, above n 29, at [13-009].

⁵⁸ For an excellent scholarly overview of contingent and non-promissory conditions see: Samuel J Stoljar, ‘The Contractual Concept of Condition’ (1953) 69 *LQR* 485; see also *Sandra Investments Pty Ltd v Booth* (1983) 153 CLR 153. A non-promissory contractual provision is a provision which is outside the promisor’s personal undertaking to the promisee. For example, where a deed is entered into pursuant to which B agrees to pay A £200 if it snows tomorrow in the Greater London area. In this simplified example, B’s liability to pay A £200 is the only promissory obligation that B owes A. B has the option of either performing or breaking his obligation to pay A £200. The same cannot be said for the ‘contingent’ condition that ‘it snows in Greater London’. This is because the condition is not something that is within B’s power to control. Rather, the contingent condition can either be fulfilled (it snows in London) or not be fulfilled (it does not snow in London). Such a contingent condition is unsuitable to be considered in terms of B’s performance or non-performance. Thus the contingency is understood as being non-promissory rather than promissory in nature. The term ‘condition’ in the context of a contingent condition is not being used in the sense of a covenant or promise to do or not to do a certain thing. Rather, ‘condition’ is being used in a sense distinct from a covenant or promise to mean a fact or event upon which a promise somehow depends.

⁵⁹ Indeed conditional bonds did exist, and were valid, where the condition of defeasance was either wholly or partially outside of the obligor’s control: Simpson, above n 36. This explains why in the report of *Sloman v Walter* (1783) 1 Bro CC 418; 28 ER 1213, Thurlow LC refers to the conditional

Although not referred to in *Andrews*, and decided before there was a formal distinction between relief against penalties and forfeitures,⁶⁰ *Wheeler v Whithall*⁶¹ serves as a good example of where a security right existed to secure the happening of a non-promissory condition. Simplified, C prepares a will leaving his estate to B (or B's heirs) on the contingent condition that B pay C's daughters (A) the sum of £500. Should B fail to pay A the sum of £500 then A (or A's heirs) will become the principal beneficiaries under the will. C dies and the ultimate sub-beneficiary in B's position does not pay A the sum of £500 for three years. Nonetheless, the Court treated the provision stripping B of the estate and devising the estate to A as being in the nature of a security to ensure that A was paid the sum of £500. B was excused from the strict legal application of the condition forfeiting the estate provided he paid to A the sum of £500 plus damages for the three year delay in payment of the sum. However, the requirement that B pay to A the sum of £500 is clearly not a promissory condition. It was a contingent condition the fulfillment of which would enable the estate to settle on B rather than having the estate ultimately settle on A. As reported:

in this case the Lord Chancellor held, that this condition being for payment of money, although in strictness of law the estate were forfeited by the non-payment of the money, and although there were an express limitation to [A], yet this was but as it were a mortgage or security for money, and [A] being paid the said money and damages, they were at no damage; and so decreed that [B] paying the same should have the land.⁶²

In this connection, the High Court in *Andrews* makes clear that a security right can secure the fulfillment of a non-promissory condition and not just the performance of an obligation. On the other hand, the Supreme Court in *Cavendish*, particularly Lord Neuberger and Lord Sumption who directly engaged with this historical issue, overlooked authorities such as *Wheeler* and incorrectly asserted that the penalties doctrine never applied, as a matter of history, absent a breach of covenant (i.e. breach of duty).⁶³ However, there is only so much

bond existing to secure the happening of a 'collateral object' (being a broad term that would capture non-promissory conditions) rather than simply the performance of a 'covenant'.

⁶⁰ See Rossiter, above n 33, p 20.

⁶¹ (1676) 2 Freeman 10; 22 ER 1023. See also Lord Denning's judgment in *Campbell Discount Company Ltd v Bridge* [1962] AC 600 at 626–32 which essentially mirrored the approach adopted by the High Court in *Andrews*. *Bridge* concerned the question whether a minimum payment required when A exercised a power to terminate (early) a hire-purchase agreement could be a penalty. Lord Denning said yes, the payment of the sum in question was a clog on A's power to terminate and could be seen as securing the fulfillment of the condition that A keep the contract on foot and not exercise the power in question (or, put another way, to secure the performance of the contract).

⁶² *Wheeler*, above n 61. The approach taken in *Wheeler* is consistent with other post-Restoration Chancery authorities which support the proposition that non-promissory conditions can be penal. In *Wallis v Crimes* (1667) 1 Chan Cas 88, 22 ER 708 Lord Keeper Bridgman held that wherever a non-promissory stipulation (such as a condition precedent) was punitive in character equity ought to relieve. See further *Bland v Middleton* (1679) 2 Chan Cas 2, 22 ER 817; and see the note on 'Conditions and Limitations' written by a gentleman of the Middle Temple in *A General Abridgement of Cases in Equity Argued and Adjudged in the High Court of Chancery (Vol I)* as reproduced in (1667–1774) 1 Eq Ca Abr 108, 21 ER 916.

⁶³ See also *Cavendish*, above n 3, at [5] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed, where their Lordships noted that 'The essential conditions for the exercise of the jurisdiction were (i) that the penal provision was intended as a security for the recovery of the true

explanatory force in the observation that the penalties doctrine applies in circumstances where A's right to a fixed sum is characterised as existing to secure the performance of some other contractual stipulation. This observation begs the question: *why* should the law restrain A's exercise of her right to a fixed sum as against B? There are broadly two possible answers to this question. The first answer is that A is restrained from exercising her right to the fixed sum because, as a matter of contractual interpretation, A's right to the fixed sum is acquired for the limited purpose of security. The second answer goes beyond contractual interpretation: the reason why A is restrained from exercising her right is to prevent A from using a right in the nature of a security to subject B to an unjustifiable detriment or punishment in light of the value of the secured stipulation or obligation. Both of these reasons for restraining A's exercise of a security right are discussed in more detail below.

iii. Security rights or interests as a question of interpretation

The *first* reason why A may be restrained from fully exercising her right to a fixed sum centres on contractual interpretation. Specifically, A's right may be characterised as existing for the purpose of security because it is the contract itself that does not allow A fully to enforce her right to the fixed sum. This approach to determining whether A's right is properly characterised as a security right depends on *interpretation*, being the objective linguistic meaning of the contract (which can include reading the text in light of shared normative and community values).⁶⁴ These normative and community values can include interpretative presumptions such as that contractual rights will be exercised reasonably and for the purpose for which they were conferred⁶⁵ and that where a contractual term which appears on its face

amount of a debt or damages; and (ii) that that objective could be achieved by restraining proceedings on a bond in the courts of common law, on terms that the defendant paid damages.' However, their Lordships question whether this reasoning could apply in the context of a bilateral contract rather than a conditional bond (see at [8]). Further, their Lordships took the view that a security right must secure a *duty* and therefore a breach of covenant was *required* in the old conditional bond penalties cases (see at [42]).

⁶⁴ For an overview as to how normative values influence the objective interpretive process see Stephen Smith, *Contract Theory*, Oxford University Press, Oxford, 2004, pp 274–9; and Ludwig Wittgenstein, *Philosophical Investigations*, revised 4th ed, Wiley-Blackwell, 2009 at [198]–[203], [228]–[242]. The objective approach to interpretation requires communication to be read in light of its joint or communal meaning. It is the objective approach to interpretation which facilitates the ability for courts to understand the meaning of instruments in light of shared normative values. For an overview of the interpretation and construction distinction see Lawrence Solum, 'The Interpretation-Construction Distinction' (2010) 27 *Constitutional Commentary* 95. It is important, however, to appreciate that often the terms interpretation and construction are used as synonyms in Anglo-Australian law, a point made in Joshua Getzler, 'Interpretation, Evidence, and the Discovery of Contractual Intention' in J Edelman, J Goudkamp and S Degeling (eds), *Contract in Commercial Law*, Lawbook Co., Sydney, 2016, p 121 at fn 2.

⁶⁵ This reflects the developing relationship between terms of cooperation and reasonableness in the exercise of contractual powers and rights: Anthony Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *LQR* 66 at 73. Sir Anthony Mason observed that the enforcement of security rights is an example where A has to take into account broader considerations in exercising her contractual rights against B. See also *Vodafone Pacific Ltd & Ors v Mobile Innovations Ltd* [2004] NSWCA 15 at [216]–[217] per Giles JA with whom Sheller and Ipp JJA agreed. In England see *MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2015] EWHC 283 (Comm) at [97] per Leggatt J although contrast with the skepticism of the Court of Appeal in *MSC Mediterranean Shipping Company SA v Cottonex Anstalt* [2016] EWCA Civ 789; [2017] 1 All ER (Comm) 483 at [45] per Moore-Bick LJ with whom Tomlinson LJ and Keehan J agreed.

to impose a significant consequence it will be interpreted narrowly against the party to be advantaged by the specific impugned term.⁶⁶ However, such interpretative presumptions can only go so far in elucidating the meaning of a text and cannot imprint upon the words a meaning they cannot possibly bear.

The interpretive approach is how the penalties doctrine functioned during the late 18th and 19th centuries and also into the early 20th century, when *laissez faire* notions of classical liberalism and the related concept of the power to contract reached their zenith. This approach is captured by Fredrick Pollock's treatise *Principles of Contract: at Law and in Equity*, which outlines the centrality of the parties' intentions in the application of the penalties doctrine at that time:⁶⁷

penal provisions inserted in instruments to secure the payment of money or the performance of contracts will not be literally enforced, if the substantial performance of that which was really contemplated can be otherwise secured. [...] Here again the original ground on which equity interfered was to carry out the true intention of the parties

As Professor Ibbetson has observed, the penalties doctrine was emasculated in the 19th century by virtue of an interpretive-based rationalisation: 'a clause was only treated as a penalty clause if it could not have represented the true intention of the parties'.⁶⁸ However, some authors question whether an interpretive-based approach provides a genuine explanation for the nineteenth century penalties cases. For example, the first edition of the seminal Australian text *Equity: Doctrines and Remedies* refers to the interpretive-based explanation of the rule against penalties as being a 'disingenuous' rationalisation for the rule.⁶⁹ With respect to the authors of that august text, it seems overly bold to suggest that for more than a century leading members of the Bar,⁷⁰ the Bench (both in the colonies and the United Kingdom)⁷¹ and

⁶⁶ For example, *Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235 (HL); and *MMP GmbH v Antal International Network Ltd* [2011] EWHC 1120 at [77] per Flaux J. See too *Tolhurst v Associated Portland Cement Manufacturers* [1903] AC 414 (HL) at 420 per Lord Macnaghten, for an example where a contract was interpreted as a matter of fairness. However, Sarah Worthington critically notes examples where courts failed to give effect to manifestly clearly drafted clauses on this basis: '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, London, 2016, p 314.

⁶⁷ Fredrick Pollock, *Principles of Contract: at Law and in Equity*, 2nd ed, Stevens & Sons, London, 1878, pp 445–6. See also Rossiter, above n 33, pp 14–20; and Warren Swain, *The Law of Contract 1670–1870*, Cambridge University Press, Cambridge, 2015, pp 190–3.

⁶⁸ David Ibbetson, *A Historical Introduction to the Law of Obligations*, Oxford University Press, Oxford, 1999, pp 255–6.

⁶⁹ RP Meagher, WMC Gummow and JRF Lehane, *Equity: Doctrines and Remedies*, Butterworths, Sydney, 1975, p 373.

⁷⁰ See, for example, the submissions of Serjeant Kinglake in *Reynolds v Bridge* (1856) 6 El & Bl 528; 119 ER 961.

⁷¹ See, for example, *Astley v Weldon* (1801) 2 Bos & Pul 346; 126 ER 1318; *Kemble v Farren* (1829) 6 Bing 141; 130 ER 1234; *Reynolds*, above n 70; *Grice*, above n 55; *Gleeson v Kingston* (1880) 6 VLR (L) 243; *Lamson Store Service Co v Weidenbach & Co's Trustees* (1904) 7 WALR 166; *Waterside Workers' Federation of Australia v Stewart* [1919] HCA 63; (1919) 27 CLR 119.

the academy separately provided disingenuous explanations for how the penalties doctrine operated. Indeed, penalties cases were being evaluated on the basis on which they properly applied the generally articulated interpretive-based principles. For example, Chitty's *Practical Treatise on Contracts Not Under Seal and upon the Usual Actions Thereon* describes the interpretive-based approach as 'settled law' and then proceeds expressly to list several authorities that were to be treated as irreconcilable with this settled approach.⁷²

The interpretive-based approach towards contractual penalties was one reason which led to the parties typically specifying that A's right to the fixed sum would stand as 'liquidated damages'.⁷³ In turn, this drafting technique ultimately resulted in greater judicial scrutiny of agreed remedies, culminating in the House of Lords' seminal decision in *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited*.⁷⁴ Thereafter the parties' intentions, as manifested by their agreement, did not provide a sufficient explanation of the operation of the penalties doctrine.⁷⁵ Rather, the court⁷⁶ would consider whether a right to a fixed sum was a penalty by asking the familiar, but now dated, question: is the fixed sum payable by B to A for B's breach of contract a genuine pre-estimate of the loss that A would suffer from the breach? Thus, applying this test, the traditional dichotomy between on the one hand a non-compensatory and therefore unenforceable or void penalty clause and, on the other, a valid and fully enforceable liquidated damages clause was born. Although enforcing this dichotomy is not necessarily inconsistent with the interpretive-based rationale, where A's right constitutes a genuine attempt by the parties at a pre-estimate of loss, this could be seen as a clear objective factor which points to the parties intending that the clause operates to give A a simple fixed sum as a remedy where the stipulation or obligation in question fails or is breached. This was the view taken by Professor Corbin in 1919, stating that the *Dunlop*

⁷² Joseph Chitty, *Practical Treatise on the use of Contracts Not under Seal and upon the Usual to Actions Thereon*, 4th American ed (from the 2nd Eng ed), G. and C. Merriam, Springfield Mass, 1839, pp 678–9, cites *Kemble* (n 71) as setting out the law and expressly lists authorities as of doubtful standing due to this new approach in the law.

⁷³ See also Rossiter, above n 33, pp 13–4. Although by referring to the sum as 'liquidated damages' the clause in question was also taken out of the relevant statutes of Anne and William. See also Francis Dawson, 'Determining Penalties as a Matter of Construction' (2016) *LMCLQ* 207 at 215–7.

⁷⁴ [1915] AC 79 (HL). This process is outlined in Ibbetson, above n 68, pp 255–6.

⁷⁵ But see PS Atiyah, *Essays on Contract*, Oxford University Press, Oxford, 1988, pp 369–74, who suggests that the parties do not intend to be bound by such clauses at all, as the penalties doctrine essentially puts to one side an ineffective deterrent and gives effect to the parties' intentions on the *fundamentals* of the contract at the expense of the side issue (ie the side issue being a penalty which is characterised as an ineffective or failed deterrent).

⁷⁶ This was the consistent position in both Australia and England until a clear divergence in the law between the two jurisdictions emerged in *Andrews*. Although prior to *Cavendish* and *Paciocco*, English cases had been reasoned on the basis of a purportedly penal clause being commercially justifiable (rather than compensatory on the *Dunlop* guidelines): see *Lordsvale Finance plc v Bank of Zambia* [1996] QB 752; and *Cine Bes Filmcilik ve Yapimcilik v United International Pictures* [2004] 1 CLC 401.

principles were ‘no more than presumptions as to the intentions of the parties; which may be rebutted by evidence of the contrary intention’.⁷⁷

By removing the strict breach of contract requirement for the penalties doctrine to be engaged, *Andrews* creates the opportunity for the law of penalties to be understood as resting on this interpretive-based rationale.⁷⁸ If such an approach were to be adopted, the doctrine would first require a penal clause to be interpreted as a security right in order for the penalties doctrine to be engaged. Indeed, the High Court’s reasoning in *Andrews* rested on many decisions that were expressly rationalised on this interpretive basis. Cases that were central to the reasoning in *Andrews* such as *Astley*,⁷⁹ *Kemble*,⁸⁰ *Reynolds*⁸¹ and *Waterside Workers*⁸² rested on an interpretive-based approach. Knox CJ, Barton and Gavan Duffy JJ in *Waterside Workers* captured this approach in the following terms:⁸³

The question whether in any given case the amount secured by a bond is to be regarded as a penalty or liquidated damages depends on the intention of the parties to the transaction, their intention to be ascertained from the language of the bond read in light of the circumstances under which it was given.

This interpretive-based approach is also reflected in the concurring judgment of Isaacs and Rich JJ who framed the relevant question as: ‘What relief would equity, on recognized principles, give here’.⁸⁴ The answer to the question was to further consider: ‘What was the real intent of the parties?’ Their Honours concluded that the impugned term in that case was so clear that it spoke for itself. This interpretive-based approach was also applied in *Boucaut Bay Co Ltd v Commonwealth*,⁸⁵ where Isaacs ACJ stated the relevant test as being: ‘whether the intention of the parties was that [the impugned fixed sum] should constitute liquidated

⁷⁷ William Anson and Arthur Corbin, *Principles of the Law of Contract: With a Chapter on the Law of Agency*, 3rd American Ed, Oxford University Press, Cambridge Mass, 1919, p 472.

⁷⁸ See Tiverios, above n 29.

⁷⁹ *Astley*, above n 71.

⁸⁰ *Kemble*, above n 71. Indeed this authority was treated as suspicious for not giving full effect to the parties’ intentions: see Kinglake Serjt in *Reynolds*, above n 70. Although see Rossiter, above n 33, pp 16–7 where Lord Westbury in *Thompson v Hudson* (1869) LR 4 HL 1 views *Kemble* as an intention or agreement based case.

⁸¹ *Reynolds*, above n 70.

⁸² *Waterside Workers’ Federation*, above n 71, 128–9 per Knox CJ, Barton and Gavan Duffy JJ; 131–2 per Isaacs and Rich JJ. It could not be suggested that the Court did not turn its mind to the decision in *Dunlop* as no less of an authority than Owen Dixon (for the appellant) referred to *Dunlop* in argument (as did Isaacs J). Indeed, *Dunlop* appears to be understood as assisting the interpretive process: e.g. where a sum is a genuine pre-estimate of loss the general objective intention would be for full enforcement of the fixed sum.

⁸³ *Waterside Workers’ Federation*, above n 71, at 128–9 per Knox CJ, Barton and Gavan Duffy JJ.

⁸⁴ *Waterside Workers’ Federation*, above n 71, at 132 per Isaacs and Rich JJ.

⁸⁵ [1927] HCA 59; (1927) 40 CLR 98.

damages' or stand as security.⁸⁶ Indeed, as the evidence which could be adduced in common law courts and in equity became unified during the 19th century, there was nothing uniquely 'equitable' about an interpretive approach towards the identification of a contractual penalty.⁸⁷ Indeed, if the authors of the first edition of *Equity Doctrines and Remedies* were right in their skepticism that the interpretive-based rationale was 'disingenuous' then it was not a skepticism shared by the High Court in *Andrews*. This is because, as outlined above, many interpretive-based cases formed the basis of the Court's reasoning. If the purported reasoning in authorities such as *Astley*, *Kemble*, *Reynolds* and *Waterside Workers* was thought to be wrong then why did the High Court in *Andrews* use these decisions to reformulate the rule?

The central point for present purposes is that if the High Court in *Andrews* is going to reach back to authorities at a certain point in time to support its reformulation of the penalties doctrine, it needs to consider the underlying doctrinal reasons *why* the grant of relief from a penalty was considered appropriate in those old authorities and assess whether those reasons are still persuasive in a modern context. In answer to this question, those who support a wide view of freedom of contract will find the adoption of an interpretive rationale appealing. So understood, *Andrews* opens the way for the law of penalties ultimately to be developed along coherent principles which reconcile the penalties doctrine with the classic critique that this doctrine derogates from the parties' powers to create mutually binding rights and obligations. However, this interpretive-based approach was not adopted in the High Court's subsequent decision in *Paciocco*.

iv. Security rights or interests as the application of an external set of legal principles to the contract: a question of construction

The *second* answer to the question of why A's use of her security right against B is limited in equity depends on contractual *construction*. Construction is used here to describe the ultimate legal effect that a court is willing to give to a legal text beyond its linguistic or semantic meaning (in contradistinction to contractual *interpretation* which concerns the linguistic meaning of the text). On a construction based approach, once A's right is characterised as a security right, it would be an abuse of that right for it to be used in particular ways. That is, a set of default rules applies once a contractual right is construed as being in the nature of a security. Although this approach is not wholly inconsistent with the interpretive-based approach described above, it requires an evaluative judgment by the court that looks more holistically at the overall nature of the impugned transaction rather than the parties' intentions.⁸⁸ The adoption of this second approach requires some further normative basis as to *why* the court would depart from the linguistic meaning attributed to the parties' promises

⁸⁶ *Boucaut*, above n 85, at 107.

⁸⁷ Indeed penalties cases such as *Astley*, above n 71; *Kemble*, above n 71; and *Reynolds*, above n 70; were all litigated in common law courts prior to the enactment of the Judicature Acts 1873–5. Note that one important procedural difference which would have led to different outcomes between common law and Chancery was that the common law did not treat a party to a cause as competent to give evidence until 1852, thus the common law court could not have looked beyond the form of a written instrument: WR Cornish and GN Clark, *Law and Society in England 1970–1950*, Sweet & Maxwell, London, 1989, p 42; and *Evidence Act 1851* (14 & 15 Vict c 99).

⁸⁸ *Prime Capital Securities Pty Ltd v Metafax Pty Ltd* [2016] NSWSC 1826 at [33] per Davies J.

(as evidenced by the contract). As the High Court subsequently made clear in *Paciocco*, where a right to a fixed sum is construed as existing to secure the performance of a primary duty, or the fulfilment of a non-promissory stipulation, then equity will intervene to disable the exercise of the impugned right so that the right is not exercised in a manner that will punish or impose an unjustifiable burden on the other contracting party.⁸⁹ That is, once a contractual right is construed as being a security, the law has a set of default rules that determine how such rights operate.

It is important to emphasise that equity is not concerned with A imposing a punishment or unjustifiable burden on B in the abstract. What equity is concerned with in these circumstances is the relationship between two contractual rights⁹⁰ and how those contractual rights are exercised. As Lord Cairns observed in a classic enunciation of the role of equity in restraining the unconscionable enforcement of a right:

if parties who have entered into definite and distinct terms involving certain legal results— certain penalties or legal forfeiture ... the person who otherwise might have enforced those rights will not be allowed to enforce them where it would be inequitable having regard to the dealings which have thus taken place between the parties.⁹¹

The penalties doctrine serves the purpose of ensuring that where the function of one right, going beyond its bare linguistic meaning, is to provide security for the performance of a primary contractual right or the fulfilment of a non-promissory stipulation, then it would be a penalty if the right to the fixed sum were permitted to be enforced beyond that function. If A is able to enforce the fixed sum significantly beyond the monetised *value* of the underlying secured primary right (or stipulation), the result would be that the fixed sum would have a punitive operation thereby imposing an unjustifiable burden on B.⁹² As Mason and Deane JJ observed in *Legione v Hately*⁹³ ‘A penalty, as the name suggests, is in the nature of a punishment for non-observance of a contractual stipulation; *it consists of the imposition of an additional or different liability upon breach [or failure] of the contractual stipulation*’.⁹⁴ The

⁸⁹ *Paciocco High Court of Australia*, above n 12, at [16]–[25] per Kiefel J with whom French CJ agreed; [127], [130], [157], [164] per Gageler J; [220], [255], [259] per Keane J. See further, *Sydney Constructions & Developments Pty Ltd v Reynolds Private Wealth Pty Ltd* [2016] NSWSC 1104 at [46] per Barrett AJA.

⁹⁰ Or stipulations, as the High Court in *Andrews* held that the penalties doctrine did not simply apply to rights to fixed sums that hinged on B’s breach of contract. See further *Cavendish*, above n 3, at [10] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; and *Paciocco High Court of Australia*, above n 12, at [164] per Gageler J.

⁹¹ *Hughes v Metropolitan Rly Co* (1876–77) LR 2 App Cas 439 at 448 per Lord Cairns.

⁹² See *Paciocco High Court of Australia*, above n 12, at [17], [32] per Kiefel J with whom French CJ agreed; [118] per Gageler J; [225] per Keane J. A penalty is a sum stipulated to be paid which could not be accounted for by reference to the value of the underlying secured stipulation or A’s other legitimate interests and thus the fixed sum can only be accounted for as a punishment for default.

⁹³ [1983] HCA 11; (1983) 152 CLR 406. Approved in *Andrews*, above n 10, at [9] per French CJ, Gummow, Crennan, Kiefel and Bell JJ; and *Paciocco High Court of Australia*, above n 12, at [22], [32] per Kiefel J with whom French CJ agreed; [118] per Gageler J; [255] per Keane J.

⁹⁴ *Legione*, above n 93, at 445 per Mason and Deane JJ (emphasis added).

essential point being: there is no way of determining whether or not an impugned penalty imposes an ‘additional’ or ‘different’ liability without a curial determination as to the monetised value of the underlying secured primary stipulation (or obligation), the failure of which triggers A’s right to the ‘penal’ fixed remedy.

In applying this construction-based approach to determine whether or not the clause is penal, the approach adopted in the cases can be broken down into three stages of inquiry.⁹⁵ The *first* stage is to ask whether the impugned clause attracts the operation of the penalties doctrine (termed the anterior stage of analysis in *Andrews*). If the penalties doctrine is applicable the *second* stage of inquiry is to consider whether the impugned clause is penal in character (as considered by the High Court in *Paciocco*). If the impugned clause is penal in character the *final* stage of analysis is for the court to consider the appropriate response: the penal clause is given a scaled down operation.

Viewed this way, for the penalties doctrine as enunciated in *Andrews* to be enlivened, there must first be a collateral right (the penalty) which as a matter of substance operates as a security right to ensure the performance of a related ‘primary’ contractual stipulation or obligation (being the first stage of inquiry: is the doctrine engaged). Where the collateral right is construed as a security right, the court will restrain the exercise of that collateral right to ensure that it is only enforced to the extent necessary to secure performance of the related primary stipulation (or the stipulation’s monetised equivalent). As partial enforcement of the collateral ‘security’ right may be all that is required to achieve performance of the ‘secured’ primary stipulation, the court may provide for a scaled down or *pro tanto* enforcement of the collateral right (being the third stage of the inquiry: the appropriate remedial response). Thus equity disables A from insisting on the strict exercise of her legal right where it is first construed as existing as mere ‘collateral’ to secure the performance of some other contractual stipulation (i.e. a duty or non-promissory condition) and where the quantum of the fixed sum is not referable to the value of the secured duty or secured stipulation (being the second stage of the inquiry: a clause is penal where the sum fixed is greater than the value the law attributes to the secured stipulation or obligation, as the sum fixed would impose an ‘additional’ or ‘different’ form of liability on B). In such circumstances it could colloquially be said that, in equity, the fixed sum stands only as security because the parties have not properly assessed the real prejudice that would be suffered if the underlying secured obligation or secured stipulation was not performed or fulfilled.⁹⁶ However, it is important to note that a more deferential standard is now adopted in determining whether or not an impugned clause is penal in character. As the High Court made clear in *Paciocco*, A’s right to

⁹⁵ The first two stages of inquiry are crisply set out in *Sydney Constructions*, above n 89, at [46] per Barrett AJA. See further, in *Andrews*, above n 10, at [9], [15] per French CJ, Gummow, Crennan, Kiefel and Bell JJ; *Magnin v Creevey* [2017] NSWSC 375 at [11] per Harrison J; and *Tiverios*, above n 29, p 488. In the English context see *Vivienne Westwood Limited v Conduit Street Development Limited* [2017] EWHC 350 (Ch) at [41] per Timothy Fancourt QC.

⁹⁶ This touches on the view of E Peden and JW Carter, ‘A Good Faith Perspective on Liquidated Damages’ in Charles EF Rickett (ed) *Justifying Private Law Remedies*, Hart Publishing, Oxford, 2008, p 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 Rossiter, above n 33, p 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’.

a fixed sum can still be fully enforceable notwithstanding that right not being a genuine pre-estimate of the loss or damage⁹⁷ suffered by the failure of the secured stipulation or obligation. Rather, 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 as the right cannot be seen as a mere security.⁹⁸ This weaker form, or more deferential standard, of judicial scrutiny 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.⁹⁹

In summary, two important points need to be made. First, there are two different contemporary 'equitable' rationales as to why A may be restrained from exercising a fixed sum security right as against B. Depending on which rationale were to be adopted, the scope and function of the penalties doctrine would be different. On an interpretive-based approach, the rule against penalties has a minimal application, functioning as it did when the power to contract was at its zenith. The rule would do no more than act as a linguistic or interpretive presumption for determining whether or not A's right to a fixed sum is enforceable outright or by way of security. On the other hand, where the equitable rule against penalties is concerned with imposing external principles onto the parties' contractual relationship to prevent A from using her right to a fixed sum to impose an unjustifiable detriment on B, then the rule against penalties will be more interventionist in operation in contrast to the interpretive-based approach (notwithstanding the adoption of a more deferential standard for whether a clause is a penalty in *Paciocco*). The second point is that, for present purposes, it does not matter too much which approach to the equitable rule against penalties is correct. What is important to emphasise is that both rationales differ from the reasoning in *Cavendish* and the rationale for the common law rule. Accordingly, the remainder of this article contrasts the security-based rationale with the leading alternative 'common law' conceptualisation for the penalties doctrine which is illustrated by the Supreme Court of the United Kingdom's decision in *Cavendish*.

II

COMMON LAW — PRESERVING A LEGALLY IMPOSED REGIME REMEDYING BREACH OF CONTRACT

i. Cavendish — the penalties doctrine as a public policy rule

⁹⁷ On the application of the guidelines set out by Lord Dunedin in *Dunlop*, above n 74.

⁹⁸ *Paciocco Full Court of the Federal Court*, above n 13, at [99]–[103] per Allsop CJ. McFarlane, above n 29, at [13.013]; and Tiverios, above n 29, p 489. See the functionally similar tests set out in *Paciocco High Court of Australia*, above n 12, at [29] per Kiefel J with whom French CJ agreed; [157], [165] per Gageler J framing the inquiry this way allows identification of whether the clause functions beyond having a punitive operation (and therefore not being limited to acting as a security right); [270] per Keane J. Although Nettle J dissented on this point.

⁹⁹ *Phillips Hong Kong v A-G of Hong Kong* (1993) 61 BLR 41 (PC) at 59 per Lord Woolf. For a powerful moral defence of party autonomy in contract see Jeremy Bentham, *Defence of Usury*, Bk 1, 4th ed, Payne and Foss, London, 1818, at [5]. See too the influential defence of the policy of freedom of contract in *Printing and Numerical Registering Company v Sampson* (1874-75) LR 19 Eq 462 at 465 per Sir George Jessel MR.

The Supreme Court of the United Kingdom expressly declined to follow the Australian approach as set out in *Andrews* in the conjoined *Cavendish* and *ParkingEye* appeals. In both appeals the Supreme Court unanimously held that the impugned contractual clauses were valid and therefore did not infringe the penalties doctrine. In *Cavendish*, the impugned clauses operated to (i) destroy B's contractual right to payments for the sale of shares, and (ii) confer on A an option to buy shares from B below market value, if B breached restrictive covenants (designed to protect goodwill) contained in a contract for the sale of a media company.¹⁰⁰ In *ParkingEye* a parking fee (of £85) was levied on motorists (B) when their vehicles were parked beyond two hours in an otherwise free car park.¹⁰¹ It is useful for the purpose of explaining the underlying rationale of the English penalties doctrine to set out the central holdings of the Court. The *first* significant holding is the express characterisation of the penalties doctrine in England as a common law rule and not, as in Australia, a rule of equity.¹⁰² The *second* significant holding was that the operation of the penalties doctrine in England was said to hinge upon circumstances where there is a breach of a contractual obligation.¹⁰³ The *third* significant aspect of the decision was that the Court set out a reformulated, and more deferential, test for when a clause is penal in character. This test is described in functionally similar terms to that later adopted by the High Court in *Paciocco*. As the plurality¹⁰⁴ said, the true test for whether a clause is 'penal' requires consideration of 'unconscionability' and 'exorbitance'¹⁰⁵ by reference to the following more specific formulation:¹⁰⁶

¹⁰⁰ Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed held that such clauses did not attract the operation of the penalties doctrine because, notwithstanding being triggered on B's breach of contract, the clauses did not create obligations equivalent to contractual alternatives to common law damages and thus they were not 'secondary obligations'. Lord Hodge and Lord Toulson, held that the penalties doctrine *was* engaged but that the impugned clauses served A's legitimate interests in preserving the value of the goodwill in the company. However, the positions of Lord Mance and Lord Clarke are ambiguous. Lord Mance did not provide a clear holding on the issue of whether the doctrine was engaged although his Lordship clearly agreed that the impugned clauses were justifiable as serving A's legitimate interests. Lord Clarke appears to have agreed with the reasoning of Lord Neuberger and Lord Sumption and also Lord Hodge but favoured Lord Hodge's approach of having an open mind as to whether the impugned clauses attracted the operation of the penalties doctrine.

¹⁰¹ The court unanimously held that the impugned parking fee was valid as it had a commercial justification or served a legitimate interest, being (i) facilitating increased consumer turnover in a related retail premises; and (ii) enabling the parking services provider to properly administer the free parking scheme.

¹⁰² *Cavendish*, above n 3, at [42] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed. This tension is also captured in *T.K (Hong Kong) Limited v Diamond Milk Formulas Limited* [2016] NZHC 2642 at [38]–[39] per Doogue J.

¹⁰³ *Cavendish*, above n 3, at [7]–[14] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; [129]–[130] per Lord Mance; [241] per Lord Hodge.

¹⁰⁴ Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed.

¹⁰⁵ *Cavendish*, above n 3, at [22], [31] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed.

¹⁰⁶ *Cavendish*, above n 3, at [22], [28], [31]–[32] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed. See also at [151]–[153] per Lord Mance; [255] per Lord Hodge. The concept of

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

The *fourth* and final significant holding of the Court for present purposes is the consequence which ensues when a right to a fixed sum fails this test. The Court held that the consequence of a finding that a clause is a penalty is that the right is wholly void and the parties are left to seek a remedy pursuant to general law principles governing relief for breach of contract. There is no room in English law for a court to ‘resuscitate’ a penalty by giving it an *Andrews* style *pro tanto* or scaled down application. For completeness, it is worth observing that the Court also said that the common law penalties doctrine could potentially apply to a range of different obligations triggered on a breach of contract. For example, (i) A’s right to a fixed sum as against B; (ii) A’s right against B to transfer an asset;¹⁰⁷ (iii) A’s right to retain payments (including deposits) made by B;¹⁰⁸ and (iv) where B becomes disentitled from receiving a payment from A.¹⁰⁹

At first blush the Supreme Court’s reformulation of the law of penalties appears to be largely pragmatic. In response to submissions that the penalties doctrine should be overruled in its entirety¹¹⁰ (or at least in its application to commercial contracts), the Court provided various practical reasons for keeping the rule, including:¹¹¹ (i) the penalties rule¹¹² is a longstanding feature of English law; (ii) the penalties doctrine, or a similar rule, is present in most other

a legitimate interest goes beyond compensation for breach of contract. As the plurality observed *Dunlop*, above n 74, could only be justified with respect to wider interests. As Lord Mance also observed, at [145]: ‘commercial interests may justify the imposition upon a 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’. The test posited by Lord Hodge at [255], was functionally the same ‘the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party’s interest in the performance of the contract’.

¹⁰⁷ *Cavendish*, above n 3, at [170] per Lord Mance; [230] per Lord Hodge.

¹⁰⁸ *Cavendish*, above n 3, at [16] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; [154], [159] per Lord Mance; [226], [234] per Lord Hodge.

¹⁰⁹ Although Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed did not expressly decide this point and *assumed* that such a clause could, in some circumstances, attract the operation of the penalties doctrine.

¹¹⁰ *Cavendish*, above n 3, at [36] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; [126] per Lord Mance; [216] per Lord Hodge.

¹¹¹ See *Cavendish*, above n 3, at [36]–[39] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; [126], [162]–[168] per Lord Mance; [256]–[268] per Lord Hodge.

¹¹² The existence of similar, but distinct, legal rules such as relief from forfeiture was also noted: *Cavendish*, above n 3, at [39] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed. Further, the Court noted that giving effect to the parties’ primary obligations is not the sole concern of the remedial policies underlying the law of contract.

jurisdictions;¹¹³ (iii) it was institutionally, and constitutionally, difficult for the Court now to overrule a longstanding legal principle; and (iv) the rule, in part, helps to redress inequalities in bargaining power in circumstances where there is no relevant legislative regime in place. This line of reasoning reflects a pragmatic judicial approach of confining a longstanding but undesirable judge made rule, which is difficult to overrule in the course of a curial process governed by precedent, by subsequently (and incrementally) reducing the scope of the rule rather than abolishing it.¹¹⁴

It is submitted that the best understanding of the *Cavendish* formulation is that it fits the view that the common law penalties doctrine voids remedial clauses contrary to public policy: the doctrine prevents clauses that impermissibly derogate too far from the state's jurisdiction to impose remedies for a breach of contract.¹¹⁵ The remedy granted for a breach of contract is part of an externally imposed regime that is enforced by the state, via the curial process, and is not bespoke to a specific contract.¹¹⁶ The general default remedy for a breach of contract is an order by the court for the payment of compensation that reflects a party's expectation loss.¹¹⁷ Thus a clause that infringes the rule against penalties is simply 'a species of agreement which the common law considers to be by its nature contrary to the policy of the law'.¹¹⁸ However, in deference to freedom of contract, being the parties' powers to determine their own mutually binding rights and obligations, post-*Cavendish* a fixed remedy clause will not be penal simply because the remedy imposed differs from the typical compensatory award that the common law would grant for a breach of contract. Rather, to be a penalty at common law post-*Cavendish*, A's fixed remedy needs to be out of all proportion when contrasted with A's legitimate interests in B's performance of her contractual duty.

ii. *Secondary rights as sanctions or remedies*

¹¹³ Reference was made to Roman law, Germany, Belgium, Italy, Switzerland, France, European law, the UNIDROIT Principles of International Commercial Contracts and the UNCITRAL Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance.

¹¹⁴ An observation forcefully made in Robert Stevens, 'Rights Restricting Remedies' in Andrew Robertson and Michael Tilbury (eds) *Divergences in Private Law*, Hart Publishing, Oxford, 2016, p 172.

¹¹⁵ See *Cavendish*, above n 3, at [7]–[14] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; [129]–[130] per Lord Mance; [239]–[241], [243] per Lord Hodge. See too *Export Credits*, above n 26. Although the parties are still free to either limit or waive their rights to recovery for a breach of contract: see Rossiter, above n 33, p 70.

¹¹⁶ Smith, above n 64, pp 390–2, 430.

¹¹⁷ Where a plaintiff seeks damages for breach of contract, the usual response is compensatory damages: *Robinson v Harman* (1848) 1 Ex 850, 154 ER 363; and *Commonwealth v Amann Aviation Pty Ltd* (1991) 174 CLR 64, 80 per Mason CJ and Dawson J. Alternative remedies include an injunction, specific performance, nominal damages, substitutive damages and, more controversially in the Australian context, restitutionary and disgorgement damages.

¹¹⁸ *Cavendish*, above n 3, at [9] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed. See too *Pencil Hill Limited v US Citta Di Palermo S.p.A* [2016] WL 212897 at [24] per Bird J. This public policy approach was recently endorsed in New Zealand, see *Diamond Milk Formulas*, above n 102, at [39] per Doogue J. See too *Paciocco High Court of Australia*, above n 12, at [253] per Keane J.

To properly appreciate what this ‘public policy’ rationale seeks to protect it must be appreciated what happens when the state, by curial intervention, provides a remedy for breach of contract. When a court awards a remedy¹¹⁹ or sanction in response to a successful breach of contract claim, that award constitutes a new ‘secondary’ right which arises as a substitute for the primary obligation to perform the contract.¹²⁰ In this connection, it was Professor John Austin who influentially drew the distinction between primary and secondary rights. He said that:¹²¹

Rights and duties which are consequences of delicts, are sanctioning (or preventive) and remedial (or reparative). In other words the ends or purposes for which they are conferred and imposed are two. First, to prevent violations of rights and duties which are not consequences of delicts; second, to cure the evils or repair the mischiefs which such violations engender.

Rights and duties not arising from delicts may be distinguished from rights and duties which are consequences of delicts, by the name of ‘primary’ or principal. Rights and duties arising from delicts, may be distinguished from rights and duties which are not consequences of delicts by the name of ‘sanctioning’ or ‘secondary’. I call them ‘sanctioning,’ because their proper purpose is to prevent delicts or offenses.

The essential observation that comes out of Austin’s influential work is that he identified that the causative event which gives rise to a secondary right must be a breach of duty. The secondary right thus provides the appropriate *sanction* or *remedy* in response to a defendant’s wrongdoing.¹²² This Austinian taxonomical delineation is important as it enables a unified

¹¹⁹ Even a decree of specific performance is different from the original obligation to perform the contract: (i) the decree carries with it the potential to be sanctioned for contempt of court; and (ii) the content of the decree is different to the primary obligation in the contract insofar as late performance ordered by the curial decree differs from actual timely performance under the terms of the contract (at least for all non-anticipatory breaches of contract). See Wesley Newcomb Hohfeld, ‘The Relations Between Equity and Law’ (1913) 6 *Michigan Law Review* 537, at 551. See also *Burnley v Stevenson* (1873) 15 Am Rep 621; 24 Oh St 474, at 478–9 per McIlvaine J with whom Day CJ, White and Rex JJ agreed; *Bullock v Bullock* (1894) 52 N J. Eq 561; 46 Am St Rep 528 at 534 per Magie J with whom Garrison J agreed; *Fall v Eastin* (1909) 215 US 1 at 14 per Holmes J.

¹²⁰ *Moschi v Lep Air Services Ltd* [1973] AC 331 at 346–7 per Lord Diplock; *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827, 848–9 per Lord Diplock; and see also Smith, above n 64, p 392.

¹²¹ John Austin, *Lectures on Jurisprudence, or, The Philosophy of the Positive Law*, Vol II, 5th ed, James Cockcroft and Company, New York, 1885, at [1031].

¹²² Austin, above n 121, at [1037]–[1040]. See further, Hohfeld, above n 119, at 554, 556; Anson and Corbin, above n 77, at [401]; Wesley Newcomb Hohfeld, ‘Some Fundamental Legal Conceptions as Applied to Judicial Reasoning II’ (1917) *Yale Law Journal* 710 at 760; Peter Birks, ‘Obligations: One Tier or Two?’ in PG Stein and ADE Lewis (eds) *Studies in Justinian’s Institutes in memory of J.A.C. Thomas*, Sweet & Maxwell, London, 1983, p 21; Peter Birks ‘Personal Property: Property Rights and Remedies’ (2000) 11 *KCLJ* 1 at 8; James Edelman, ‘Gain-Based Damages and Compensation’ in Andrew Burrows and Lord Rodger of Earlsferry (eds) *Mapping the Law: Essays in Memory of Peter Birks*, Oxford University Press, Oxford, 2006, pp 142–6; Robert Stevens, ‘Damages and the Right to Performance’ in Jason Neyers, Richard Bronaugh and Stephen Pitel, *Exploring Contract Law*, Hart Publishing, Oxford, 2009, p 172; and Stephen A Smith, ‘Remedies for Breach of Contract’ in Gregory Klass, George Letsas and Prince Saprari (eds.) *Philosophical Foundations of Contract Law*, Oxford University Press, Oxford, 2014, pp 354–361.

law of remedies which responds to all manner of civil wrongs rather than a *sui generis* series of remedial principles responding to each species of wrongdoing.¹²³

The salient point here about delineating between primary and secondary rights is twofold. First, it proved essential in the reasoning in *Cavendish* and subsequent cases: the penalties doctrine in England only applies to ‘secondary rights’ (although there is some uncertainty in the post-*Cavendish* jurisprudence as to whether a ‘secondary right’ in the context of the penalties doctrine is a fixed remedy clause that: (i) only performs the same function as a contractual award of damages; or (ii) provides any agreed sanction or remedy for breach of contract).¹²⁴ Second, the delineation provides an analytical framework for understanding why the penalties doctrine in England, and most other common law jurisdictions for that matter, is best understood as a common law rule of public policy. The doctrine preserves the state’s jurisdiction to impose a secondary right for the breach of a primary obligation (here a breach of a contract): the law will not assist in the enforcement of a fixed sum clause that would go too far in stultifying the general remedial policies which would otherwise be applicable on a breach of contract.

While the penalties doctrine affords the parties considerable scope to set the quantum of damages payable on a breach of contract (and this scope to fix damages appears to have further increased in *Cavendish* due to the creation of a more deferential test for whether or not a clause is penal), where the fixed remedy clause is out of all proportion to A’s legitimate interest in the performance of the related primary obligation, the doctrine applies to wholly invalidate the impugned term. Further, as punitive damages are not available for a breach of contract,¹²⁵ the penalties doctrine ensures that a fixed remedies clause will not result in a party being unduly ‘punished’¹²⁶ as the doctrine requires a fixed remedies clause to be referable to the value (albeit loosely) of the relevant primary obligation breached. Accordingly, on this

¹²³ Austin, above n 121, at [1038]: ‘In strictness, my own terms, “primary and secondary rights and duties” do not represent a logical distinction The reason for describing the primary right and duty apart, for describing the injury apart, and for describing the remedy or punishment apart, is the clearness and compactness which result from the separation. For the same remedial process is often applicable to a variety of classes of rights, and repetition is consequently avoided’.

¹²⁴ Compare *Paul Richards, Keith Purves v IP Solutions Group Ltd* [2016] EWHC 1835 (QB) at [83]–[85] per May J; *Edgeworth Capital (Luxembourg) S.A.R.L, Aabar Block S.A.R.L v Ramblas* [2016] EWCA Civ 413 at [7] per Moore-Bick LJ with whom King and Sales LJJ agreed; *Hayfin v Windermere VII CMBS* [2016] EWHC 782 (Ch) at [132] per Snowden J; and *Browns Bay Resort Ltd v Pozzoni (Antigua and Barbuda)* [2016] UKPC 10 at [9] per Lord Hodge; *Gray v Braid Group (Holdings) Ltd* [2016] CSIH 68 at [81]–[82] per Lord Menzies; [106] per Lord Brodie.

¹²⁵ Smith, above n 64, p 417. In England see *Cassell & Co v Broome* [1972] AC 1027. In Australia see *Hospitality Group Pty Ltd v Australian Rugby Union Ltd* (2001) 110 FCR 157 at [133] per Hill and Finkelstein JJ. In *Hospitality*, the Court drew support from a number of cases including *Addis v Gramophone Co Ltd* [1909] AC 488; *Butler v Fairclough* (1917) 23 CLR 78 at 89 per Griffith CJ; *Whitfeld v De Lauret & Co Ltd* (1920) 29 CLR 71 per 77 Knox CJ; *Gray v Motor Accident Commission* (1998) 196 CLR 1 at [13] per Gleeson CJ, McHugh, Gummow and Hayne JJ. For a powerful academic argument that exemplary damages should be available for breach of contract see James Edelman, ‘In Defence of Exemplary Damages’ in Charles EF Rickett (ed) *Justifying Private Law Remedies*, Hart Publishing, Oxford, 2008, p 225.

¹²⁶ *Cavendish*, n above 3, at [31] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed; [243] per Lord Hodge.

conceptualisation of the penalties doctrine, the doctrine *requires* a breach of contract in order to be engaged because there is no secondary obligation to pay damages imposed by the court in lieu of performance of the primary contractual obligation *unless* that primary obligation has first been breached.¹²⁷ This is because A's right to damages for a breach of contract is an *a posteriori* right: the remedy imposed by the state (in this case generally A's right to damages) would never materialise unless there was first an *a priori* breach of contract.¹²⁸ For example, on the common law conceptualisation of the penalties doctrine, if an impoverished PhD student (B) agrees to work for A as a private law tutor on day X for the sum of £200, it would be *prima facie* inconsistent with the nature of B's obligation to work on day X, and A's interests in the performance of that obligation, to include a clause in the contract that: 'should B breach the contract by failing to provide the contracted services on day X she must pay to A £100,000'.

iii. *Limitations on the primary and secondary rights distinction*

The distinction between the content of the parties' primary obligations contained within a contract and the remedy which may ultimately be imposed for any breach of those primary obligations was emphasised in *Cavendish* by Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed: 'The penalty rule regulates *only* the remedies available for breach of a party's primary obligations, not the primary obligations themselves'.¹²⁹ One important caveat should be placed on the use of the terms 'primary' and 'secondary' obligations to describe rights to fixed sums in the context of the penalties doctrine and as used by Lords Neuberger and Sumption in *Cavendish*. The need for this caveat arises from the form in which their Lordships expressed the test for whether a clause was penal and their failure properly to distinguish between 'primary rights' and 'secondary rights' in the context of the penalties doctrine.¹³⁰ Such a criticism of their Lordships' reasoning would proceed along these lines: every time A has a contractual right to a fixed sum, that right is actually a primary right in the Austinian sense. This is because the right to the fixed sum is contained within the 'four corners' of the contract. The causative event that creates A's right to the fixed sum is the original exercise of consent by the parties in entering into the contract in question (and A's right to the fixed sum is merely *triggered* or *enlivened*, but not created, by B's wrongdoing). The impugned right to the fixed sum is not a true secondary right as it is *not externally imposed* on the parties as a sanction or remedy by operation of law¹³¹ or the curial process.

¹²⁷ Stevens, above n 114, p 176.

¹²⁸ Edelman, above n 125, p 237. See too Austin, above n 121, at [1039].

¹²⁹ *Cavendish*, above n 3, at [13] per Lord Neuberger and Lord Sumption with whom Lord Carnwath agreed.

¹³⁰ The primary and secondary rights distinction was considered unworkable in Carmine Conte, 'The penalty rule revisited' (2016) 132 *LQR* 382 at 386.

¹³¹ A secondary right can arise independently of the curial process. Indeed, Austin and Hohfeld both used the example of the privileges of self-help and self-defense which arise in response to the wrongs of trespass to land and trespass to person. Thus if A commits an assault against B, then it can be observed that B has a privilege of self-defense against A. This privilege of self-help can be seen as a secondary right (or secondary jural relation): a remedy or sanction that arises as a direct response to A's wrongdoing. In order for B to gain the privilege to inflict reasonable bodily harm against A to fend

Thus where A can enforce the fixed sum clause against B, the sum fixed by the parties functions as an agreed debt rather than true contractual damages.¹³² Therefore, if the penalties doctrine is about policing the content of secondary obligations, why cut down A's right to the fixed sum as it is *not* a secondary or court ordered obligation but is part of the primary rights and obligations that the parties have inserted into their bargain?

The response to this criticism is that it only raises a semantic problem. The underlying rationale for the English penalties doctrine is that it preserves the court ordered regime for imposing a remedy for *breach* of contract. Despite the unhelpful use of language by the Court in *Cavendish*, this rationale does *not* require that A's right to a fixed sum is a 'secondary' or 'sanctioning' obligation in the precise sense used by Austin. Rather, it requires A's right to the fixed sum to perform the same *function* as a 'secondary' or 'sanctioning' right in the Austinian sense. That is, the mischief that the English penalties doctrine is concerned with is that A's right to the fixed sum performs the same remedial or sanctioning function for B's breach of contract as would a 'secondary' or 'court ordered' obligation. This is precisely why, on the English approach, a breach of contract is required to enliven the penalties doctrine. A's right to a fixed sum is not performing the same sanctioning or remedial function as a court award for damages *unless* A's right to the fixed sum first turns on B's breach of contract.¹³³

III

SOME STRENGTHS AND WEAKNESSES

The thesis put forward in this article is relatively modest. It sets out two alternative views of how the penalties doctrine can be conceptualised. No final view is taken as to which approach is superior. Both Australia and England have adopted rational solutions to the same legal problem. Each approach has its strengths and weaknesses.

First, as a matter of which approach fits best with legal history, the High Court of Australia's decision in *Andrews* appears sound. The formulation enunciated in *Andrews* for when the penalties doctrine is engaged does not depend on a breach of contract. This is because the Court took the view that it was the characterisation of a fixed sum remedy as being a security to ensure the happening of some other event that was the essential hook on which the jurisdiction to relieve against penalties operated in its full historical context. Further, as this article has made clear, the High Court's conception of A's right to a fixed sum existing to secure the fulfillment of a non-promissory condition does not simply represent a conceptual possibility, but is reflected in authorities where relief against a penalty was granted for the

off A's attack, B is *not* required to first obtain an order from a court. See Austin, above n 121, p 294; and Hohfeld, above n 119, at 554.

¹³² Andrew Burrows, *Remedies for Torts and Breach of Contract*, 3rd ed, Oxford University Press, Oxford, 2004, pp 440–1. Thus A is still given the advantage of avoiding the limitations associated with whether she can claim damages for breach of contract (causation, remoteness and mitigation do not enter the analysis). Indeed, one benefit of a fixed damages clause is that it might expand the loss recoverable under the remoteness rules limiting recovery for breach of contract: *Hadley v Baxendale* (1854) 9 Exch 341. See *Paciocco High Court of Australia*, above n 12, at [163] per Gageler J.

¹³³ Austin, above n 121, at [1039].

failure of a non-promissory condition.¹³⁴ Thus the criticism levied at the High Court of Australia's use of legal history in *Andrews* by Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed) in *Cavendish* was unfounded. Indeed, the breach requirement to enliven the penalties doctrine, which was reaffirmed in *Cavendish*, appears to be an accident of history.¹³⁵ The breach requirement was *not* based on a conscious judicial policy to limit the scope of the penalties doctrine but stems from an incorrect enunciation of principle contained in a 1926 *ex tempore* judgment of Salter J (with whom Fraser J agreed) in the Divisional Court of England and Wales which eventually crystallised into a fixed legal rule.¹³⁶ However, a legal history lesson alone ought not solely govern the proper rationalisation for the penalties doctrine. For example, no one would suggest today that the antiquated procedure of a wager of law or compurgation¹³⁷ in simple debt cases was a good legal rule because it was, at one time, a longstanding historical feature of the common law.

Second, where the penalties doctrine (as it is in England) is rationalised as existing to preserve the externally imposed remedial regime for breach of contract, then requiring a 'secondary' contractual right arising on breach of contract to enliven the doctrine can, on one view, be seen as providing a principled threshold test. However, the English approach of hinging the application of the penalties doctrine on breach of contract creates a paradox whereby a wrongdoer may be afforded relief from a penalty, whereas such relief is unavailable to a contractual party who kept her bargain. Thus where the penalties doctrine hinges on breach of contract, the benefit of the doctrine enures only to those who have committed a wrong: B may escape paying A a fixed remedy only in circumstances where B has first committed the civil wrong of breach of contract. The objection to the English rule of penalties based on the distinction between circumstances when the court's jurisdiction to grant a remedy for breach of contract is (and is not) enlivened is robbed of much of its force on the Australian approach, where the relevant inquiry for the doctrine to be enlivened is the question of whether A's right to a fixed remedy against B is a mere collateral or security right. However, it is important to appreciate that any threshold test for when the penalties doctrine is engaged is always going to turn, to some extent, on questions of drafting. Indeed, it appears possible to draft around the post-*Andrews* security rights formulation for when the penalties doctrine is engaged. As the High Court observed in *Andrews* it is not conceptually possible for A's right to a fixed sum against B to attract the operation of the equitable

¹³⁴ See above text to n 58.

¹³⁵ JD Heydon, MJ Leeming and PG Turner, *Meagher, Gummow & Lehane's Equity Doctrines & Remedies*, 5th ed, LexisNexis Butterworths, Sydney, at [18-040]–[18-045]; Rossiter, above n 33, pp 66–9; and Tiverios, above n 29, at 472–3.

¹³⁶ *Elsey & Co Ltd v Hyde* (Divisional Court, 9 June 1926), extracted in CG Jones and R Proudfoot, *Notes on Hire Purchase Law*, 2nd ed, Butterworth & Co, London, p 107.

¹³⁷ The procedure whereby, in response to A's debt claim, B would swear on oath that he did not owe A the impugned debt. The court would accept B's oath as a full answer to A's claim if B obtained the oaths of typically 11 'witnesses' testifying to B's character and not the facts of the case. Often the witnesses had no local nexus to the dispute (as witnesses were often paid and based in London): JH Baker, *An Introduction to English Legal History*, 4th ed, Oxford University Press, Oxford, 2007, p 74; Simpson, above n 37, p 137–9; and TFT Plucknett, *A Concise History of the Common Law*, 5th ed, Little & Brown Co, 2010, Liberty Fund ed., pp 115–6. The process was fully abolished in 1833 by statute, see *Civil Procedure Act 1833* (UK) (3 & 4 Will. IV, c. 42), s 13.

penalties doctrine in circumstances where the fixed sum constitutes the consideration for B's further contractual right or benefit. This is because a fee imposed as consideration for a benefit does not operate as a security right.¹³⁸ Thus there still remains room in Australia for parties to change the underlying substance of a transaction in order to escape the operation of the penalties doctrine (e.g. by making the potentially penal fixed fee the consideration payable for a further right or benefit).

Finally, although there are some significant differences between the two approaches to the law of penalties set out in this article, it is important to note that there is also a degree of conceptual overlap. The differences are clear, Australian and English law has diverged on the questions of: (i) when the penalties doctrine is engaged; and (ii) the potential remedial consequences of a finding that a clause is penal. However, a degree of overlap arises at the important stage of inquiry as to whether or not a clause is punitive in character. The Australian approach requires the court, applying a deferential standard, to consider the monetised value of the underlying secured primary stipulation (or obligation) in order to assess whether or not A's enforcement of her right to a fixed sum would punish or impose an unjustifiable detriment on B. Put shortly, to paraphrase the influential dicta of Mason and Deane JJ in *Legione*, there is no way of determining whether or not an impugned penalty imposes an additional or different liability on B without first determining what B's default liability under the contract ought to have been. At a high level of generality, the English approach is not dissimilar at this stage of inquiry, as the court must consider whether the sum fixed in the contractual agreed remedy clause is referable to the value of the relevant primary obligation breached. Like Australia, English law also now adopts a deferential standard in making this assessment.

CONCLUSION

In view of the decisions in *Andrews*, *Cavendish*, *ParkingEye* and *Paciocco*, this article has provided two potential rationales that can explain the distinct approaches to the law of penalties adopted in England and Australia. The Australian or 'equitable' rule 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 way of security from being enjoyed beyond the function or purpose of security (by imposing an unjustifiable detriment on B) in light of how the law attributes value to the underlying secured stipulation or obligation. Whereas the English or 'common law' rule, as stated in *Cavendish*, regulates the parties' ability to determine the quantum of the secondary obligation that arises upon breach of a primary contractual obligation. The English rule prevents fixed sum clauses which derogate too far from the default remedy available for a breach of contract (ie the primary contractual obligation, breach of which gives rise to a secondary right to damages enforceable by A against B). While there is overlap between these two rationales, which is unsurprising given that the rules share a common history, they remain distinct.

The two rationales explain the two essential differences between the English law and the Australian law of penalties. The first difference is that, unlike England, a breach of contract is not required to enliven the penalties doctrine in Australia. The second difference is the

¹³⁸ *Andrews*, above n 10, at [79]–[82] per French CJ, Gummow, Crennan, Kiefel and Bell JJ.

consequence of a finding that a clause is a penalty. In Australia, equity disables or scales down A's legal right to a fixed sum so that it is not penal in operation. Conversely, in *Cavendish* the Supreme Court staunchly rejected that such an approach was possible. However, post-*Cavendish* and *Paciocco* there has been one significant convergence in the law. Both the Australian rule and English rule have adopted a deferential 'legitimate interest' standard in order to assess whether an impugned clause is penal in character. The adoption of this deferential standard is readily justifiable on the basis that courts should in general be reluctant to limit the parties' powers to set the terms of consensually created rights and obligations.