

# THE PENALTY RULE:<sup>1</sup> A MODERN INTERPRETATION

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## 1 ABSTRACT

This paper focuses on the common law doctrine of the penalty rule and the recent Supreme Court decision in *Cavendish Square Holding v Makdessi* and *Parking Eye v Beavis*. The state of the penalty rule prior to the judgment was unsatisfactory and criticized by both commentators and practitioners alike. Its indiscriminate application and unclear criteria was a needless source of uncertainty for both contracting parties and lawyers. Nevertheless, their Lordships in *Makdessi* refused to abolish the penalty rule but acknowledged its limited application in the modern commercial context. This paper accordingly aims to justify the continued existence of the doctrine on theoretical grounds within the English private law framework despite its practical obsolescence.

**Keywords:** Agreed Remedies, Penalty Rule, Freedom of Contract, *Cavendish v Makdessi*

## 2 INTRODUCTION

Contract law lies at the heart of commercial law along with its central doctrines of freedom of contract and *pacta sunt servanda*.<sup>2</sup> An important aspect of the freedom of contract is that contractual parties may agree upon remedies in the event of a breach of contract. As Hugh Collins notes, “most written contracts...pay considerable attention to agreed remedies.”<sup>3</sup> A liquidated damages clause, a clause that quantifies the sum payable upon breach by the defaulting party, is a useful example of an agreed

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<sup>1</sup> As termed by the Supreme Court in *Cavendish Square Holding v Makdessi* [2015] 3 WLR 1373. The rule against penalties, and the penalties doctrine, will be used synonymously for the penalty rule.

<sup>2</sup> Roy Goode, *Commercial Law in the Next Millennium* (The Hamlyn Lectures Series, Sweet & Maxwell 1998) 31.

<sup>3</sup> Hugh Collins, *The Law of Contract* (4th edn, Cambridge University Press 2003) 365.

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remedy. Liquidated damages clauses serve various practical purposes: they reduce the uncertainties and expenses of pursuing damages under the default contract rules, allocate the risk of loss and allow parties to price the contract more accurately,<sup>4</sup> and ensure that the innocent party receives a subjectively-satisfactory compensation that might not be recoverable in an ordinary action for damages due to proof of actual loss.

In contrast the penalty rule is an impediment to liquidated damages and its underlying doctrine freedom of contract. The penalty rule applies on a breach of contract and renders an agreed remedy clause (traditionally a liquidated damages clause) to be a penalty and unenforceable. Because of its unprincipled application, the rule has been described as a “blatant interference with the freedom of contract”,<sup>5</sup> impossible to rationalise,<sup>6</sup> and a recipe for disaster.<sup>7</sup> Nor has the longstanding debate over the rule waned. In the past decade, penalty clauses have been at the forefront of judicial discussion both in Australia and in the United Kingdom. In the United Kingdom, the issue of the penalty rule reached the Court of Appeal twice within two years and culminated in the Supreme Court decision of the joint appeals in *Cavendish v El Makdessi* (“Makdessi”) and *ParkingEye v Beavis* (“ParkingEye”) in November 2015.<sup>8</sup>

### 3 THE PRESENT STUDY

Whilst the Supreme Court in *Makdessi* explained the penalty rule to be based on public policy, their reasoning for continuing to uphold the rule (i.e. refusing to abolish the doctrine) is not entirely convincing. Specifically, Lords Neuberger and Sumption were doubtful that “the courts would have invented the rule today if their predecessors had not done so three centuries ago”.<sup>9</sup> Such apprehension about the rule leads to questions over the precise purpose of the rule against penalties in contract law and the modern commercial world.

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<sup>4</sup> Samuel Rea, ‘Efficiency Implication of Penalties and Liquidated Damages’ [1984] *Journal of Legal Studies* 148.

<sup>5</sup> *Makdessi v Cavendish Square Holdings* [2013] EWCA Civ 1539 [44].

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

<sup>7</sup> Sarah Worthington, ‘Common Law Values: The Role of Party Autonomy in Private Law’ in A Robertson and M Tilbury (eds), *The Common Law of Obligations: Divergence and Unity* (Hart Publishing 2015).

<sup>8</sup> *Makdessi* (CA) (n 5); *ParkingEye v Beavis* [2015] RTR 27. See also *Andrews v Australia and New Zealand Banking Group* [2012] HCA 30; *Paciocco v Australia and New Zealand Banking Group* [2015] FCAFC 50; Australian High Court (judgment pending).

<sup>9</sup> *Makdessi* (SC) (n 1) [36].

This paper attempts to fill this void by providing a rationalisation of the “modern” penalty rule based on the Supreme Court judgment and developments in the past two decades. I assert that the major criticisms against the rule, namely uncertainty over when the rule operates,<sup>10</sup> and its abrogation of party autonomy,<sup>11</sup> are genuine but inconsequential concerns as the rule has been confined in its application since the late nineties and with the culmination of the recent Supreme Court decision has become all but symbolic especially within the commercial context (i.e. where neither party deals as a consumer).

I consequently argue that the doctrine’s survival is justified since the penalty rule is consistent with other well-established principles within English private law and is best viewed as a constituent of a coherent and rational set of private law rules. Thus, not only would the abolishment of the penalty rule prove no more beneficial in practice for commercial parties, it would also lead to an anomalous and unnecessary contrast to principles within contract law and the law of unjust enrichment.

The focus of this paper will be on the commercial context (although there will be discussions of the consumer case *ParkingEye*) as this is the area the rule is most relevant. Many standard contracts in various industries contain agreed damages clauses such as those in the construction industry (by the Joint Contracts Tribunal). The majority of recent case law concern also only commercial parties, a development largely attributable to the rise of consumer protection mechanisms such as the Unfair Contract Terms Act 1977 (“UCTA”) and The Unfair Terms in Consumer Contracts Regulations 1999 (“UCCTR”) (both consolidated under the Consumer Rights Act 2015).

The discussion will be threefold. Part I sets the scene with an examination of the Supreme Court decision in *Makdessi*. In particular, I discuss the reformulated two-stage test for determining a penalty, and their Lordship’s dismissal of “genuine pre-estimate” and “a sum *in terrorem*” as factors in the finding of a penalty clause. The concept of a “legitimate interest” points towards a high threshold for the finding of a penalty clause and serves as important judicial recognition that commercial parties often have an interest in enforcing the contract *beyond* simple financial compensation. I conclude with a discussion of the justifications offered against abolishing the doctrine.

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<sup>10</sup> R Halson, ‘Remedies for Breach of Contract’ in M Furmston et al (eds), *Butterworths Common Law Series: The Law of Contract* (4th edn, Butterworths Law 2007); Lucinda Miller, ‘Penalty Clauses in England and France: A Comparative Study’ [2004] *International and Comparative Law Quarterly* 79.

<sup>11</sup> Worthington (n 7).

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Part II examines the penalty rule in its modern form beginning with Colman J's decision in *Lordsdale Finance*<sup>12</sup> and its subsequent development. By demonstrating the rule's consistently limited application in practice, criticisms against the rule are tempered. I examine the rare occasions that the courts made the finding of penalty clause and argue that this was due to a misunderstanding of the rule as it has developed since *Lordsdale*.<sup>13</sup>

Part III puts forth my justification for the penalty rule and its modern role, elaborating on an argument introduced but not fully explored by the Supreme Court.<sup>14</sup> I demonstrate that the penalty rule is consistent with other firmly established doctrines within English private law including the limited availability of specific performance and punitive damages as remedies, as well as the principle within the law of unjust enrichment that no party, even though innocent, should be allowed to unfairly enrich himself at the expense of another.

### 4 PART I: MAKDESSI V CAVENDISH

#### 4.1 Facts and Background

The state of the penalty rule prior to the Supreme Court decision was beyond unsatisfactory: Smith had described the penalty rule as "indiscriminate in effect and uncertain in application"<sup>15</sup> and Whincup had considered it very difficult to say which clauses will be upheld and which will be rejected.<sup>16</sup> When Clarke LJ in the Court of Appeal held the disputed clauses in *Makdessi*, clauses carefully negotiated by well-advised commercial parties, to be penalties, commentators were understandably equally critical of both the decision and of the penalty rule itself.<sup>17</sup> The appeals of *Makdessi* and *ParkingEye* were of disparate ilk: the former

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<sup>12</sup> *Lordsdale Finance v Bank of Zambia* [1996] QB 752.

<sup>13</sup> *Jeancharm v Barnet Football Club* [2003] EWCA Civ 58; *County Leasing v East* [2007] EWHC 2907 QB; *Unaoil v Leighton Offshore* [2014] EWHC 2965 (Comm).

<sup>14</sup> *Makdessi* (SC) (n 1) [39].

<sup>15</sup> Jonna Smith, 'Penalty Clauses: Essential Protection or Anachronistic and Uncommercial?' (*Construction Law Conference*, 2015)

<[http://www.whitepaperdocuments.co.uk/index.php?option=com\\_docman&task=doc\\_download&gid=2665&Itemid=2](http://www.whitepaperdocuments.co.uk/index.php?option=com_docman&task=doc_download&gid=2665&Itemid=2)> accessed 12 December 2015.

<sup>16</sup> Michael Whincup, *Contract Law and Practice* (5th edn, 2006 Kluwer) 369.

<sup>17</sup> Janet Sullivan, 'Lost on Penalties' [2014] CLJ 480; E Peel 'Unjustified Penalties or an Unjustified Rule Against Penalties?' [2014] *Law Quarterly Review* 365; W Day, 'Penalty Clauses Revisited' [2014] *Journal of Business Law* 512.

concerned disputed clauses within a contract subject to extensive negotiations where both parties were advised by “very experienced lawyers”, whereas the latter case concerned a clause in a consumer contract. As Lord Mance aptly explains: the two cases lie at the “opposite ends of a financial spectrum”.<sup>18</sup> The appeals were also the first time either the Supreme Court or House of Lords had considered the penalties doctrine in over a century and thus the decision serves as a new landmark for the penalty rule in English law.

#### 4.1.1 *Facts of Cavendish*

Mr Makdessi was a key figure in the marketing world of the Middle East and the co-founder and majority shareholder of the largest advertising and marketing communications group in that region. Makdessi agreed to sell 47.4% of his shares in his company to Cavendish Holdings (a subsidiary of the world’s largest advertising company), and to certain restrictive covenants. The breach of such covenants (under clause 11, titled “Protection of Goodwill”)<sup>19</sup> disentitled Makdessi from receiving the final two instalments of the purchase price (clause 5.1), a substantial sum in the tens of millions, and required Makdessi to sell his remaining stake to Cavendish at a substantially reduced price, a value that excluded his goodwill to the business (clause 5.6).

#### 4.1.2 *Facts of ParkingEye*

ParkingEye Ltd managed the car park at Riverside Retail Park in Chelmsford, Essex. Numerous “reasonably large, prominent and legible” signs reading “2 hour max stay... Failure to comply... will result in Parking Charge of £85” were displayed throughout the car park.<sup>20</sup> Mr. Beavis, a local chip shop owner, overstayed by nearly an hour and argued that the £85 charge was unenforceable as a penalty at common law. Or that that the charge was unfair and unenforceable under the UTCCR.

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<sup>18</sup> *Makdessi* (SC) (n 1) [116].

<sup>19</sup> *Cavendish Square Holdings v Makdessi* [2012] EWHC 3582 (Comm) [4]: 11.1. Each Seller recognises the importance of the goodwill of the Group to the Purchaser and the WPP Group which is *reflected in the price* to be paid by the Purchaser for the Sale Shares. Accordingly, each Seller commits as set out in this Clause 11 to ensure that the interest of each of the Purchasers and the WPP Group in that goodwill is properly protected.’ (Italics supplied).

<sup>20</sup> *ParkingEye* (n 8) [2].

#### 4.2 Criticism of the Dunlop Test

The Supreme Court acknowledged and described the penalty rule to be an “ancient, haphazardly constructed edifice which has not weathered well...”<sup>21</sup> For many years, the courts had struggled to apply standard tests formulated over a century ago, namely the four propositions set out by Lord Dunedin in *Dunlop Pneumatic Tyre v New Garage & Motor*.<sup>22</sup> Lord Dunedin’s second proposition has been relied upon the most by subsequent courts:

The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage.<sup>23</sup>

The rigidness of this dichotomy has caused decades of difficulties for the judiciary. As Miller points out, Lord Dunedin’s second proposition assumes that an agreed damages clause is either liquidated damages *or* a penalty. Even where one function is more dominant than the other, it is not always the case that the other function is entirely absent (i.e. the two functions are not mutually exclusive).<sup>24</sup> For example, a clause may be a genuine pre-estimate, but it may still have an element of deterrence, even if to a lesser extent. Similarly determining whether a clause is a penalty on the concepts of “*in terrorem*” and genuine pre-estimate is obfuscating, since a party may not be the least terrorised by the prospect of having to pay an exorbitant fee upon breach but under the old test, may well be entitled to protection from the courts. Miller considered classification under this test as potentially “misleading”.<sup>25</sup>

A related problem emerges from this timeworn distinction. The two disputed clauses in *Makdessi* were restrictive covenants and certainly much more complex than what Lord Dunedin may have contemplated in his time. The breach of the two clauses would have deprived the obligor Makdessi, tens of millions of dollars in value, but the immediate loss stemming from the loss would have been minimal for Cavendish. Nevertheless the loss of goodwill resulting from the breach of the clauses was of great importance to Cavendish and the value of the marketing

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<sup>21</sup> *Makdessi* (SC) (n 1) [3].

<sup>22</sup> [1915] AC 79.

<sup>23</sup> *Ibid* 86; Modern cases have preferred “intended to deter” as opposed to “stipulated as in terrorem”.

<sup>24</sup> Miller (n 10) 82.

<sup>25</sup> *Ibid*.

company, and would have been very difficult to assess.<sup>26</sup> A decade earlier Mance LJ (as he then was) acknowledged the problem that the penalty rule's premise on a strict dichotomy between genuine pre-estimate and a penalty could not possibly cover all possibilities of clauses operating upon breach.<sup>27</sup>

The Supreme Court in *Makdessi* agreed that the penalty rule had become the prisoner of artificial categorisation, a result of the unsatisfactory distinctions between penalty and genuine pre-estimate, and a genuine pre-estimate and a deterrent. Confirming Miller's analysis, Lords Neuberger and Sumption held that a penalty and a genuine pre-estimate are not natural opposites or mutually exclusive categories and that whether a contractual provision is a penalty is whether it is penal, and not whether it is a pre-estimate of loss.<sup>28</sup>

### ***4.3 The Reformulated Test: "Legitimate Interest"***

Whilst Lord Dunedin's traditional four tests in *Dunlop* remains useful for straightforward cases of agreed damages (i.e. a clause stipulating a fixed sum payable upon breach), it had otherwise become too rigid and unfortunately had been treated in a quasi-statutory manner, something that Lord Dunedin himself never intended. The majority held the new test for ascertaining whether a contractual provision was penal to be:

...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"<sup>29</sup>

Lords Mance and Hodge provided differently worded tests to the same substantive effect.<sup>30</sup> There are two ascertainable elements to the test: firstly, whether one contracting party has a legitimate interest in enforcing the primary obligation of the other party, and secondly, whether the detriment to the latter party is out of all proportion to such an interest. The concepts of genuine pre-estimate of loss and deterrence that had once been at the heart of the rule are notably absent.

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<sup>26</sup> *Makdessi* (CA) (n 5) [109].

<sup>27</sup> *Cine Bes Filmcilik v UIP* [2004] 1 CLC 401 [15].

<sup>28</sup> *Makdessi* (SC) (n 1), [31] (Lords Neuberger and Sumption) [152] (Lord Mance).

<sup>29</sup> *Ibid* [32].

<sup>30</sup> *Ibid* [152] (Lord Mance) [255] (Lord Hodge); See also [293] (Lord Toulson).

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It was emphasised that the penalty rule was only applicable to secondary obligations. This distinction in practice however may prove difficult to delineate and even in *Makdessi* there was disagreement over whether clause 5.6 constituted a primary or secondary obligation. Lords Hodge and Clarke, contrary to the majority believed the clause to be a primary obligation but kept an “open mind” over clause 5.1.<sup>31</sup> There is indeed still a degree of uncertainty and certainly scope for future litigation over this distinction.<sup>32</sup>

Nonetheless the wording suggests a high standard for a successful invocation of the penalty rule. We might contrast this wording directly with another of Lord Dunedin’s proposition from *Dunlop* that “a clause will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in comparison with the greatest loss that could conceivably be proved.”<sup>33</sup> The new legitimate interest element requires courts to take into account why a party might seek to enforce the clause as opposed to concentrating solely on whether the clause was a genuine pre-estimate. Their Lordships pointed towards *Dunlop* itself as an example: a sum of £5 was stipulated for the sale of each tire in breach of the agreement was incommensurate with the actual loss suffered from the sale of one tire, but was *not* incommensurate with the wider interest that Dunlop had in enforcing the damages clause. Indeed, their Lordships believed this broader interpretation to be the best way of explaining *Dunlop*.<sup>34</sup> Lord Mance, comparing *Dunlop* with *Makdessi*, held that in each case, “the focus should be on the overall picture, not on the individual breaches”.<sup>35</sup> An isolated reading of the new test, where a clause will be a penalty only where its enforcement is “out of all proportion” to any legitimate interest, *ceteris paribus*, is *prima facie* tougher for the party seeking relief than it traditionally was under Lord Dunedin’s formulation.

More telling are the dicta of the Supreme Court Justices. The majority judgment affirmed passages by Diplock LJ from *Robophone* that the court should not be eager to make the finding of a penalty clause, and Lord Woolf in *Philips Hong Kong* that any stringent approach would lead to undesirable uncertainty.<sup>36</sup> Where both parties are properly advised and of comparable bargaining power, their Lordships believed there to be a *strong* initial presumption that the parties themselves are the best judges

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<sup>31</sup> Ibid [270] (Lord Hodge), [291] (Lord Clarke).

<sup>32</sup> J Smith and M McCreath, ‘No Penalty? *Cavendish v Makdessi*: The Rule Against Penalties Redefined’ [2016] CRI 3.

<sup>33</sup> *Dunlop* (n 22) 87.

<sup>34</sup> *Makdessi* (SC) (n 1) [22].

<sup>35</sup> Ibid [172].

<sup>36</sup> Ibid [33].

of what is legitimate in provisions dealing with the consequences of a breach.<sup>37</sup> Lord Hodge remarked that “judges should be modest in their assumptions that they know about business”, and acknowledged that there were real benefits in allowing parties to agree the consequences of a breach of contract.<sup>38</sup>

The Supreme Court definitively refused to follow its Australian counterpart in *Andrews v Australia and New Zealand Banking* in holding that the penalty rule could apply without the requirement of a breach of contract.<sup>39</sup> For our purposes it is important to note that the decision refusing to follow *Andrews* was influenced by the fear that an expansion of the court’s supervisory jurisdiction (into what has always been governed by mutual agreement) would lead to uncharted areas of uncertainty.<sup>40</sup> Again we can see evidence of the judiciary’s desire for legal certainty, a theme prevalent in the judgment.

#### ***4.4 Application to the facts***

The Supreme Court upheld the validity of the clauses in both cases, affirming the Court of Appeal’s decision in *ParkingEye* and overruling its decision in *Makdessi*.

##### *4.4.1 Makdessi v Cavendish*

The majority believed clause 5.1 to be a price adjustment clause and “in no sense a secondary provision”, and that in this particular case was outside the jurisdiction of the penalties doctrine.<sup>41</sup> Whilst the withholding of the interim and final payments in clause 5.1 had no relationship to the measure of damages arising from the breach (and would have been disproportionate as a genuine pre-estimate), it was believed that Cavendish had a legitimate interest in the observance of the restrictive covenants which extended beyond the recovery from the breach of clause 11. The fact that the breach of clause 11 would cause very little in the way of recoverable loss to Cavendish was considered “beside the point”.<sup>42</sup> In reaching said conclusion, Lords Neuberger and Sumption emphasised that

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<sup>37</sup> *Makdessi* (SC) (n 1) [35] (Italics supplied).

<sup>38</sup> *Ibid* [259].

<sup>39</sup> *Ibid* [34]. See also [130] (Lord Mance’s lone dissent).

<sup>40</sup> *Ibid* [42].

<sup>41</sup> *Ibid* [74].

<sup>42</sup> *Ibid* [75].

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the parties on both sides were “sophisticated, successful and experienced commercial people bargaining on equal terms with expert legal advice.”<sup>43</sup>

Clause 5.6 which required the transfer of Makdessi’s remaining shares at a reduced price was similarly justified by the same legitimate interest behind clause 5.1. The court was notably attuned to the business rationale behind the clause: their Lordships explained that since Makdessi’s efforts and connections were no longer available to the company and would be applied to benefit the company’s competitors, there was a strong case for Cavendish to pay a price for the remainder of the shares net the value of Makdessi’s goodwill.<sup>44</sup>

### ***4.5 ParkingEye v Beavis***

The Supreme Court equally held the parking fine of £85 in *ParkingEye* not to be a penalty. It decided that there was a legitimate interest on the part of the park management to enforce the fee for overstaying beyond the two hours, and that £85 was not out of all proportion to this interest. The interest of enforcing the clause, the Court held, was a key part of the entire car park scheme: to make efficient use of parking space for the retail outlets and to use the proceeds from the charge as an income stream towards operating profits.<sup>45</sup> The Court further reached the conclusion that £85 was not disproportionate whilst referencing the maximum charge of £100 set by the British Parking Association and the fact that many motorists use the car park aware of the charge. The widespread usage of such a payment structure and level of charge in the UK further supported the conclusion that the clause in question was not a penalty.<sup>46</sup>

### ***4.6 Justifications against Abolishment or Restrictions***

Whilst counsel for Cavendish argued “with considerable forensic skill” for the abolishment of the penalty rule,<sup>47</sup> the Supreme Court unanimously rejected Cavendish’s primary and secondary submissions that the rule either be abolished or restricted to non-commercial cases or cases involving payment of money. The majority offered three main justifications against the abolishment of the penalty rule with Lords Mance and Hodge offering largely similar reasons. In examining these

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<sup>43</sup> Ibid.

<sup>44</sup> Ibid [82].

<sup>45</sup> Ibid [99].

<sup>46</sup> Ibid [100].

<sup>47</sup> Ibid [36].

justifications, which I shall term the “prevalence”, “protectionist”, and the “legal consistency” justifications, I respectfully address the first two and explain why they are not a convincing account for the continued existence of the rule. I put forth my support for the third justification, a justification that I will further develop in Part III.

Regarding the prevalence justification, the Supreme Court Justices noted that that rule is not only long-standing in English law but is common to all major systems of law with those of the United States, Germany, France, Switzerland, Belgium, and Italy provided as examples.<sup>48</sup> It is perhaps unfortunate that the court did not elaborate further upon this line of reasoning. Whilst uniformity amongst the law of contracts internationally may be an important consideration, it is far from a trump reasoning for upholding the penalty rule. On account of the brevity of their Lordships’ explanation and the lack of analysis as to *why* other legal jurisdictions continue to apply the penalty rule, it appears that the Supreme Court’s reasoning is analogous to lemmings following each other off a cliff. There certainly was an opportunity to have salvaged this argument. For example, Colman J in the case of *Lordsvale* clearly argued that the penalty rule ought not to apply on the facts of that case (an interest clause upon default) because inconsistency between the law applicable in London and New York would have been a great disservice to international banking.<sup>49</sup>

The protectionist justification concerns gaps in statutory regulation and the protection of parties not covered by either the UCTA or the UTCCR: “there are major areas, notably non-consumer contracts, which are not regulated by statute.”<sup>50</sup> This justification, whilst normatively sound, is not entirely consistent with the court’s application of the penalty clause in recent cases. As Professor Chuah contests, under the newly reformulated test, whether the detriment is out of all proportion to the legitimate interest is a very difficult threshold to cross (he believes the standard to be much higher than mere unreasonable)<sup>51</sup> and thus it seems unlikely that the courts can afford the legal protection that they have promised under this justification. Revisiting modern penalty clause authorities later on, I show that the courts have rarely found a clause to be a penalty, with only *one* lone instance where a small business was protected. Thus the second justification leads to an unhealthy divergence between what the court claims the penalty rule can accomplish and what it

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<sup>48</sup> Ibid [36].

<sup>49</sup> *Lordsvale* (n 12) 767.

<sup>50</sup> *Makdessi* (SC) (n 1) [38].

<sup>51</sup> J Chuah, ‘Penalty Clauses - A Clarification of Principle’ [2016] Student Law Review 48.

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in practice does accomplish - and actions always speak louder than words. For such reasons, the second justification is not entirely satisfactory.

Before discussing the final legal consistency justification, we might note Lord Mance's reasoning where his Lordship starts from the contrary position holding that "there would have to be shown the strongest reasons for so radical a reversal of jurisprudence which goes back over a century in its current definition and much longer in its antecedents."<sup>52</sup> This demonstration of judicial conservatism is understandable and might be the best way of understanding the thinking behind the Supreme Court's reasonings, but an argument along the lines of: if it is not [completely] broken, don't fix it, is itself not satisfactory for justifying the disparity between the rule's existence and the rule's application.

Finally, the legal consistency justification maintains that the penalty rule is consistent with other well-established principles within English private law including the equity of redemption, relief from forfeiture, refusal to grant specific performance.<sup>53</sup> As this paper aims to prove, not only does this reasoning not conflict with the rule's restricted application, it is the best principled legal justification for upholding the modern penalty rule. The penalty rule, thus viewed a manifestation of a strand of private law jurisprudence, merits its existence even if, as Day argues, the rule is now "de facto extinct".<sup>54</sup>

### 5 PART II: THE MODERN PENALTY RULE

The penalty rule has been applied few and far between since Colman J's decision in *Lordsvale*: Professor Peel (discussing the Court of Appeal's decision in *Makdessi*) noted: "such a finding [of a penalty clause] is a rare event and the decision is worthy of note for this feature alone ..."<sup>55</sup> whereas Jackson J in *Alfred McAlpine* commented: "Looking at the bundle of authorities provided ... I note only four cases where the relevant clause has been struck down as a penalty."<sup>56</sup> The modern penalty rule, delineated by what Christopher Clarke LJ terms the "new approach", has, as a matter of authority shifted English law towards a laissez-faire approach towards agreed damages clauses within the commercial context. The Supreme Courts decision in *Makdessi* was an affirmation and continuation of this development.

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<sup>52</sup> *Makdessi* (SC) (n 1) [162].

<sup>53</sup> *Makdessi* (SC) (n 1) [39].

<sup>54</sup> W Day 'A Pyrrhic Victory for the Doctrine against Penalties: *Makdessi v Cavendish Square Holding BV* [2016] Journal of Business Law 115.

<sup>55</sup> Peel (n 17) 365.

<sup>56</sup> *Alfred McAlpine Capital Projects v Tilebox* [2005] EWHC 281 (TCC) [48].

## 5.1 *The Penalty Rule's Development*

### 5.1.1 *Modern Origins - Lordsvale Finance*

Professor Macfarlane and Christopher Clarke LJ consider Lordsvale as the inception of the modern approach.<sup>57</sup> In that case it was held there was no reason to strike down a clause as a penalty if in the circumstances the clause could be explained as “commercially justifiable” provided that the dominant purpose was not to deter the other party from breach.<sup>58</sup>

Lordsvale concerned two syndicated loan agreements entered into by the defendant Bank of Zambia. It is important to note the international nature of these transactions: the original syndicate was entered into by banks led by Sumitomo (based in Japan) and the now defunct BCCI (founded by a Pakistani financier) with of course, the defendant Bank of Zambia (the country's central bank). The loan sums were both calculated in American dollars at \$100m and \$130m. The international emphasis is important for contextualising the decision and understanding the penalty rule's shift in emphasis as a result of the exigencies of international parties conducting business in England. As Colman J recognised in his decision, the disputed clauses in the case were of “considerable importance for English banking law”.<sup>59</sup>

On the facts, both loan agreements provided that in the event of default, not only was the defendant required to pay an interest rate of 1.5% during the default period, but an additional and unexplained 1 per cent, amounting to a total 2.5% interest rate. The defendants contended this additional one percent to be a penalty and in terrorem as its sole function was to ensure compliance with the loan agreements. Colman J disagreed, holding that, whilst an additional one percent in interest was not a genuine pre-estimate and entailed an element of deterrence, the disputed clauses were not penalties.<sup>60</sup>

This case is firstly an excellent example of the tension between the penalty rule's jurisdiction and the flexibility required by modern commerce. On one hand Colman J's interpretation and endorsement of commercial justifiability might seem to poke a large and unsettling hole in

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<sup>57</sup> B Macfarlane, ‘Penalties and Forfeiture’ in J McGhee (ed), *Snell's Equity*, (33rd edn, Sweet & Maxwell 2015) Paras 13 - 012; *Makdessi (CA)* (n 5), [84]. Indications of judicial reticence towards the penalty rule have predated *Lordsvale*: e.g. *Philips Hong Kong v AG of Hong Kong* [1993] UKPC 3 and *The Scaptrade* [1983] 2 AC 694, 702.

<sup>58</sup> *Lordsvale* (n 12).

<sup>59</sup> *Ibid* 761.

<sup>60</sup> *Ibid* 767.

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Lord Dunedin's second proposition. On the other hand, a contrary decision would have gone against the common practice of loan agreements charging higher default interest rates (which parties are otherwise perfectly entitled to contract into).<sup>61</sup> Colman J noted London to be "one of the greatest centres of international banking in the world" and that the courts of New York were prepared to enforce such "prevalent provisions".<sup>62</sup> If we recall the "Big Bang" deregulation of the financial markets under the Thatcher government and its following developments a decade earlier, Colman J's concept of commercial justification might be viewed as aligning the law with commercial practice.

The second point is that *Lordsvale* is an instance of a judge considering factors not strictly relevant for determining whether the clause was a genuine pre-estimate. This admission of broader considerations allows for judicial maneuver: for example Colman J reasoned the additional interest rate applicable upon the defendant's default to be proportionate by taking into account that a borrower with bad credit, (i.e. the Bank of Zambia in default) would incur more expensive costs for borrowing than a borrower who has good credit. The result from *Lordsvale* is that the courts will not only focus on the question of a genuine pre-estimate, but also on the wider question of whether there is a legitimate commercial justification. The concept that delineates the modern rule unfortunately is also the problem that has plagued it. How much a court must focus on commercial justifications in relation to deterrence is uncertain, and depending on how one frames this question, if asked at all, will invariably lead to differing results as evident in recent case law.

### 5.1.2 *Court of Appeal Approval*

In the two decades since *Lordsvale*, the English courts, influenced by the concept of commercial justifiability, have not found the disputed clauses to be penalties in the majority of cases.<sup>63</sup> An important judicial endorsement of Colman J's decision comes from Mance LJ in *Cine Bes* where the Court of Appeal gave credence to the concept of commercial

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<sup>61</sup> J MacCarthy, 'Loan Agreements: Default Interest' (1996) 11(7) *Journal of International Business and Law* 144.

<sup>62</sup> *Lordsvale* (n 12), 767.

<sup>63</sup> *Bluewater Energy v Mercon Steel* [2014] EWHC 2132 (TCC); *Lancore v Barclays Bank* [2008] EWHC 1264 (Ch); *E-Nik v Department for Communities and Local Government* [2012] EWHC 3027 (Comm); *Associated British Ports v Ferryways* [2008] EWHC 1265 (Comm); *Steria v Sigma Wireless* [2008] BLR 79; *BNP Paribas v Wockhardt* [2009] EWHC 3116 (Comm).

justifiability. The importance of the case also lies with Mance LJ's finding that a part of the disputed clause (enforcement costs incurred from prior litigation between the parties) "was understandable in the *overall context* of the settlement of [their] prior litigation" and therefore not penal.<sup>64</sup> *Cine Bes* was also the first time a Lord Justice of Appeal unequivocally believed that the popularised dichotomy from *Dunlop* to be rigid and obsolescent. In this way the decision, whilst not necessarily comprehensive, serves as an important steppingstone away from the rule's ancient origins towards its modern, and rational form. The following year Arden, Clarke and Buxton LJ in *Murray v Leisureplay* unanimously approved of the approaches taken in *Lordsvale* and *Cine Bes*.<sup>65</sup> Arden LJ included the justification element in her "practical step by step guide" to penalty clauses as a part of the court's final inquiry stage: where the claimant can prove that the agreed amount payable does not constitute a genuine pre-estimate, the court should ask whether there was some reason that could justify the discrepancy between the amount payable under the clause and the amount payable under common law damages.<sup>66</sup> Buxton LJ (with whom Clarke LJ agreed) took a broader approach than that of Arden LJ, re-examined the House of Lord's decision in *Dunlop*, and put forth an explanation of *Dunlop* in commercial rather than deterrent terms, emphasising the need to look at any disputed clause in its commercial context.<sup>67</sup> This disagreement, which Christopher Clarke LJ (wrongly) believed to be not ...as marked as it might appear ...<sup>68</sup> is indicative of the troubles that judges have faced in framing the commercial justification concept. The Supreme Court recently clarified the issue and affirmed Buxton LJ's wide approach, disagreeing with Arden LJ in treating commercial justification as evidence that the clause was not intended to deter.<sup>69</sup>

### 5.1.3 A Prevalent Judicial Attitude

Whilst the speeches of Mance LJ in *Cine Bes* and Arden LJ in *Murray* are the most recognised, the post-*Lordsvale* sentiment of a restrained penalty rule is equally evident in other decisions. For example, Jackson J in *Alfred McAlpine* explained that "the courts, are predisposed, where possible, to uphold contractual terms which fix the level of damages for

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<sup>64</sup> *Cine Bes* (n 27) [33] (Italics supplied).

<sup>65</sup> [2005] ECWA Civ 963, IRLR 946.

<sup>66</sup> *Ibid* [54].

<sup>67</sup> *Ibid* [118].

<sup>68</sup> *Makdessi* (CA) (n 5) [124].

<sup>69</sup> *Makdessi* (SC) (n 1) [28].

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breach ...”<sup>70</sup> and held that a liquidated damages clause for £45,000 a week in damages in a building contract not to be a penalty, whilst Burton J in *M & J Polymers* made the finding that the “take or pay clause was commercially justifiable ..., and did not have the predominant purpose of deterring a breach of contract.”<sup>71</sup>

The courts have reached the same conclusion against the finding of a penalty in cases concerning demurrage clauses,<sup>72</sup> agreed damage clauses in employment contracts,<sup>73</sup> as well as in yacht construction contracts.<sup>74</sup> Beatson J’s remarks in *General Trading* perfectly reflects the changed attitude of the courts:

At the outset of the hearing I inclined to the view that this clause inserted, at the very end of the negotiations, was penal because of the size of the difference between the amount of the loan to be guaranteed and the amount of the loan notes that would be cancelled. In the light of the evidence, however, and the broader approach of Buxton and Clarke LJ in *Murray v Leisureplay*, I am satisfied that it is not.<sup>75</sup>

To drive home the point, there have been a series of cases where the court, whilst not finding the contested clause(s) to engage the penalty rule, nevertheless held obiter that they would not have found the clause to be penal had it fallen within the scope of the rule.<sup>76</sup> It is clear that, as a starting point, the modern penalty rule has been very limited in its application. Establishing this as the norm, we can examine the rare instances where the courts have found a clause to be penal post-*Lordsvale* as to whether they are exceptions or rather, a misunderstanding of the rule’s modern application.

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<sup>70</sup> *Alfred McAlpine* (n 56) [47](3).

<sup>71</sup> *M & J Polymers v Imerys Minerals* [2008] EWHC 344 (Comm) [46].

<sup>72</sup> *Mediterranean Shipping v Cottonex Anstlat* [2015] EWHC 283 (Comm), [2015] 1 CLC 143.

<sup>73</sup> *Tullett Prebon v Ghaleb* [2008] EWHC 1929 (QB).

<sup>74</sup> *Azimut Benetti v Darrell Healey* [2010] EWHC 2234 (Comm).

<sup>75</sup> *The General Trading Company v Richmond Corporation* [2008] EWHC 1479 (Comm) [133].

<sup>76</sup> *Ibid*; *Euro London v Claessens International* [2006] EWCA Civ 385; *Henning Berg v Blackburn Rovers Football Club* [2013] EWHC 1070 (Ch); *Edgeworth Capital v Ramblas Investments* [2015] EWHC 150.

## 5.2 *Exceptions or Misconceptions?*

In analysing the decisions where the court did make a finding of a penalty, this paper will avoid *Jobson v Johnson*<sup>77</sup> and *Workers Trust v Dojap*<sup>78</sup> as both cases concern the penalty rule's relationship with the relief from forfeiture, an area that the Supreme Court considers unresolved.<sup>79</sup> Similarly, this paper will only examine post-*Lordsvale* case law, omitting preceding decisions such as *Bridge v Campbell Discount* and *Lombard North*, as subsequent developments have notably altered the interpretation of *Dunlop* and the penalty rule.<sup>80</sup> It is submitted that the three authorities that we will reexamine in *Jeancharm*, *County Leasing* and *Unaoil*,<sup>81</sup> are instances where the commercial justification was either not applied or misapplied and that with an accurate application of the modern rule, these clauses would be upheld as enforceable liquidated damages and *a fortiori* would be upheld under the new Supreme Court test, which demonstrated above, is harder for proving a penalty clause.

### 5.2.1 *Jeancharm v Barnet Football Club [2003]*

*Jeancharm* is the first significant finding of a penalty clause since the shift in *Lordsvale*. The case concerned an agreement for the supply of football kit from *Jeancharm* to *Barnet*. The contract contained a late payment provision where 45 days after the payment date, *Barnet* would incur interest at the rate of 5% per week on any outstanding sums. There was also significantly a reciprocal obligation on *Jeancharm* within that same clause that *Barnet* would be entitled to a late penalty of 20 pence per garment per day; a total of 5,000 replicas had been ordered for each of the 1999/2000 and 2000/2001 seasons.<sup>82</sup> The Court of Appeal unanimously held the clause to be a penalty.

First and foremost *Jeancharm* was decided after the High Court's decision in *Lordsvale* but before *Cine Bes* and *Murray* where the concept of commercial justifiability gained widespread judicial acceptance. In *Jeancharm*, Jacob J, delivering the leading judgment, relied exclusively on Lord Dunedin's formulation of genuine pre-estimate as the determinative factor as to whether a clause was to be regarded as penal.<sup>83</sup> Whilst

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<sup>77</sup> [1989] 1 WLR 1026.

<sup>78</sup> [1993] AC 573.

<sup>79</sup> *Makdessi* (SC) (n 1) [17], [18], [87].

<sup>80</sup> See also the Australian High Court decision in *Andrews* (n 8).

<sup>81</sup> *Jeancharm*; *County Leasing*; *Unaoil* (n 13).

<sup>82</sup> *Jeancharm* (n 13) [3].

<sup>83</sup> *Ibid* [11].

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Lordsvale was discussed, Jacob J interpreted Colman J's dicta narrowly and considered the decision justified only on the basis that on those facts "...the borrower was a risky borrower".<sup>84</sup>

Consequently, the reciprocal obligation on Jeancharm within the clause had not been given adequate consideration. Within the modern approach, provisions within a clause are generally weighed as a whole. For example, in *Azimutt-Benetti*, the court rejected submissions that the clause was a penalty because although "the clause places an obligation on the buyer, ... it also places an obligation on the builder".<sup>85</sup> Similarly in *Murray*, Arden LJ considered that the disputed clause had advantages for both sides.<sup>86</sup> The same conclusion could have been reached here - Jeancharm was obligated under that same clause to a penalty of 20 pence per garment per day had it been late in its delivery. Thus, the purpose of the clause, to use the words of Blair J in *Azimutt-Benetti*, was "to strike, or seek to strike, a balance between the interests of the parties".<sup>87</sup> Reinterpreted in this way, the clause would certainly not be deemed a penalty. Interestingly, even before the modern approach had fully developed, commentators had considered Jeancharm to be "an exceptional case".<sup>88</sup>

### 5.2.2 *County Leasing v East* [2007]

In this case, the defendant Mr East, had entered into a long-term business loan with County Leasing Ltd., a company directed by Mr and Mrs Kirkpatrick (who were also majority shareholders of the company). East and the Kirkpatricks had known each other for over 25 years and had "done business on many occasions".<sup>89</sup> The loan agreement contained a certain clause 5 where, upon a failure to pay a specified instalment within 7 days of its due date, East would be liable to repay the principal and all interest over duration of the term of the loan (20 years).<sup>90</sup> At the time of East's default, the principle amount outstanding was £378,000 and repayment with interest would have cost East £1.2 million.<sup>91</sup> The High Court judge deemed clause 5 to be a penalty and unenforceable, relying

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<sup>84</sup> *Ibid* [16].

<sup>85</sup> *Azimutt-Benetti* (n 74) [26].

<sup>86</sup> *Murray* (n65) [76].

<sup>87</sup> *Ibid* [76]

<sup>88</sup> H Lal, 'Liquidated Damages' [2009] *Construction Law Journal* 569, 571.

<sup>89</sup> *County Leasing* (n 13) [5].

<sup>90</sup> Such a clause is best classified as an acceleration clause in that it accelerates, as oppose to increasing the liability of the debtor.

<sup>91</sup> *Ibid* [41].

solely on Lords Dunedin and Parmoor's speeches in *Dunlop* and obiter dicta by Sir Donaldson MR in *The Angelic Star*.<sup>92</sup> There are two paths around this decision, neither which compromise our argument: the first is to argue that *County Leasing* was decided without a proper understanding of the modern approach, the second is to confine the case to its facts - accepting *County Leasing* to be a commercial case concerning the penalty rule, but to take nuanced view that this decision was reached in light of East conducting business as a sole trader as opposed to through a limited company.

Regarding the judge's reasoning, counsel for the claimant cited neither *Cine Bes* or *Murray* as authority but rather relied on the Consumer Credit Act 1974, arguing that the clause was not an "an extortionate credit bargain" and thus not a penalty.<sup>93</sup> It was however emphasised that East was an experienced businessman, had entered into agreements with very similar terms as clause 5 with the claimants before, had access to legal advice before contracting and had been warned specifically by letter by County Leasing to take legal advice before entering into the agreement.<sup>94</sup> The judge failed to take such consideration into account and that the contract was freely entered into by parties of comparable bargaining power who had entered into similar agreements for many years. Nor did the judge consider whether the "predominant purpose" of the clause was to deter breach, taking into account any possible commercial justifications, before he made the finding of a penalty clause.

The decision was largely based on brief obiter dicta in *The Angelic Star*, a shipping case decided itself exclusively premised on the rigid dichotomy ("proposition 2 in the speech of Lord Dunedin")<sup>95</sup> developed from *Dunlop*, a dichotomy that we criticised in Part I, was equally doubted in *Murray* and largely discarded by the Supreme Court in *Makdessi*.<sup>96</sup>

Alternatively, we might give the judge the benefit of the doubt and reconsider *County Leasing* not as a true commercial case. If we view this case more so a consumer case as opposed to a commercial one, one would certainly consider any oppression as more oppressive towards East in principle. Because East contracted into the loan agreement as a sole trader (as opposed to via a limited company) he was personally liable for any losses incurred, not having benefitted from limited liability had he formed and incorporated a company, the finding of a penalty clause can be

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<sup>92</sup> [1988] 1 LLR 122.

<sup>93</sup> *County Leasing* (n 13) [86].

<sup>94</sup> *Ibid* [113].

<sup>95</sup> *Ibid* [115], [117].

<sup>96</sup> *Makdessi* (SC) (n 1) [31].

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justified since potential personal bankruptcy is arguably more severe than a potentially failed business. Furthermore, to elaborate on a point by Zimmermann,<sup>97</sup> because an agreed damages clause places the debtor under a conditional obligation that is to take place in the future, the natural confidence in one's ability to render performance often leads one to underrate the often gravely detrimental nature of a clause; on this view, the hubris and error of one sole trader may be viewed as more deserving of relief from the penalty rule than that of a larger company with multiple directors benefitting from limited liability.

### 5.2.3 *Unaoil v Leighton Offshore [2014]*

*Unaoil* is the most recent instance of a judicial finding of a penalty clause taking place after the Court of Appeal's decision in *Makdessi* but before the Supreme Court's overturning of that decision upon appeal. It is an exemplary example of the inconsistent emphasis placed on the concept of commercial justification.

*Unaoil* concerned a memorandum of agreement between Leighton Offshore Ltd, a contractor and Unaoil Ltd, a subcontractor. Both parties agreed that Leighton would appoint Unaoil as its subcontractor for the onshore construction work if it succeeded in its bid for a substantial oil infrastructure project in Iraq.<sup>98</sup> The agreement however also contained an agreed damages clause, clause 8.1, stipulating that if Leighton did procure the oil project but did not adhere to the terms of their subcontract agreement, i.e. appoint Unaoil as its subcontractor, it would pay an agreed amount of \$40 million US Dollars to Unaoil. Notably, the contract was amended afterwards, reducing the contract price from \$75 million to \$55 million dollars in a final attempt to make Leighton's bid more competitive; clause 8.1 however remained unaltered. Leighton won the bid but eventually elected not to appoint Unaoil as its subcontractor. Unaoil sought to enforce the agreed damages clause whilst Leighton argued that it was a penalty. Eder J found the clause to be "*extravagant and unconscionable with a predominant function of deterrence [sic] without any other commercial justification for the clause*".

The most cogent criticism against this decision is the inadequate focus on the commercial realities of the agreement. Eder J acknowledged, but did not address, the inclusion of the clause as a counterbalance to certain risks as a possible justification: in the course of evidence the Chairman of Unaoil, when questioned as to how the liquidated damages amount was

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<sup>97</sup> R Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Ch 4, 1996 OUP) 106.

<sup>98</sup> *Unaoil* (n 13) [3].

calculated, explained that “in Iraq estimates are not estimates. Things change...I just take a view and go forward” and “that the clause was considered a ‘sort of insurance for high profit in an area where other people see a perceived high risk.’”<sup>99</sup>

A separate criticism is that Eder J premises his decision on how \$40 million as an agreed damages would have been a genuine pre-estimate of the loss and not a penalty had the contract price remained at \$75 million and hence if the contract price was reduced, it could no longer be a genuine pre-estimate and thus a penalty.<sup>100</sup> The judge importantly conceded “the reason why the figure...was not reduced at the same time was not explained ... Perhaps ... a mistake or an oversight. I do not know.”<sup>101</sup> Both parties clearly had the opportunity to amend the clause 8 when amending the contract price and having not done so, by all accounts had still agreed to the clause. Yet without firmly establishing the clause was either due to an oversight (or mistake), Eder J provided Leighton with a very generous benefit of the doubt, at odds with the modern penalty rule and the predisposition that the courts are to uphold contractually fixed damages for breach; Jackson J notably reiterated in *Alfred McAlpine* that such a “predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power.”<sup>102</sup> The *Unaoil* decision is disappointingly stultifying and certain commentators have described the decision as a “trap for the wary”.<sup>103</sup>

### 5.3 Final Words

An understanding of the penalty rule’s modern development has shown that the rule is in keeping with the needs of commercial parties. The new Supreme Court test in *Makdessi* has clarified that broader interests (including commercial) need to be given adequate consideration. Any concerns over legal uncertainty and inconsistent application have thus been alleviated, and any remaining concerns that might arise from the overly cautious can be answered by shrewd drafting around the doctrine by either making any sums payable on an event other than breach or to frame the clause as a primary obligation.

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<sup>99</sup> Ibid [18].

<sup>100</sup> Ibid [71].

<sup>101</sup> Ibid.

<sup>102</sup> *Alfred McAlpine* (n 56), [48](3) (Jackson J).

<sup>103</sup> V Bange, ‘Reducing Risk with Liquidated Damages’ [2015] Construction Law 6, 7.

## 6 PART III: A MODERN RATIONALISATION

It is important to note that commercial parties are not concerned with the existence or abolishment of the penalty rule either way: the businessman almost exclusively wishes to know whether agreed damages contained in his contract will be upheld by the courts or deemed unenforceable as a penalty (and if so, how he might protect himself);<sup>104</sup> earlier discussions should hopefully have assuaged his concerns that the courts rarely make the finding of a penalty in commercial contracts. The rare finding of a penalty, however, does not mean the rule has entirely lost its bite; Lord Halsbury's example of a penalty payment of a million pounds for a building contract worth fifty pounds would in all likelihood still be deemed a penalty clause.<sup>105</sup>

The discussion here is primarily academic and aims to answer the pundit's inquiry: if the penalty rule is scarcely used, why not abolish it altogether? The answer lies beyond the rule itself and in an examination of other areas of private law.

Within English private law, the modern penalty rule is not only not an anomaly, but is perfectly coherent and should be rationalised as a manifestation of important principles within the law of obligations. This is a bold and arduous disagreement with Diplock LJ in *Robophone* who described the rule as "anomalous" and famously declared: "I make no attempt, where so many others have failed, to rationalise this common law rule. It seems to be *sui generis*."<sup>106</sup> The penalty rule encapsulates three related principles that we will summarise as the aversion towards oppression, punishment and unfairness.

Consistency within the law is intrinsically valuable: support for the current English position on punitive damages, specific performance and unjust enrichment logically lends support to the existence of a penalty rule as they rest upon the same three principles encapsulated by the penalty rule. Supporting one but not the other is analogous to having a window removed from one's home and leaving a hole in the wall; when a storm comes, even if all the other windows are shut, their effectiveness in keeping the room dry will be greatly diminished.<sup>107</sup>

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<sup>104</sup> P Devlin, 'The Relation between Commercial law and Commercial Practice' [1951] *Modern Law Review* 249, 254.

<sup>105</sup> *Clydebank Engineering v Castaneda* [1905] AC 6, 10.

<sup>106</sup> *Robophone* (n 6).

<sup>107</sup> For a lack of a better example.

This paper will not discuss the equity of redemption or relief from forfeiture as noted by the Supreme Court,<sup>108</sup> but the analysis can equally be extended to such doctrines.

### *6.1 The Law on Specific Performance*

The order for specific performance is an equitably remedy granted at the discretion of the courts. *Chitty* defines specific performance as “the remedy available in equity to compel a person actually to perform a contractual obligation.”<sup>109</sup> This remedy however is rare in practice and even rarer in commercial cases.<sup>110</sup> Furthermore it will not be binding on the courts even if parties agree to it in the contract as “it is not the function of the court to be a rubber stamp”.<sup>111</sup>

Lord Hoffmann’s judgment in *Co-operative Insurance Society v Argyll Stores (Argyll)* sheds light onto English law’s reluctance towards specific performance.<sup>112</sup> There are references to all three principles in his Lordship’s speech. Without explicitly acknowledging anti-oppression as its proper basis for limiting specific performance, it is a sentiment prevalent throughout the judgment. In explaining “constant supervision” as a reason why courts should limit granting specific performance, Lord Hoffmann explained that due to the “heavy handed nature” of the court’s power (its enforcement mechanism of finding the defendant in contempt of court), it would be unacceptable to make the defendant run his business under the “sword of Damocles”.<sup>113</sup> Perhaps his Lordship may have fared better to acknowledge anti-oppression as a separate reason for limiting specific performance,<sup>114</sup> but the principle against oppression was evidently a factor behind his decision.

Further on, his Lordship acknowledges that whilst undoubtedly it is the defendant has put himself in such a position by his breach of contract, “the purpose of the law of contract is *not* to punish wrongdoing ...”<sup>115</sup> This is equally consistent with the law’s position on punitive damages. Whilst English law’s current position on specific performance has its

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<sup>108</sup> *Makdessi* (n 53).

<sup>109</sup> H Beale, *Chitty on Contracts* (33rd edn, Sweet & Maxwell 2015) para 27-004.

<sup>110</sup> Whincup (n 16) 373.

<sup>111</sup> *Quadrant Visual Communications v Hutchison* [1993] BCLC 442 [452] (Butler-Sloss LJ).

<sup>112</sup> [1998] AC 1.

<sup>113</sup> *Ibid* [13]. Referring to the Greek anecdote of living in constant fear of negative consequences.

<sup>114</sup> A Burrows, ‘Judicial Remedies’ in *Principles of the English Law of Obligations* (OUP 2015) para 4.192.

<sup>115</sup> *Co-Operative Insurance* (n 112) 15.

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critics, even critics such as Rowan who have persuasively argued in favour of upholding agreed remedies, acknowledge there is some force to this principle against oppression, especially when the specific performance sought is personal in character such as in employment contracts.<sup>116</sup>

### 6.2 *The Law on Punitive Damages*

Punitive (or exemplary, vindictive) damages go beyond normal compensatory damages as a form of punishment against the defendant. Specifically *Addis v Gramophone* established that punitive damages could not be recovered for breach of contract.<sup>117</sup> The House of Lord's decision in *Rookes v Barnard* clarified the law regarding punitive damages for civil wrongs laying down only two narrow categories where punitive damages could be recovered at common law;<sup>118</sup> in any case, punitive damages have been described by McGregor as "effectively outlawed".<sup>119</sup> Lord Devlin, in his leading judgment, expressed three considerations for the court's to consider regarding exemplary damages and the second is especially of note. In his second consideration, his Lordship found that exemplary damages often amount to greater punishment had the conduct actually been criminal, and this would all have been imposed without the safeguard that criminal law provides an offender with (e.g. right to trial by jury). Lord Reid's speech in *Broome v Cassell* echoes this sentiment: "to allow pure punishment in this way [exemplary damages] contravenes almost every principle which has been evolved for the protection of offenders".<sup>120</sup> Professor Street similarly identified as a critique against exemplary damages that, the "sharp cleavage between criminal law ... and the law of torts and contract ... is a cardinal principle of our legal system."<sup>121</sup>

Reflecting back on penalty clauses, there is certainly a common underpinning between exemplary damages and Lord Neuberger and Sumption's comment in *Makdessi* that: "the innocent party can have no proper interest in *simply punishing* the defaulter".<sup>122</sup> Rowan believes that

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<sup>116</sup> S Rowan, 'For the Recognition of Remedial Terms Agreed Inter Partes' [2010] Law Quarterly Review 448, 472.

<sup>117</sup> [1909] AC 488; cf *A-G v Blake* [2000] UKHL 45.

<sup>118</sup> [1964] AC 1129, 1227.

<sup>119</sup> H McGregor, 'Restitutionary Damages' in P Birks (ed) *Wrongs and Remedies in the Twenty-First Century* (Clarendon Press 1996) 203.

<sup>120</sup> [1972] AC 1027, 1087

<sup>121</sup> H Street, *Principles of the Law of Damages* (Sweet & Maxwell 1962) 34-6.

<sup>122</sup> *Makdessi* (SC) (n 1) [32]; (Italics supplied).

the introduction of exemplary damages for breach of contract would require the reconsideration of other rules within contract law, including the penalty rule and the restricted availability of specific performance, amongst others.<sup>123</sup> Comparing the penalty rule with punitive damages, Rowan believes “this [penalty rule] [similarly] constitutes a resounding rejection of deterrence and punishment as acceptable aims in the law of contract.”<sup>124</sup>

### ***6.3 The Law of Unjust Enrichment***

The English legal position against unfairness links the penalty rule with infrequent specific performance and the law of unjust enrichment. It is a qualified notion however, as Lord Roskill explains: “it is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an onerous or possibly even a commercially imprudent bargain.”<sup>125</sup> Within the penalty rule, the principle against unfairness is subsidiary, applicable only to secondary obligations in the same way there will normally be no claim in unjust enrichment so long as a contract subsists.<sup>126</sup>

The principle against unfairness, that no party, even though innocent, should be allowed to unfairly enrich himself at the expense of another, underlies *quantum meruit* claims in void contracts such as *Mohammed v Alaga*<sup>127</sup> and in cases of non-existent contracts<sup>128</sup> and is a longstanding principle of English law that can be traced as far back to the 18th century foundational case of *Moses v Macferlan*.<sup>129</sup>

Even where the claimant is in breach, the innocent party is not allowed to retain the benefits if not provided for under the contract. For example in *Dies v British and International Mining*, Stable J allowed the recovery of part of the purchase price by the claimants who, in breach of contract, refused to take delivery of goods and pay the rest of the purchase price. Stable J’s fortified his view by referencing the penalty rule, and explained that it would be a “manifest defect in the law” if the vendor

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<sup>123</sup> S Rowan, ‘Reflections on the Introduction of Punitive Damages for Breach of Contract’ [2010] Oxford Journal of Legal Studies 495.

<sup>124</sup> *Ibid* 509.

<sup>125</sup> *Export Credits Guarantee v Universal Oil* [1983] 1 WLR 399, 403.

<sup>126</sup> C Mitchell, ‘Unjust Enrichment’ in A Burrows (ed) *Principles of the English Law of Obligations* (OUP 2015) para 3.226.

<sup>127</sup> [1999] 3 All ER 699.

<sup>128</sup> *British Steel v Cleveland Engineering* [1984] 1 All ER 504.

<sup>129</sup> (1760) 97 ER 676.

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could retain both the goods and the money irrespective of whether the money corresponded to the amount of actual damages.<sup>130</sup>

This principle is equally evident behind the restricted availability of specific performance. In *Argyll*, Lord Hoffmann was convinced (by Millett LJ's reasoning) to refuse specific performance due to the injustice that might arise "by allowing the plaintiff to enrich himself at the expense of the claimant" because the "loss which the defendant may suffer through having to comply with the order ... may be far greater than the plaintiff would suffer from the contract being broken."<sup>131</sup>

### 7 CONCLUSION

We have thus come full circle. Initial doubts over the penalty rule have emerged into an appreciation of the rule's modern role and underlying justifications.

Part I examined the background leading to the Supreme Court decision in *Makdessi* and the judgment itself. It was argued that the reformulated test would be a high threshold for parties attempting to prove that a clause was penal. The justifications offered against abolishing the doctrine were not altogether convincing and the "legal consistency" justification required further elaboration.

Part II considered the origins and development of the "modern" penalty rule. The decisions in *Cine Bes* and *Murray* firmly established commercial justifications as a factor when arguing over the penalty rule before the courts. As a matter of authority, the courts have almost entirely refrained from applying the rule. The varying emphasis placed on the aspect of commercial justification however, had unfortunately led to its inconsistent application with its entailing legal uncertainty; we reconciled the three isolated instances with the modern norm.

Part III rationalised the rule's continued existence in spite of its limited application. It was shown that the penalty rule is not anomalous, but rather a constituent of a rational set of private law principles. Brief discussions and comparisons were made with English law's position on specific performance, punitive damages, and certain forms of unjust enrichment.

To contrast Professor Teitel's remarks in 1988 that the penalty rule, which lacked the certainty of enforcement yet placed an undue premium on draftsmanship, gets the "worst of both worlds",<sup>132</sup> the modern penalty

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<sup>130</sup> [1939] 1 KB 724, 744. cf *Sumpter v Hedge* [1898] 1 QB 673.

<sup>131</sup> *Argyll* (n 112) 15.

<sup>132</sup> GH Treitel, *Remedies for Breach of Contract: A Comparative Account* (Oxford University Press 1998) 233.

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rule by delineating its narrow application allows commercial parties to freely conduct business and include agreed damage clauses in their contracts as needed without undue fear of judicial intervention. On a theoretical level, the rule aligns itself with other doctrines within private law and serves as a lighthouse, illuminating important principles that run through the English law of obligations.