Banking and Financial Services Law Association Conference
Penalties and the protection of freedom of contract
Justice Julie Ward*

SUMMARY

This paper will discuss some of the key elements of the doctrine of penalties and consider some of the potentially controversial and uncertain aspects of the principle, particularly in relation to its interaction with the doctrine of freedom of contract. To the extent that there seems to have been a shift in the underlying policy concerns of the doctrine of penalties, (from the equitable origins of the doctrine to one better understood as a rule of law) it may be said that this correlates with a trend, towards protection of freedom of contract and to ensure contractual certainty in commercial contexts.

The recent New South Wales Court of Appeal decision in *Interstar Wholesale Finance v Integral Home Loans*[1] would suggest that the doctrine must be seen in the context that, within limits, parties have freedom of contract. To some extent (at least this would seem to be the criticism inherent in the dicta of Brereton J in the first instance decision in *Interstar*[2]) the position now reached after the Court of Appeal decision in *Interstar* has struck a balance in favour of protecting freedom of contract as expressed in (and giving precedence to the form of the agreement) rather than placing the ultimate (or perhaps undue) emphasis on what might have been perceived as the concept of fairness underpinning the equitable concerns of the doctrine, as voiced by Mason and Wilson JJ in *AMEV-UDC Finance Limited v Austin* [3].

On the one hand, the statements by Mason and Wilson JJ in *AMEV-UDC*[4] emphasise the role of the doctrine of penalties in protecting against provisions which are so unconscionable or oppressive that their nature is penal rather than compensatory, and

* Justice of Supreme Court of New South Wales. This presentation has been prepared with the invaluable assistance and research of Jessica Hudson, tipstaff to her Honour, whose substantial contribution to this paper is gratefully acknowledged.
[1] *Interstar Wholesale Finance Pty Limited v Integral Home Loans Pty Limited* [2008] NSWCA 310, Allsop P, with whom Giles JA, at [163] and Ipp JA, at [164] agreed.
[2] *Integral Home Loans Pty Ltd & Anor v Interstar Wholesale Finance Pty Ltd & Anor* [2007] NSWSC 406.
[3] *AMEV-UDC Finance Limited v Austin* [1986] HCA 63; 162 CLR 170, at 193-194.
[4] *AMEV-UDC*, at 193-194.

so answer the criticism often levelled against unqualified freedom of contract, namely the potential for inequality of bargaining power. Such statements are aided by the doctrine's preference for substance over form[5]. On the other hand, as recognised in the Court of Appeal decision in *Interstar*[6], the scope and operation of the doctrine must be considered in this context of the recognition of contractual freedom. Is there any need (or scope for operation) of the doctrine in the modern law of contract? What are the main concerns or aims of the doctrine, and does its current scope and operation achieve them?

PART 1 – when will a clause amount to a penalty?

Introduction

Lord Dunedin's speech in *Dunlop Pneumatic Tyre Co v New Garage and Motor Co*[7], is the starting point for assessing whether a clause is penal. The oft cited passage, contrasting an unenforceable *in terrorem* claim with an enforceable liquidated damages clause, is:

> 2. 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 ...
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> 3. The question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach ...
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> 4. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:

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[5] *Interstar*, NSWSC, at [70] and there Brereton J refers to the following cases; *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo Y Castaned* [1905] AC 6, at 15; *Bridge v Campbell Discount Co Ltd* [1962] AC 600, at 624; *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359, at 368; *Deputy Commissioner of Taxation v Advanced Communications Technologies (Australia) Pty Ltd (Rec & Mgrs Apptd) (Subject to Deed of Company Arrangement)* [2003] VSC 487, at [113]; Meagher, Heydon and Leeming, *Meagher Gummow & Lehane, Equity: Doctrines and Remedies*, 4th ed, Butterworths, 2002, at [18-085].

[6] *Interstar*, NSWCA, from [112], there referring to *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 2 All ER 205 and *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71; (2005) 224 CLR 656, at 659.

[7] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1914] UKHL 1; [1915] AC 79, at 86-87.

> (a) It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach ...
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> (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid ...
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> (c) There is a presumption (but no more) that it is a penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage". (citations omitted)

This statement remains the classic formulation of the doctrine of penalties which has been accepted as such and applied in numerous cases[8]. Whilst the potential for reconsideration of the extent to which this statement represents the entire scope of the doctrine of penalties has been hinted at, it has not been fully argued nor decided[9].

The common shorthand way of describing the doctrine is that as formulated by the High Court in *Ringrow*[10]:

> the law of penalties in its standard application is attracted where a contract stipulates that on breach the contract-breaker will pay an agreed sum which exceeds what can be regarded as a genuine pre-estimate of the damage likely to be caused by the breach[11].

The simplicity with which such a statement is framed masks the fact that each element of the principle raises fine distinctions and complex (often unresolved or controversial issues) in relation to the construction of contracts. The legal principles underlying the doctrine have been approached from different perspectives. Indeed, that there was such a vast difference in approach and in the opinions expressed between the first instance and intermediate judgments in the *Interstar* proceedings[12]

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[8] See for example, *O'Dea*, at 368, 378, 399; *Acron Pacific Ltd v Offshore Oil NL* [1985] HCA 63; (1985) 157 CLR 514, at 520; *AMEV-UDC*, at 190; *Stern v McArthur* [1988] HCA 51; (1988) 165 CLR 489, at 540 and *Esanda Finance Corporation Ltd v Plessnig* [1989] HCA 7; (1989) 166 CLR 131, at 139, 143, 145; *Ringrow Pty Limited v BP Australia Pty Limited*, at 662; *Luong Dinh Luu v Sovereign Developments Pty Ltd* [2006] NSWCA 40, at [12]; *Interstar,* NSWSC, at [11] and NSWCA, at [115]; [144].

[9] See for example *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd* (1989) 15 NSWLR 564, at 566; *AMEV-UDC,* at 190; *Ringrow*, at 663.

[10] See for example *Luong Dinh Luu v Sovereign Developments*, at [10], with whom McColl and Handley JJA agreed.

[11] *Ringrow*, at 662.

[12] *Interstar,* NSWCA, and *Interstar,* NSWSC.

indicates just how deceptively simple the doctrine can be in its enunciation. The *Interstar* proceedings, the judgments at first instance and on appeal, considered most of the key elements of the doctrine, and yet came to different decisions as to nearly each of the elements considered.

What this means in practice is that practitioners must be equipped with strong technical skills concerning contractual construction. The only real penalty in this area seems to be the penalty for poor draftmanship.

Interstar - précis

As much of this part will discuss the respective *Interstar* decisions, it is useful to set out briefly some of the factual background to the dispute.

Integral Home Loans Pty Limited and Integral Financial Pty Limited (together "Integral") were mortgage originators who found and submitted to Interstar Wholesale Finance Pty Limited and Interstar Non-Conforming Finance Pty Limited (together "Interstar") applications by third parties for loans, and managed the ongoing servicing of such loans. Interstar engaged in the business of lending and procuring of moneys on the security of mortgages. In return for the origination and management of the loans, Interstar would pay Integral fees. The relationship between Interstar and Integral was governed by two written agreements called Loan Origination and Management Agreements ("LOMAs") which were in substantially the same form, and despite the differences discussed by Allsop P on appeal[13], were treated by both courts as being the same for the purposes of the determination of the proceedings[14].

On 17 March 2006, Interstar exercised a right of termination, under clause 20.1(c)[15], on the basis that it had formed the opinion that Integral had engaged in deceptive

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[13] *Interstar*, NSWCA, at [77].
[14] *Interstar*, NSWCA, at [78].
[15] Clause 20.1 of each LOMA provided for termination by the Manager in various circumstances, as follows:
The Managers may terminate this Agreement immediately upon the happening of any of the following events:
(a) upon the occurrence of an Insolvency Event in relation to the Originator;

conduct relating to loan application files. Interstar terminated both LOMAs which had the consequence that Integral ceased to be entitled to certain income under the agreements (clause 20.3(c))[16]. Integral asserted that clause 20.3(c) which provided for the cessation of the payments, was a penalty.

The primary judge, Brereton J, held that clause 20.3(c) was void as a penalty[17] and that Integral continued to be entitled to the commissions in question. On appeal, it was held that the doctrine of penalties did not apply to clause 20.3(c), and that even if it did, clause 20.3(c) was not a penalty[18].

(b) upon the Originator breaching any of the terms and conditions of this Agreement and/or a Manual and the breach not being rectified to the absolute satisfaction of each Manager within fourteen days after the date upon which written notice of such breach is given by each Manager to the Originator;
(c) where the Originator or the Originator's Representative has engaged in any proven deceptive or fraudulent activity in relation to an Application or a Settled Loan or a Manager considers, in its reasonable opinion, that the Originator or Originator's Representative has engaged in deceptive or fraudulent activity in relation to an Application or a Settled Loan;
(d) where, in the sole bona fide opinion of a Manager, there is a change in the management or effective control of the Originator which change is not acceptable to that Manager.

[16] Clause 20.3 of each LOMA provided:

In the event that this Agreement is terminated by the Managers:

(a) the Originator acknowledges that the Relevant Manager will be entitled (but without being under an obligation to the Originator to do so) to assume (or appoint a third party to assume) the servicing and management of the Settled Loans and to otherwise fulfil the servicing and managing obligations of the Originator as set out in this Agreement;
(b) pursuant to clause 20.1(b) or (d) the Originator shall, despite the termination of this Agreement, continue to be entitled to receive an amount equal to:
the Originator's Fee (in accordance with clause 10) in relation to the Outstanding Loan Balance
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the amount which the Relevant Manager reasonably determines to be the remuneration or compensation which the Relevant Manager (or a third party appointed by the Relevant Manager) is entitled to receive to continue to service and manage the Settled Loans as contemplated in paragraph (a); and
(c) pursuant to clause 20.1(a) or (c), then the Originator shall, with effect from the date of termination, have no further entitlement to receive any Originator's Fee or Upfront Fee.

[17] *Interstar*, NSWSC, at [78]-[81].

[18] *Interstar*, NSWCA, at [75]; [94]; [141]; [157].

The importance of considering the terms of the contract first – is there a circumscription or definition of entitlements or forfeiture of accrued rights?

Whilst the finer details concerning the application of the doctrine remain uncertain, the doctrine of penalties itself has been well accepted and applied by the courts for a long time[19]. Consequently, those responsible for drafting agreements have been able to keep apace of the entrenchment and development of the doctrine. Not surprisingly, therefore, it may be comparatively rare that one comes across a term in an agreement that is on its face obviously a penalty (save perhaps for the recent example in *Fermiscan Pty Ltd v Veronica Jean James*[20], as discussed below). Today, agreements, (particularly complex commercial agreements) might be expected to be drafted or structured in such a way as to prevent the application of the doctrine.

The importance of looking first to the terms of the agreement is no new concept, and was alluded to by Lord Dunedin in his famous speech in *Dunlop Pneumatic Tyre,* where it is said that "the question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract"[21].

In *Interstar,* the importance of looking first to the terms of the contract was made evident in the difference between differing conclusions there reached as to whether there was any accrued entitlement to fees at the time the alleged penal clause was said to operate.

Allsop P, from the outset (at [76]), emphasised that one needs to analyse the terms of the contract to form an understanding of the operation and effect of the relevant provisions. Accordingly, his Honour set out and considered in great detail the terms of the LOMAs.

[19] See for example, an outline of the development of the doctrine as set out by Priestley JA in *Austin v United Dominions Corp Ltd* [1984] 2 NSWLR 612, from 614 and decision of Mason and Deane JJ in *Legione v Hateley* [1983] HCA 11; (1983) 152 CLR 406, at 444.
[20] *Fermiscan Pty Ltd v Veronica Jean James* [2009] NSWCA 355.
[21] *Dunlop Pneumatic Tyre,* at 86-87, point 3.

Brereton J had considered that the LOMAs conferred an immediate entitlement to fees upon the settlement of a loan and that this right was not conditioned upon the contract not being terminated[22] so that any forfeiture of a right to such fees on termination affected by clause 20.3(c) operated as a forfeiture of an accrued entitlement to fees. Allsop P disagreed, his Honour considered that the treatment of the Originator's Fee as "earned upon the settlement of the loan" went too far – and that the right to the fees had not accrued or been "fully earned" at the time of termination[23].

Allsop P instead found that the fees should be understood as earned for a "combined or bundled consideration (origination and management)" and the entitlement (that is a fully accrued legal right, forfeiture of which might be capable of engaging the penalties doctrine) to receive them was by reference to all the terms of the LOMAs, including cl 20.3(b) and (c)[24]. That the right or entitlement to the payment of fees was conditional upon performance of the management obligations necessarily required the continuation of the LOMAs so that the termination of the agreement qualified and ended the outright entitlement to the fees, as performance of the management obligations was not by then complete[25]. As such, there was no unconditional entitlement to the fee until the consideration for the fee had been performed, that is until both loan origination and its management had been undertaken.

On Allsop P's approach, only one aspect of the consideration had been performed – the loan origination – before the termination occurred. Accordingly, at the time of termination there was no accrued entitlement to the fees capable of being forfeited, and thus capable of enlivening the doctrine of penalties. Allsop P's construction of cl 20.3(c) permitted the conclusion that the clause was part of the "circumscription or the definition of the entitlement; it is not the forfeiture of accrued property for the collateral purpose of encouraging compliance with the contract"[26].

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[22] *Interstar*, NSWSC, at [16]-[17].
[23] *Interstar*, NSWSC, at [79].
[24] *Interstar*, NSWSC, at [82].
[25] *Interstar*, NSWCA, at [83].
[26] *Interstar*, NSWCA, at [94].

Thus the first condition, that there be a forfeiture of money (or possibly of "rights" – which I discuss below) for the application of the doctrine, was not satisfied and the doctrine of penalties did not apply to cl 20.3(c), as a matter of contractual construction. The importance of focussing on the operation of the contractual term(s) was affirmed by Allsop P in *Fermiscan*[27].

Characterising the penalty - is it necessary for there to be forfeiture of money or will the doctrine apply where there is a forfeiture of "rights" or "accrued entitlements"?

Lord Dunedin's formulation of a penalty simply makes reference to "a payment of money stipulated as *in terrorem* of the offending party"[28]. Likewise, the High Court in *Ringrow* said the following:

> The law of penalties, in its standard application, is attracted where a contract stipulates that on breach the contract-breaker will pay an agreed sum which exceeds what can be regarded as a genuine pre-estimate of the damage likely to be caused by the breach[29].

However, later cases were treated in *Ringrow* as representing the essence or standard application of the doctrine (but not its universal or exclusive application) so that the doctrine can potentially apply to situations not falling directly within the ambit of the above statement of principle.

Indeed this broader scope was recognised by both Brereton J[30], and Allsop P[31] in their respective decisions in *Interstar*, both finding that a stipulation may be penal in character even though the penalty is not expressed in terms of the payment of money but in terms of transfer of property. There are, of course, examples of cases where clauses requiring the forfeiture or transfer of property or rights other than money have been found to be capable of attracting the doctrine of penalties[32]. In *Jobson v*

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[27] *Fermiscan*, at [133], Ipp JA and Handley AJA agreeing.
[28] *Dunlop Pneumatic Tyre*, at 86-87.
[29] *Ringrow*, at 662-663.
[30] *Interstar*, NSWSC, at [12].
[31] *Interstar*, NSWCA, at [101]-[104].
[32] Other cases referred to by Brereton J in *Interstar*, NSWSC, at [12], are; *Bysouth v Shire of Blackburn & Mitcham* [1928] VLR 562; *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1974] AC 689; *Jobson v Johnson* [1989] 1 All ER 621 and additional cases referred to by Allsop P in *Interstar*, NSWCA, at [102], are *Forestry Commission of New*

Johnson[33] Dillon LJ found that the doctrine is not limited to obligations to pay a monetary sum, but extends to obligations to transfer property and provisions that have the effect of authorising retention or withholding payment of, or extinguishing a right to receive, remuneration already earned but unpaid. In *Wollondilly Shire Council v Picton Power Lines Pty Limited*[34], Handley JA (with whom Clarke and Meagher JJA agreed) stated:

> Equity always looked to substance rather than form and the penalty doctrine developed from Equity. In principle therefore the doctrine should apply not only to clauses which provide for the payment of money on breach but also to those which provide for the transfer of money's worth.

Allsop P referred[35] to the decision of Hely J in *Ringrow Pty Limited v BP Australia Ltd*[36] who stated:

> The sphere of operation of the penalties doctrine is limited to payment of agreed sums or transfer of property upon a breach of contract … A clause providing for a payment of an agreed sum on termination of a contract (in itself not an event of breach) is still within the reach of the penalties doctrine if one of the grounds on which the agreement may be terminated is breach
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> A stipulation may be penal in character even where the penalty is not expressed in terms of money. So much was conceded in *Forestry Commission (NSW) v Stefanetto* … *Jobson v Johnson* … and *Wollondilly Shire Council v Picton Power Lines Pty Ltd* … are each authority for the proposition that the penalty doctrine is not confined to clauses providing for the payment of money, but extends to clauses providing for the transfer of moneys worth[37].

As pointed out by Allsop P, Hely J's statement was adopted on appeal by Conti and Crennan JJ[38]. (In the High Court, it was not submitted[39] that the provision was not a penalty on the basis that it did not provide for a payment of money.)

Whilst it seems relatively settled that the doctrine can extend beyond payments of money to transfers of property or non-monetary sums, it was not necessary for the

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South Wales v Stefanetto [1976] HCA 3; 133 CLR 507 and *Wollondilly Shire Council v Picton Power Lines Pty Limited* (1994) 33 NSWLR 551.

[33] *Jobson v Johnson*, at 628, referred to by both Brereton J in *Interstar*, NSWSC, at [12] and Allsop P in *Interstar*, NSWCA, at [101].

[34] *Wollondilly Shire Council v Picton Power Lines*, at 555.

[35] *Interstar*, NSWCA, at [102].

[36] *Ringrow Pty Limited v BP Australia Pty Ltd* [2003] FCA 1297; (2003) 203 ALR 281.

[37] *Ringrow*, at [97]; [100].

[38] *Ringrow Pty Limited v BP Australia Ltd* [2004] FCAFC 206; (2004) 209 ALR 32, at [109].

[39] *Ringrow*, at 659-660.

purposes of the *Interstar* appeal to consider the application of the doctrine, to *forfeiture* of property (as opposed to *transfer* of property) (Allsop P[40] cf Brereton J[41]). Allsop P acknowledged[42] that it is but a small step for such an extension to be accepted, and was prepared to accept that the doctrine can apply to forfeiture of rights *or property* but observed that once such an acknowledgment is made then "the relationship between penalties and relief against forfeiture at this point becomes less than pellucid", a point which will be addressed below.

Characterising the penalty – when will a change in the nature of the obligation to repay amount to a penalty?

It has long been recognised that where there is a debt due immediately but repayable in the future, or by instalments (*debita in praesenti* although *solvenda in futuro*[43]), the acceleration of the debt, even upon breach, will not be a penalty[44]. There can be no penalty on the basis that there is no additional or collateral obligation being imposed upon breach as the debt was always due, and it was simply by way of an indulgence that the debt was repayable by instalments, (or by way of a lower interest rate or reduced principal for example). The critical distinction is between debts that are immediately due (but not yet payable) such that there is a presently existing obligation to repay and debts that are conditional such that they only become due in full upon breach[45].

Thus if an obligation to repay can be characterised as being immediately effective (but by way of an indulgence is postponed, or the debtor is permitted to repay that amount by instalments or at a reduced interest rate provided it makes punctual payment of the amount in respect of which it is given an indulgence or compliance with other obligations) then the later acceleration of the debt, (or the fact that it

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[40] *Interstar*, NSWCA, at [104].
[41] *Interstar*, NSWSC, at [12].
[42] *Interstar*, NSWCA, at [104].
[43] *Wallingford v Mutual Society* (1880) 5 App Cas 685, at 696.
[44] *The Protector Loan Co v Grice* (1880) 5 QBD 592; *Wallingford v Mutual Society*, at 696; *Thompson v Hudson* (1869) LR 4 HL 1, at 15-16; *O'Dea*, at 366; 380; 386; *Acron Pacific Ltd v Offshore Oil*; *Hunt v Kallinicos* [2009] NSWCA 5, at [18]-[20].
[45] For a recent application of this distinction see the decision of Davies J in *Perpetual Trustee Company Ltd v Mitchell* [2010] NSWSC 825, from [13]; *Perpetual Trustee Co Ltd v Aspley Specialist Centre Pty Ltd* [2010] QSC 232, from [22], see also see also *Cameron v UBS AG* [2000] VSCA 222; [2000] 2 VR 108.

becomes payable at the original interest rate) upon a breach cannot be a penalty, as there is no additional or collateral obligation arising upon breach, as the obligation to pay the debt was always operative, irrespective of breach[46].

However, where a debt which is not presently payable, or is conditional and then becomes unconditional upon breach, this constitutes an imposition of additional or collateral obligations and can amount to a penalty. For example, in *Fermiscan*, the impugned clauses, when read together, required payment of $700,000 on the following terms: (i) $200,000 was payable upon committal of certain breaches; and (b) $500,000 would be payable out of (and only upon the earning of) fees and royalties unless certain breaches occur, whereupon the fees were to be payable forthwith by the respondent out of her own resources. So, the obligation to pay the $500,000 (absent a breach of contract) was conditional upon money being earnt by the commercialisation of certain inventions. However the dependence on fees being earnt was severed (and the obligation would become an unconditional obligation to pay, the full amount immediately regardless of whether fees were earnt) on breach of contract. Allsop P held that the transformation of a limited or conditional obligation to pay to that of an unconditional obligation, by way of more onerous terms which operated only upon breach, was capable of attracting the doctrine of penalties[47]. Similarly, the obligation to pay $200,000 upon breach, was capable of being a penalty[48].

In *Fermiscan,* Allsop P indicated that an important consideration is the absence of any indication from the terms and context of the agreement that the sums in question were part of a genuine pre-estimate of damage that might flow from a breach of certain clauses giving rise to the additional obligation[49]. This is because it assists in the conclusion that the contractual purpose of the clause (and the objective intention of the parties) was not to deal with the consequences of breach, but to coerce performance. In *Fermiscan*, when regard was had to the commercial background and context of the terms of the agreement, neither supported the conclusion that the

[46] *O'Dea*, at 366-367, 369, 386.
[47] *Fermiscan*, at [143]-[145].
[48] *Fermiscan*, at [154].
[49] *Fermiscan*, at [145], there Allsop P cited *Clydebank Engineering*, at 19; *Commissioner of Public Works v Hills* [1906] AC 368, at 375-376 and *Campbell Discount*, at 622.

required additional payments (both of $200,000 and of $500,000) were intended as an agreed pre-estimate of damages for breach; instead such payments were characterised as encouraging or coercing performance of the agreement.

Does the doctrine apply only to the circumstances of breach of contract?

Perhaps one of the most vexed issues concerning the doctrine of penalties is whether it is necessary that the penal clause operate upon the occurrence of breach, such that it can be said that the clause is aimed at compelling performance of the contract and operates *in terrorem* to induce performance and so be described as a punishment for default [50]. Uncertainty has arisen as to whether the doctrine applies to situations where payments are conditional upon the happening of specified events, as opposed to a breach of the contract. There is even more uncertainty where the specified events themselves seem very much like breaches of contract (in that the same factual circumstances could satisfy the event as well as being a breach of contract), as was the case in *Interstar*.

One of the main points of distinction between the first instance and appeal decisions in *Interstar* was in relation to the issue of whether the doctrine of penalties was limited to the circumstances of breach of contract. At first instance, Brereton J, after conducting an extensive review of English, Australian and other common law authorities and placing particular reliance upon the decision of Deane J in *AMEV-UDC*[51], considered that it was open to him to find that the doctrine could extend to:

> the occurrence of an event which can be seen, as a matter of substance, to have been treated by the parties as lying within the area of obligation of the first party, in the sense that it is his or her responsibility to see that the specified event does or does not occur[52]

Like Brereton J, Allsop P analysed previous authorities to determine whether it was open to extend the doctrine in this way. However Allsop P came to the contrary conclusion[53]. Allsop P found that the weight of the decisions given by the High Court (despite Deane J's decision) in *AMEV-UDC* could be seen to adhere to the correctness of the House of Lords' decision in *Export Credits Guarantee Department v Universal Oil*

[50] *Legione v Hateley*, at 444-445; *Interstar*, NSWSC, at [10].
[51] *AMEV-UDC*, Deane J, at 199.
[52] *Interstar*, NSWSC, at [74].
[53] *Interstar*, NSWCA, at [119]; [134].

Products Co and to the correctness of the comments of Walsh J in *IAC (Leasing) Ltd v Humphrey*[54]. Both these decisions maintained the position that the doctrine could only apply to the circumstances occasioned by breach of contract (and perhaps termination for breach of contract).

Allsop P was of the opinion that the current state of authorities did not permit the fashioning of a principle based on the dissenting views of Deane J in *AMEV-UDC*, which went beyond the boundaries of the doctrine expressed in *IAC (Leasing)* and the other decisions in *AMEV-UDC*, by the House of Lords in *Export Credits* and by intermediate appellate courts in Australia and Canada[55].

Export Credits is considered to be a powerful indication of the limits of the doctrine of penalties[56]. In that House of Lords decision, Lord Roskill affirmed the lower courts' decisions[57], which included reference to a decision of Diplock LJ in *Philip Bernstein (Successors) Ltd v Lydiate Textiles*[58], where Diplock LJ identified the distinction drawn between a payment which by the terms of the contract a party undertakes to make in a specified event and payments which are promised to be made on breach of contract. Diplock LJ was of the view that at the time there was no authority to support the extension of the doctrine to the former situation, and refused to do so.

In the Court of Appeal[59], Waller LJ cited this same passage from Diplock LJ's judgment in *Philip Bernstein* and stated that where the contract provides for a sum of money to be payable on the happening of an event no question of a penalty arises and the court will not grant any relief. Similarly Slade LJ with whom Sir Sebag Shaw agreed, approved Diplock LJ's statement and indicated that the mere fact that a person contracts to pay another person on a specified contingency a sum of money which far exceeds the damage likely to be suffered by the recipient as a result of that contingency does not of itself render the provision void as a penalty. Slade LJ went

[54] *IAC (Leasing) Ltd v Humphrey* [1972] HCA 1; 126 CLR 131.
[55] *Interstar*, NSWCA, at [134].
[56] *Interstar*, NSWCA, at [112].
[57] *Export Credits*, at 224.
[58] *Philip Bernstein (Successors) Ltd v Lydiate Textiles* (unreported, Court of Appeal of England and Wales, 1962).
[59] *Export Credits Guarantee Department v Universal Oil Products Co* [1983] 1 Lloyd's Rep 448; [1982] Com. L.R. 232; (1982) 126 S.J. 853.

on to affirm the requirement that the payment of money against which relief is sought must be conditioned upon a breach of the agreement.

In the House of Lords, Lord Roskill, was "in complete agreement" and clearly approved the views of Staughton J in the first instance and Slade and Waller LJJ on appeal[60]. Allsop P in his decision in *Interstar* considered the House of Lords' approval of the lower courts' approaches in *Export Credits* as an indication of the limits of the doctrine of penalties[61]. That limit being that the doctrine will apply only to circumstances of a breach of contract. Whilst there is other English authority (as discussed by Brereton J[62]) including the judgment of Diplock LJ in *Financings Ltd v Baldock*[63] (which was decided after *Philip Bernstein*), Allsop P considered that such authority did not detract from the application and effect of *Export Credits*[64]. In addition, Allsop P was of the view[65] that intermediate appellate courts in Australia have dealt with the governing principles of the law of penalties on the basis that it is essential that payment be conditioned on breach of contract, pointing to the application of *Export Credits* in Australia[66]. As discussed by Allsop P[67] it is also worth noting that *Export Credits* was applied, without qualification, by the British Columbia Court of Appeal[68] in support of the proposition that payment conditioned on a breach of contract is an essential element of a penalty.

The High Court in *Ringrow* stated the standard application of the doctrine, as discussed above, emphasising the application of the doctrine upon a breach of contract[69]. (In contrast, Hely J at first instance in *Ringrow* had phrased the doctrine as applying where an agreement imposed an additional or different liability *upon breach*

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[60] *Export Credits*, at 224.
[61] *Interstar*, NSWCA, at [112].
[62] *Interstar*, NSWSC, from [20].
[63] *Financings Ltd v Baldock* [1963] 2 QB 104.
[64] *Interstar*, NSWCA, at [119].
[65] *Interstar*, NSWCA, at [126].
[66] Noting the decision of Hely J in *Ringrow*; *Bartercard v Myallhurst* [2000] QCA 445, Thomas JA (with whom Davies JA and Ambrose J agreed), at [27]-[28] and Davies JA at [2]; *Wollondilly*, Handley JA (with whom Meagher and Clarke JJA agreed), at 555.
[67] *Interstar*, NSWCA, at [127].
[68] *Cunning v Riddell* 1990 CanLII 854; and *Doman Forest Products Ltd v GMAC Commercial Credit Corp* (2007) BCCA 88; (2007) 29 BLR (4th) 1.
[69] *Ringrow*, at 662.

of a contractual stipulation[70].) Allsop P also referred to the High Court's comments in *Ringrow*[71] concerning the underlying policy concerns of the doctrine in relation to ensuring freedom of contract[72].

Although Brereton J in *Interstar* considered that Mason and Wilson JJ's historical summary in *AMEV-UDC* at least did not preclude application of the doctrine of penalties in the absence of breach[73], on appeal, Allsop P was of the view that Mason and Wilson JJ's judgment did not support such a conclusion, pointing to Mason and Wilson JJ's approval of *Export Credits* and Walsh J's comments in *IAC (Leasing)*[74]. Indeed Wilson and Mason JJ began their historical reviews by stating; "…it is a risky enterprise to construct an argument on the basis of the old decisions"[75]. Allsop P concluded (cf Brereton J[76]) that the reasons of Mason and Wilson JJ "certainly" did not support the views of Lord Denning in *Bridge v Campbell Discount Co Ltd* [77] (where Lord Denning, rejected the notion that the doctrine of penalties was confined to sums stipulated to be paid for breach of contract)[78].

The decision of Dawson J in *AMEV-UDC* adds to this conclusion, as his Honour likewise found that the doctrine of penalties would only be engaged upon a breach of contract, Dawson J stated[79]:

> The decision in *Cooden Engineering Co. Ltd. v. Stanford* was approved in *Campbell Discount Co. Ltd. v. Bridge*, and applied in *Financings Ltd. v. Baldock*, and was clearly accepted by the majority in *O'Dea* … However, treatment of the termination of an agreement upon breach in the same way as the breach itself for the purpose of determining whether a stipulated payment is capable of amounting to a penalty has no extended application. It would seem clear that a provision calling for the payment of money by one party on the occurrence of a specified event, rather than upon breach by that party, cannot be a penalty: *Campbell Discount Co. Ltd. v. Bridge; Export Credits v. Universal Oil Co.* (citations omitted)

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[70] *Ringrow*, at [97], approved on appeal the Full Federal Court by Conti and Crennan JJ (at [109]) and the reservation expressed by the High Court expressed in relation to other issues (at 670-671) did not concern nor detract from this statement of principle by Hely J at first instance.
[71] *Ringrow*, at 669.
[72] *Interstar*, NSWCA, at [113].
[73] *Interstar*, NSWSC, at [57]; [69].
[74] *Interstar*, NSWCA, at [131].
[75] *AMEV-UDC*, at 186.
[76] *Interstar*, NSWSC, at [57]; [69].
[77] *Campbell Discount*, at 629-631.
[78] *Interstar*, NSWCA, at [131].
[79] *AMEV-UDC*, at 211.

In *IAC (Leasing)*[80] Walsh J was of the view that there was a preponderance of opinion in favour of the view that the question whether an obligation is penal arises only where the provision is conditional upon a breach of contract. Another High Court authority referred to by Allsop P is the decision of *O'Dea*[81]. In that case Brennan J, referring to Walsh J in *IAC (Leasing)*, indicated that the balance of opinion in the High Court favored the view that no question of penalty arises unless the obligation to pay occurs upon breach of contract[82].

As mentioned above, Denning LJ in *Campbell Discount Co v Bridge* rejected the notion that the doctrine of penalties was confined to sums stipulated to be paid for breach of contract[83]. However, and as discussed by Dawson J[84] and Mason and Wilson JJ in *AMEV-UDC*[85], the majority of speeches delivered in *Campbell Discount* were to the contrary view (namely that the doctrine had no application to a stipulation which provides for payment on the happening of a specified event rather than a breach of contract). It is this majority position which was affirmed by the House of Lords in *Exports Credits*[86], (as discussed above) and accepted as such in *IAC (Leasing)*[87], and *AMEV-UDC*[88].

An opportunity for this issue to be ventilated again might arise in the context of the anticipated challenge to the imposition of certain bank fees. Such a challenge has already been run in England and was ultimately unsuccessful[89], where one of the challenges to certain bank fees, brought against numerous banks, was on the basis that the fees were penal (the fees were also challenged on the basis of the "fairness" of their imposition under English banking and financial regulations). At first instance[90],

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[80] *IAC (Leasing)* Walsh J, at 143.
[81] *Interstar*, NSWCA, at [129].
[82] *O'Dea*, at 390.
[83] *Campbell Discount*, at 629-631.
[84] *AMEV-UDC*, at 211.
[85] *AMEV-UDC*, at 184.
[86] *Exports Credits*, at 223-224.
[87] *IAC (Leasing)*, at 143.
[88] *AMEV-UDC*, at 184, Mason and Wilson JJ and at 211, Dawson J.
[89] *Office of Fair Trading v Abbey National plc* [2009] UKSC 6; [2010] 1 All ER 667; [2009] 3 WLR 1215.
[90] *Office of Fair Trading v Abbey National plc* [2008] All ER (D) 349 (Apr); [2008] EWHC 875 (Comm); [2008] 2 All ER (Comm) 625.

it was found by Smith J that the law of penalties did not apply in this context, as there was no imposition of obligations upon a breach[91]. Smith J stated;

> Undoubtedly the law about penalties does not apply if the obligation is to pay for a service or upon an event other than a breach, even if the service is supplied or the event takes place against the background of or accompanied by a contractual breach, and even if the service would not have been provided or the event would not have occurred but for the breach. A customer could not necessarily invoke the law about penalties to challenge charges payable for his bank lending him money simply because his account would not be overdrawn but for his own breach. If an obligation to pay is penal, it must require payment upon the breach itself[92].

On appeal the Supreme Court found that the bank fees levied on personal current account customers in respect of unauthorised overdrafts constituted part of the price or remuneration for the banking services provided, and under the relevant regulations this precluded the Office of Fair Trading from assessing the fairness of the fees (the finding in relation to penalties was not challenged). The Supreme Court's finding is consistent with the first instance finding that the fees were not operational upon breach but were consideration for a service such that the doctrine of penalties could not apply.

The reasons of Smith J at first instance are consistent with the approach adopted by Allsop P in *Interstar*. Smith J indicates that there must be a direct link between breach and the impost of fees, so that it is not enough that the specified event takes place against the background of or is accompanied by breach and irrespective of whether it can be said that the fees would not have been imposed but for a breach.

To the extent that the doctrine of penalties does not apply beyond the circumstances operating upon a breach of contract, pending any higher consideration of the issue[93], it would seem likely that a challenge to the validity of bank fees on the ground that such fees are a penal, would be decided similarly to the case in England, unless it can be established that the imposition of the fees are expressed to be operative upon breach.

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[91] *Office of Fair Trading v Abbey National*, at [323].
[92] *Office of Fair Trading v Abbey National*, at [299].
[93] Noting that leave to appeal was granted by the High Court although the matter settled before reaching the final hearing.

Application of the doctrine to circumstances of termination where termination is conditioned upon breach (and other events)

What the Court of Appeal judgment in *Interstar,* does not expressly address is whether the doctrine can extend to the circumstances arising from termination of a contract, where that termination is conditioned upon multiple events, including events other than breach. Brereton J's formulation of the doctrine extended its application to the occurrence of an event treated by the parties as lying within the area of obligation of the party said to be suffering by reference to the allegedly penal clause[94]. The Court of Appeal's rejection of the formulation in these terms[95] does not address whether the doctrine can apply with a more limited scope to circumstances conditioned on termination.

Based on the state of authorities addressing this point, as Interstar had exercised its right to terminate on the basis of a specified event (rather than a breach) it seems unlikely that the doctrine would have applied.

The application of the doctrine to the circumstances of termination has been recognised by the High Court previously as being one which generates difficulties, Mason and Wilson JJ in *AMEV-UDC,* stated:

> Unfortunately the proposition that the doctrine of penalties has no operation in relation to a sum agreed to be paid on the happening of an event which is not a breach of contract generates difficulties when an attempt is made to apply the proposition to the exercise of an option to terminate a contract which is conditional upon, or associated with, a breach of contract[96].

Mason and Wilson JJ were of the opinion that it accords with principle and authority that payments conditional upon an option to terminate exercised on breach can be penal unless they represent a genuine estimate of damage and that the rationale underlying this is that the doctrine is concerned with matters of substance, not of form, there relying upon the authority of *O'Dea*[97]; *Cooden Engineering v Stanford*[98]; *Campbell Discount*[99]*; United Dominions Trust v Ennis*[100]; and *IAC (Leasing)* [101].

[94] *Interstar,* NSWSC, at [74].
[95] *Interstar,* NSWCA, at [106]; [134].
[96] *AMEV-UDC,* at 184.
[97] *O'Dea,* at 368.

Similarly, Dawson J in *AMEV-UDC* (relying on *Cooden Engineering*, *Bridge v Campbell Discount*, *Export Credits* and *O'Dea*) said:

> However, treatment of the termination of an agreement upon breach in the same way as the breach itself for the purpose of determining whether a stipulated payment is capable of amounting to a penalty has no extended application. It would seem clear that a provision calling for the payment of money by one party on the occurrence of a specified event, rather than upon breach by that party, cannot be a penalty…[102]

In *O'Dea*, Gibbs CJ, relied upon the decisions of *Cooden Engineering v Stanford*[103], *Bridge v Campbell Discount*[104] and *Financings Limited v Baldock*[105] and concluded that it has been settled in England that in a case where an agreement is terminated by reason of a breach committed by the hirer, the sum payable will be a penalty unless it is a genuine pre-estimate of the loss suffered by the owner by reason of that breach.

However, Mason and Wilson JJ in *AMEV-UDC* did not go on to consider the issue of the applicability of the doctrine to payments conditioned upon termination where termination has been exercised on account of a specified event which does not amount to breach. Nor did the Court of Appeal address this issue, as Allsop P instead disposed of this point on appeal on the basis that it was not open to extend the doctrine to the consequences suffered upon a failure to fulfil an obligation seen as lying within the area of obligation of the penalised party. Brereton J's formulation of the doctrine goes beyond the circumstances of termination for specified events. As such, Allsop P's rejection of that broader formulation does not expressly address the more limited application of the doctrine to circumstances occasioned on termination for a specified event.

Some of the extracts from cases that Allsop P set out in his Honour's decision as representing the current statements of principle did expressly address the issue of whether the doctrine could apply to payments occasioned on termination.

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[98] *Cooden Engineering Co Ltd v Stanford* (1953) 1 QB 86, at pp 96, 116.
[99] *Campbell Discount,* at 624.
[100] *United Dominions Trust (Commercial) Ltd v Ennis* (1968) 1 QB 54, at 65, 68, 69.
[101] *IAC (Leasing),* at 142-143.
[102] *AMEV-UDC,* at 211.
[103] *Cooden Engineering Co. Ltd v Stanford,* at 96; 116.
[104] *Campbell Discount; United Dominions Trust (Commercial) Ltd. v Ennis*, at 65, 68, 69.
[105] *Financings Limited v Baldock.*

Specifically, his Honour referred to[106] statements from Hely J in *Ringrow*, which were approved by the Full Federal Court's decision and not questioned on appeal by the High Court in *Ringrow*[107] to the effect that a clause providing for a payment of an agreed sum on termination of a contract (in itself not an event of breach) is still within the reach of the penalties doctrine if one of the grounds on which the agreement may be terminated is breach[108].

In *Interstar*, Allsop P also referred to a passage[109] from *Bartercard v Myallhurst*[110], where Davies JA stated:

> It now appears to be accepted that where a right to terminate a contract and to receive a payment arises on the happening of any of a number of events some only of which are breaches of contract it is only where the termination is in consequence of breach that the question of penalty can arise.

Neither of the passages from Davies JA nor Hely J, as cited by Allsop P (and extracted above), considered the issue of the application of the doctrine of penalties to payments occasioned on termination for a specified event other than breach. So, on either of Davies JA's approach in *Bartercard v Myallhurst*, or Hely J's approach in *Ringrow*, the doctrine of penalties would not have applied to the facts in *Interstar* in any event, as Integral had exercised its right to terminate not on the basis of a breach of contract but because of a certain event occurring (albeit the event was that in Interstar's opinion Integral had engaged in certain conduct and such conduct amounted to a breach of the contract anyway, yet Interstar chose not to exercise rights of termination on the basis of breach).

Thus it would seem that a clause providing for penal consequences following the exercise of a right to terminate for breach, may be subject to the doctrine of penalties, but that where the right to terminate has in fact been exercised due to the occurrence of a specified event, which is not itself a breach, then the consequences flowing from that termination will not be subject to the doctrine of penalties.

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[106] *Interstar*, NSWCA, at [116].
[107] *Ringrow*, Hely J, at [97]; Conti and Crennan JJ, at [72]; [109].
[108] *Ringrow*, Hely J, at [97] there citing *O'Dea*, at 367 and Lanyon 'Equity and the Doctrine of Penalties' (1996) 9 JCL 234, at 235.
[109] *Interstar*, NSWCA, at [122].
[110] *Bartercard v Myallhurst*, at [2].

What then is the situation where a right of termination arises on the happening of a series of events which could amount to breach as well as specified events?

Whether a certain obligation is penal depends in the first instance upon what the obligation is conditioned and it seems possible that a clause providing for the consequences flowing from a breach or termination for breach may be a penalty but that the very same consequences if conditioned upon the occurrence of specified events (which may arise on the same facts as a breach) will not. On this understanding, the determination of a penalty clause appears to depend very much upon the drafting of the contract rather than the obligations said to flow from certain events. To some extent it would also seem to depend upon whether the innocent party elects to terminate for breach (in which case the doctrine may apply to such consequences) or to terminate on the basis of a specified event such as the formation of an opinion (which would not attract the doctrine, as the case was in *Interstar*).

The way in which the LOMAs were drafted in *Interstar,* meant that Interstar had the option of relying upon the formation, reasonably, of the opinion that Integral had engaged in fraudulent conduct, as giving rise to the right to terminate which would safeguard the forfeiture of any accrued rights (had they been found to exist) from the operation of the doctrine of penalties because such forfeiture was conditioned on the occurrence of a specified event (termination for the formation of an opinion), not on the occurrence of breach. This means that Interstar was able to gain the benefits of such a right to terminate and to withhold payment of fees, simply on the basis that it forms an opinion, rather than a breach having actually occurred, yet if Interstar had relied on the potentially more serious consequences of there being in fact an actual breach, then it may have been possible for Integral to call into aid the doctrine of penalties. That such relief is not available against the same obligation in response to a potentially less serious event, would seem to be contrary to any underlying policy concerns to relieve against unfair or unconscionable terms (assuming that such considerations remain relevant to the doctrine today at all, which will be discussed further below).

Out of all proportion?

Once it has been determined that the doctrine applies to a particular clause, it is then necessary to determine whether the particular clause is penal. In assessing whether the payment or forfeiture required by the impugned clause is not a genuine pre-estimate of damage, one must assess what might be the actual consequences suffered as a result of a breach as compared with the value or worth of the stipulated payment, transfer or forfeiture[111]. As regards the relationship between the payment and consequences of breach, one should look to the High Court's statement in *Ringrow*[112] as the law applicable in this country, which approved Lord Dunedin's speech (as set out above) in *Dunlop Pneumatic Tyre*, including paragraph 4, concerning the relationship between the payment and the consequence of breach[113].

In *Ringrow*, the High Court sets out the current law regarding the relationship between the consequences and actual damage suffered as a result of breach[114] indicating that the principles of law relating to penalties require only that the money stipulated to be paid or the property stipulated to be transferred on breach is "extravagant and unconscionable in amount" or "out of all proportion" when compared with a genuine pre-estimate of damage[115]. It is not enough that it should be lacking in proportion[116].

Despite the use of the word "proportion" in these various formulations, whether there is proportion or disproportion between the innocent party's commercial interests and the promise extracted to protect them is not relevant to the assessment or comparison between the actual damage suffered and the contractual consequences from breach[117]. The concept of proportionality between the commercial interests sought to be protected and the obligations imposed to ensure such protection is not part of the law

[111] *Interstar*, Allsop P, at [143].
[112] *Ringrow*, at 662.
[113] *Interstar*, NSWCA, at [144].
[114] *Ringrow*, at 667-669.
[115] *Ringrow*, at 667-669.
[116] *Ringrow*, at 669.
[117] *Ringrow*, at 667-669.

of penalties[118]. That is, it is not necessary that there be strict proportion, between the compensation or additional obligations and the damage suffered from the breach[119].

The High Court in *Ringrow* explained that the reason for the non-application of any concept of "proportionality" was because such a concept is inconsistent with the law of penalties on the basis that the law of contract normally upholds the freedom of parties, with no relevant disability, to agree upon the terms of their future relationships[120] and how and at what price their commercial interests are to be protected. Accordingly, it is not appropriate for a court to determine what are or are not the legitimate commercial interests of parties and the price of protecting such interests which would be inherent in the determination of the degree of proportionality between the innocent party's commercial interests and the promise extracted to protect them.

As explained by the High Court in *Ringrow,* exceptions to the parties' freedom of contract will "require good reason to attract judicial intervention to set aside the bargains upon which parties of full capacity have agreed"[121]. This is the reason why the law of penalties is, and is expressed to be, an exception from the general rule and in such exceptional language[122]. As such, it would be considered "a reversal of longstanding authority" to substitute a test expressed in terms of mere disproportionality[123].

The task of determining what could be the maximum damage suffered upon breach will often require consideration of the position but for the breach[124]. When undertaking the task of comparing what could be the maximum loss suffered by the breach and the allegedly penal amount, this can involve detailed consideration and extrapolation of the damage that could flow from breach (or conversely the profits

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[118] *Ringrow* at 669.
[119] *Lord Elphinstone v Monkland Iron and Coal Co* (1886) 11 App Cas 332, at 345, Lord Herschell LC, as referred to in *Ringrow,* at 668.
[120] *Ringrow*, at 669, there relying upon statement by Mason and Wilson JJ in *AMEV-UDC,* at 190.
[121] *Ringrow*, at 669.
[122] *Ringrow*, at 669.
[123] *Ringrow*, at 669.
[124] as was the issue in *Tullett Prebon (Australia) Pty Limited v Purcell* [2009] NSWSC 1079, from [119].

that would be expected if performance is duly rendered). Such tasks can be complex when undertaken beyond the realm of loan agreements. (For example, where an employee in breach of a contract terminates their employment, assessment of whether any liquidated damages clause is penal may involve consideration of what would have been the likely profit the employee would have generated over the term of the employment.) Having said that, a party seeking to make out a penalty will not be able to say that the determination of the maximum amount of damages should be reduced to account for mitigation of loss, that is, the question of mitigation is not of relevance when assessing the greatest loss that might be suffered[125].

In assessing whether the obligation is penal, if the same obligation arises on the breach of more than one provision, then one can have regard to Lord Dunedin's speech (as extracted above) which provides that there is a presumption that a clause will be a penalty when a sum is payable on the occurrence of one or more or all of several breaches, some of which may occasion serious damage and some of which may occasion only trifling damage[126].

In addition to this, regard should also be had to Lord Watson's speech in *Elphinstone's Case*[127] which held that if there are various breaches to which one indiscriminate sum to be paid in breach is applied then the strength of the chain must be taken at the weakest link, so if it can clearly be seen that the loss on one particular breach could never amount to the stipulated sum then it is a penalty. Against this presumption is that a clause will not be presumed penal simply because the consequences of breach are difficult to precisely pre-estimate, as it is in such circumstances that parties would be likely to have agreed in advance a sum payable[128]. However as Allsop P reminds us, these are just presumptions or tests to be used in the process of contractual construction and the ascertainment of the true operative character of the clauses[129].

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[125] *Murray v Leisureplay plc* [2005] EWCA Civ 963, at [115], Buxton LJ (a case which also related to an employment contract, although where the penalty was sought to enforced against the employer) and *Tullett Prebon*, at [126].
[126] *Dunlop Pneumatic Tyre*, paragraph (c) of point 4.
[127] *Lord Elphinstone v Monkland Iron and Coal*.
[128] *Dunlop Pneumatic Tyre*, paragraph (d) of point of 4; *Fermiscan*, Allsop P at [152]-[153].
[129] *Fermiscan*, at [153].

The decision in *Fermiscan*[130], is a recent example of the application of this presumption. Allsop P phrased the issue as follows: taking the least serious clause (as the "weakest link in the chain") does the impugned penal sum exceed the greatest loss that could flow from the breach of that clause[131]. Where his Honour was of the view that breach of the least serious clause would not have very serious consequences, it was found that the clauses had no intended contractual role to compensate for breach and instead their contractual function reflected, an intention of the parties, objectively ascertained to coerce compliance[132].

In determining what is the greatest loss that could flow from the clause upon which the allegedly penal obligation is conditioned, where the obligation is conditioned upon termination for breach, regard can be had to the loss that would flow from termination of the agreement as well as the loss that flows from the breach triggering termination[133]. This allows the draftsman (or woman) to include clauses allowing an innocent party to terminate for breach (which may be trivial) and to recover, by way of an additional payment conditioned upon termination for breach, loss of bargain damages - something which is not possible when claiming damages for termination for a minor breach[134].

When it is remembered that a justification of the application of the doctrine to the circumstances of termination for breach is because the payment for this purpose is regarded as payable on breach, as a matter of principle[135] there seems little justification for allowing recovery beyond the loss flowing from breach[136]. Deane J regarded this as a justification for extending the doctrine to apply to circumstances of termination other than for breach, given that the loss flowing from termination above the loss from breach would be included in an assessment of whether the clause is a

[130] *Fermiscan*, at [153].
[131] *Fermiscan*, at [152].
[132] *Fermiscan*, at [153].
[133] *AMEV-UDC*, Deane J, at 204-205; Dawson J, at 210.
[134] *Shevill v Builders Licensing Board* [1982] HCA 47; (1982) 149 CLR 620**.**
[135] *AMEV-UDC*, Wilson and Mason JJ, at 184-185.
[136] Such criticisms were made in *AMEV-UDC* by Dawson J, at 210; 215 and Deane J at 204; see also criticisms made by Lord Denning in *Campbell Discount*, at 629, there stating that this situation amounted to an "'absurd paradox' … [where equity] would grant relief to a man who breaks his contract but will penalise the man who keeps it".

penalty[137]. Dawson J however justifies this seeming incongruity on the basis that if the position were otherwise, this would be an "unwarrantable interference" with the freedom of the parties to a contract to determine for themselves the course which their agreement should take upon the failure of one party to perform their obligations under it[138].

PART 2 – what is the role of penalties?

Introduction

On the current state of authorities, the doctrine of penalties can apply to clauses requiring the payment of money and transfer of property or rights (and probably the forfeiture of accrued rights[139]) consequent upon breach of contract (and consequent upon an exercise of a right of termination arising on or for breach). Clauses requiring payment, transfer and forfeiture of money, property, entitlements or accrued rights consequent upon the happening of a specified event, as opposed to breach of contract, will not attract the doctrine of penalties[140]. This is so even where the specified event is the formation of an opinion that breach has occurred. It may be that the same facts and events of breach will trigger additional obligations but still, the doctrine of penalties will not apply.

That such deference will be afforded to the form of an agreement can be explained by the fact that the doctrine is now applied by a jurisdiction that gives precedence to freedom of contract, such freedom being seen as embodied in the form of the agreement itself. Indeed, when the historical origins of the doctrine are compared with the modern day position, it becomes evident that there has been a shift in the operation of the doctrine which is reflective of (or perhaps caused by) a change in the underlying foundations of the doctrine, perhaps due to the doctrine's development in the common law jurisdiction and the resurgence of emphasis on freedom of contract and ensuring certainty in commercial transactions.

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[137] *AMEV-UDC*, Deane J, at 205.
[138] *AMEV-UDC*, Dawson J, at 215, there citing *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428; [1996] 3 All ER 128, at 142.
[139] In *Interstar* Allsop P was prepared to accept this proposition for the purposes of the appeal, at [104].
[140] *Interstar*, NSWCA, at [106]; [134].

By comparison, the historical foundations of the doctrine indicate a concern to operate as a flexible, discretionary doctrine to be applied in circumstances of unconscionability, mistake, accident, fraud, and are reminiscent of the doctrine's associations and shared equitable origins with the doctrine of relief against forfeiture which is itself conditioned upon unconscionability[141].

Whilst the deference afforded to contractual freedom explains the precedence given to the form of the agreement, and justifies the limits imposed upon the scope of the doctrine, the question remains as to what extent unconscionability has a role to play (if at all) in providing a basis for the doctrine of penalties and to what extent this is to be balanced with the need to ensure contractual freedom[142]. Consideration of this issue ultimately leads one to consider what is the doctrinal basis for the modern day doctrine of penalties as it exists in the common law.

Historical development of the doctrine

The historical development of the doctrine of penalties can be traced back to its equitable origins where, along with the doctrine of relief against forfeiture (as recognised by Allsop P in *Interstar*[143]), the courts of equity would provide relief because of the absurdity in making a man pay a larger sum by reason of the non-payment of a smaller[144]. It has been suggested that, in the early stages of the doctrine's existence (from about the late Middle Ages) relief against penalties and forfeiture was granted in accordance with equity's desire to do justice between the parties in accordance with their real intentions and to relieve against strict observance

[141] *Tanwar Enterprises Pty Ltd v Cauchi* [2003] HCA 57; (2003) 217 CLR 315.
[142] As to the tension between freedom of contract and other equitable doctrines, such as unconscionability and undue influence, see Black A., 'Unconscionability, Undue Influence and the Limits of Intervention in Contractual Dealings: *Commercial Bank of Australia v, Amadio'* [1986] *Sydney Law Review*, 1986 11(1) 134.
[143] *Interstar*, NSWCA, at [99].
[144] For example in *Wallis v Smith* (1882) 21 Ch D 243, at 256-262, Sir George Jessel MR (after announcing that he did "know a little Equity") said that relief against payment of penalties was granted because of the absurdity in making a man pay a larger sum by reason of the non-payment of a smaller. For consideration of the historical origins and development of the doctrines see the decision of Mason and Wilson JJ in *AMEV-UDC*; Mason and Deane JJ in *Legione v Hateley*, at 444; Young, Croft and Smith, *On Equity*, Lawbook Co, 2009, from [5.960]; and *Equity Doctrines and Remedies*, from [18-002].

of time limitations and formalities[145] or is another instance of equity acting according to the fundamental principle that a party having a legal right shall not be permitted to exercise it in such a way that the exercise amounts to unconscionable conduct[146]. Alternatively, other authorities have suggested that the jurisdiction to relieve against penalties (and forfeiture) was on the basis of there having been accident, mistake, fraud or surprise[147] or equity's desire to deal with intention or substance rather than form[148].

With the introduction of the Judicature Acts, what had already become a practice of the common law courts of relieving against penal clauses[149], was further entrenched as all relevant relief could be sought through the common law courts without a need to invoke the equitable jurisdiction to relieve against penalties[150] until, it is said, "the equitable jurisdiction to relieve against penalties withered on the vine"[151].

A role for unconscionability?

Despite the divergence regarding the original motivations of the doctrine of *penalties*, it is accepted that the motivation of *relief against forfeiture* is unconscionability[152]. In relation to the doctrine of penalties, the term unconscionability is also used, but in

[145] Young, Croft and Smith, *On Equity*, at [5.780] and Rossiter C., *Penalties and forfeiture; judicial review of contractual penalties and relief against forfeiture of proprietary interests*, Lawbook Co, 1992, see Ch 1.
[146] Mason and Deane JJ in *Legione v Hateley*, at 444.
[147] Mason and Deane JJ in *Legione v Hateley*, at 444; Young, Croft and Smith, *On Equity*, at [5.780], although this view has been strongly contested, see *Pomeroy's Equity Jurisprudence*, 5th ed. (1941), vol. 2, [433], n. 18 - on the ground that the correct foundation of the jurisdiction was expressed by Lord Macclesfield LC in *Peachy v. Duke of Somerset* (1721) 1 Str 447, at 453; (1721) 93 ER 626, at 630; see generally *Equity, Doctrines and Remedies*, at [18-010].
[148] Young, Croft and Smith, *On Equity*, at [5.780]; *Peachy v Duke of Somerset*, at 453; see also Brereton J discussion of this point in *Interstar*, NSWSC, at [70].
[149] *AMEV-UDC*, Mason and Wilson JJ noted, at 189, that the practice of the common law courts in this respect was regulated by the Statute 8 & 9 Wm III c. 11, s 8 and Statute 4 & 5 Anne c.3, ss 12, 13.
[150] *AMEV-UDC*, Mason and Wilson JJ, at 191.
[151] *AMEV-UDC*, Mason and Wilson JJ, at 191; see also *On Equity*, at [5.1080], however the learned authors of *On Equity* note that the equitable jurisdiction would be capable of being invoked, for example where certain orders are required, as the case was in *Jobson v Johnson*, at 1049.
[152] *Tanwar v Cauchi; Legione v Hateley*, at 444; 447; 449.

multiple contexts[153]. References to unconscionability in this area can be in relation to determining when the stipulated sum is out of all proportion[154]. Alternatively, the term has also been used in suggesting that the main motivation or concern of the doctrine, like relief against forfeiture, is to relieve against unconscionability[155]. Use of the term in the latter context is more controversial (and appears contrary to the recent approach taken by Allsop P in *Interstar*[156]). That the term unconscionability has been used in these different ways has been described as "unfortunate", especially given the multiple meanings[157] (or "baggage") that unconscionability carries in Australian law[158].

An example of the former use of the term unconscionability is in relation to the assessment of whether the penal sum when compared with the potential damages flowing from breach, is out of all proportion or unconscionable[159]. Further, Mason and Wilson JJ in *AMEV-UDC* were of the view that:

> equity and the common law have long maintained a supervisory jurisdiction, not to rewrite contracts imprudently made, *but to relieve against provisions which are so unconscionable or oppressive that their nature is penal rather than compensatory* (emphasis added)[160]

which again highlights the role that unconscionability plays in assessing whether the stipulated sum is a genuine pre-estimate of damages (thus compensatory) or penal.

In comparison, if there is a concern to relieve against something that is unconscionable, as Allsop P in *Interstar* indicates quite clearly, the seeking of relief

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[153] Paula Baron, in her article, 'Confused in words; Unconscionability and the doctrine of penalties', *Monash University Law Review*, (2008) vol 34, no 2, 285, at 290-291, sets out the multiple ways in which this term is used in relation to the doctrine of penalties.
[154] *AMEV-UDC*, Mason and Wilson JJ at 190, there referring to *Clydebank*, at 10-11; 17 and *Dunlop Pneumatic Tyre*, at 87.
[155] *AMEV-UDC*, Mason and Wilson JJ, at 194; Deane J in *O'Dea*, at 400; see also Mason and Deane JJ in *Legione v Hateley*, at 444.
[156] *Interstar*, NSWCA, at [159].
[157] *Tanwar v Cauchi*, at [20]; *Australian Competition and Consumer Commission v C G Berbatis Holdings Pty Ltd* [2003] HCA 18; (2003) 214 CLR 51, at 72-73.
[158] Baron P., 'Confused in words; Unconscionability and the doctrine of penalties', at 290-291.
[159] *Ringrow*, at 667, 669; *Dunlop Pneumatic Tyre*, point 4(a) of Lord Dunlop's test set out above; see also *O'Dea*, at 400, where Deane, J. analysed the question in terms of whether the agreed sum provision is "extravagant and unconscionable in amount in comparison with the greatest loss" or whether it is "an unconscionable burden".
[160] *AMEV-UDC*, at 193.

against such unconscionable terms should not be done by recourse to the doctrine of penalties, explaining:

> The role or place of equity and relieving parties from injustice or unconscionable bargains or from unfair forfeitures is most effectively brought about by judging the operation of the clause or provision in the light of principles of relief against forfeiture, unconscionable bargains, any found obligation of good faith or such other consideration. This approach would enable an approach to be taken to the justice of the case by reference to an analysis of the behaviour of the parties and the circumstances at the point of asserted breach or forfeiture[161].

It may be possible to reconcile the views of Mason and Wilson JJ in *AMEV-UDC* with those of Allsop P in *Interstar*, if Mason and Wilson JJ's comments are read as indicating simply the role that the unconscionability plays in assessing whether and when a clause will be penal, as opposed to explaining the underlying policy of and justification for the doctrine's incursion into contractual freedom. This is possible when regard is had to the passage following on from the passage cited above from Mason and Wilson JJ:

> The test to be applied in drawing that distinction is one of degree and will depend on a number of circumstances, including (1) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to the defendant, and (2) the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in seeking to enforce the term. The courts should not, however, be too ready to find the requisite degree of disproportion lest they impinge on the parties' freedom to settle for themselves the rights and liabilities following a breach of contract[162].

However, as the statement below indicates, Mason and Wilson JJ seemed to be of the view that unconscionability has a role to play in explaining the foundations and reason for existence of the doctrine itself and in determining when a clause will be penal:

> The doctrine of penalties answers, in situations of the present kind, an important aspect of the criticism often levelled against unqualified freedom of contract, namely the possible inequality of bargaining power. In this way the courts strike a balance between the competing interests of freedom of contract and protection of weak contracting parties[163].

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[161] *Interstar*, NSWCA, at [159].
[162] *AMEV-UDC*, at 193-194.
[163] *AMEV-UDC*, at 194.

In this instance, Mason and Wilson JJ indicate the type of unconscionability that the doctrine of penalties is concerned with is that associated with the nature of the relationship between the contracting parties, that is the possible inequality of bargaining power. Indeed there is a degree of symmetry in the view that the limits of the doctrine is the preservation of freedom of contract, and that one suggested positive motivation of the doctrine is the need to protect against inequality of bargaining power, which is one of the main criticisms levelled at the freedom of contract.

In addition to the statements of Mason and Wilson JJ, is then the subsequent decision of the Court of Appeal in *AMEV Finance v Artes Studios Thoroughbreds*[164] where Clarke JA (with whom Kirby P and McHugh JA agreed) concluded that a term "should be struck down as a penalty only if the agreed sum be either extravagant in amount or imposes an unconscionable or unreasonable burden upon a party" [165].

These views are in stark contrast to that of Allsop P to the extent that his Honour has clearly indicated (as set out in the passage above) that the doctrine of penalties does not have a role to play in relieving against unconscionable transactions and the precedence given to freedom of contract and ensuring commercial certainty[166]. Such concerns are reinforced when regard is had to the observations made by Mason and Wilson JJ themselves in *AMEV-UDC*, that:

> there is much to be said for the view that the courts should return to allowing parties to a contract greater latitude in determining what their rights and liabilities will be[167],

so that an agreed sum is only characterised as a penalty if it is out of all proportion to damage likely to be suffered as a result of breach.

Potentially adding to the uncertainty concerning the motivation or underlying policy of the doctrine of penalties, is the traditional association of the doctrine with relief against forfeiture, the latter being motivated by unconscionability. Added to this is the fact that, despite the divergence of the doctrine of penalties away from the courts of equity to become almost exclusively a common law doctrine, its equitable origins still echo in the discussion and consideration of the doctrine. For example, the

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[164] *AMEV v Artes Studios*.
[165] *AMEV v Artes Studios*, at 576-577, see also reasons of Kirby P at 566.
[166] *Interstar*, NSWCA, at [159].
[167] *AMEV-UDC,* at 190, referring to *Robophone Facilities Ltd v Blank*, at 42-44.

authoritative equity texts still include sections on the doctrine of penalties, often coupled with consideration of relief against forfeiture[168]. In fact it is perhaps the doctrine's equitable origins that explains its strong association with "unconscionable transactions"[169], suggesting that there is some discretionary scope to allow sensitivity to the justice or equity of the situation, as there is with the doctrine of relief against forfeiture.

In addition to the shared association with unconscionability, both the doctrines of relief against penalties and forfeiture share the same policy motivation that act as a limit or circumscription on their scope – freedom of contract. Just as freedom of contract operates as marking the boundaries of the scope of the doctrine of penalties, freedom of contract operates in a similar way upon the doctrine of relief against forfeiture[170]. Indeed the need to preserve freedom of contract has been explained as the justification for the requirement that exceptional circumstances exist before either of the doctrines will apply[171].

The learned authors of *Equity, Doctrines and Remedies*, explain that the development of the jurisdiction to relieve against forfeiture and penalties highlights the "antithical attitude of equity and the common law", and the relief in equity rested "at bottom" on the notion that a person should not use their legal rights to take advantage of another's misfortune[172]. They somewhat perceptively refer[173] (in the publication predating *Interstar*) to the uncertainty between the different approaches to the doctrine and to the distinction that was discussed by Meagher JA in *PC Developments Pty Ltd v Revell*[174] between the views of Mason and Wilson JJ (which favour the doctrine's concern to prevent the enforcement of unconscionable clauses) and those which stress

[168] For example, see *On Equity*, and *Equity, Doctrines and Remedies*.
[169] For example the inclusion of penalties in "Unconscionable Transactions" Chapter in *Equity Doctrines and Remedies*, at 577 and in the chapter titled "Fraud" in *On Equity*.
[170] In considering whether intervention on the basis of relief against forfeiture is justified, great weight will be given to the bargain which the parties have made for themselves. "Generally speaking equity expects men to carry out their bargains and 'will not let them buy their way out by uncovenanted payment"; *Shiloh Spinners Ltd v Harding* [1973] AC 691, Lord Wilberforce, at 723. Nor will Equity remake the parties' contract simply because it transpires that as things have happened one party has made a bad bargain; *Legione v Hateley*, Mason and Deane JJ, at 444; 447; 449; see also *Tanwar v Cauchi*, at [106].
[171] *Ringrow*, at 669*; Tanwar v Cauchi*, at [106].
[172] *Equity, Doctrines and Remedies*, at [18-010].
[173] *Equity, Doctrines and Remedies*, at [18-150].
[174] *PC Developments Pty Ltd v Revell* (1991) 22 NSWLR 615, at 650-651.

the need for a doctrine capable of predicable application and one that respects freedom of contract (along the lines of Allsop P in *Interstar*).

In *PC Developments,* Meagher JA distinguished two different tests as to when a clause will be penal which seemed evident from the authorities at the time of the decision. First, there was the "purely mechanical test" of whether the provision sought to be impugned exceeds the loss or damage which the innocent party could obtain[175] (Meagher JA there indicating that such a test had nothing to do with any notion of unconscionability[176] and is a reflection of the common law origins of the doctrine) and the second, being that which suggests that relief against penalties is in its nature discretionary, so that it is the nature of the relationship between the contracting parties that can make the contractual stipulation (or reliance upon it) unconscionable. In support of this latter proposition, Meagher JA refers not surprisingly, to the decision of Mason and Wilson JJ in *AMEV-UDC*, and then indicates that this view reflects the doctrine's existence in equity[177].

Meagher JA was of the view that the "distinguished line of cases" in support of the first test or approach to the doctrine makes its adoption "inevitable". Indeed this conclusion, whilst not expressly said to be the case (in opposition and preponderance to the discretionary test expounded by Mason and Wilson JJ in *AMEV-UDC*) is that adopted by Allsop P in *Interstar,* as explained above.

Shortly after *PC Developments* is the decision by Cole J in *Multiplex Constructions v Abgarus* [178], in which Cole J observed that whether a burden imposed upon a breach is unconscionable and thus a penalty, will depend upon the inequality or equality of the bargaining position of the parties and the relationship generally.

[175] Meagher JA cites the decision of Mason J in *Forestry Commission of New South Wales v Stefanetto,* at 519 and *Citicorp Australia Ltd v Hendry* (1985) 4 NSWLR 1.
[176] *PC Developments Pty Ltd v Revell,* at 651.
[177] *PC Developments Pty Ltd v Revell,* at 651.
[178] *Multiplex Constructions Pty Limited v Abgarus Pty Limited* (1992) 22 NSWLR 504, at 509-510.

Dr Peden in her article, 'Penalty clauses and what would the High Court have made of *Interstar Wholesale Finance Pty Ltd v Integral Home Loans*?'[179] also considers the role that unconscionability has to play in the doctrine's application. Dr Peden first refers to Lord Dunedin's use of the term "unconscionable", although warns readers that Lord Dunedin's usage of the term should not be confused with the modern law concerning unconscionable conduct such as that in *Amadio*[180], (indeed in England in 1915 there was no such doctrine) [181]. Dr Peden is of the view that Lord Dunedin's usage of the term "unconscionable" is instead a colloquial use of the term which would be translated into "out of all proportion" today. After referring to a passage by Mason and Wilson JJ from *AMEV-UDC* (as discussed above), Dr Peden indicates that there have been a few decisions[182] in addition to *AMEV-UDC*, suggesting the inequality of bargaining power is a basis on which to strike down an agreed damages clause[183].

One decision which supports the view that unconscionability is a basis for the doctrine's existence is that of a majority of the Victorian Court of Appeal in *Yarra Capital Group v Sklash*[184], (a decision referred to by Dr Peden, as being a "radical" decision). There, the majority view was that "unconscionability is a separate ground for striking down an agreed default provision as a penalty" (citing Mason and Wilson JJ in *AMEV-UDC*)[185]. Dr Peden expressed the view that the decision is radical[186] because it suggests "the existence of unconscionability may be sufficient to strike down a penalty clause"[187]. This is against High Court authority such as *Ringrow*,

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[179] Peden E., 'Penalty clauses and what would the High Court have made of *Interstar Wholesale Finance Pty Ltd v Integral Home Loans*?', (2009) 6 *Commercial Law Quarterly*, September-November, at 10.
[180] *Commercial Bank of Australia Ltd v Amadio* [1983] HCA 14; (1983) 151 CLR 447.
[181] Peden E., 'Penalty clauses and what would the High Court have made of *Interstar Wholesale Finance Pty Ltd v Integral Home Loans*?', at 10.
[182] Peden cites *Phillips Hong Kong Ltd v Attorney General of Hong Kong* (1993) 61 BLR 41, where the Privy Council suggested that the 'situations where one of the parties to the contract is able to dominate the other as a choice of terms of a contract' would be an exception to the normal operation of the penalty principles.
[183] Peden E., 'Penalty clauses and what would the High Court have made of *Interstar Wholesale Finance Pty Ltd v Integral Home Loans*?', at 10.
[184] *Yarra Capital Group Pty Ltd v Sklash Pty Ltd* [2006] VCA 109, at [19].
[185] *Yarra Capital*, at [19].
[186] Peden E., 'Penalty clauses and what would the High Court have made of *Interstar Wholesale Finance Pty Ltd v Integral Home Loans*?', at 10.
[187] Peden E., 'Penalty clauses and what would the High Court have made of *Interstar Wholesale Finance Pty Ltd v Integral Home Loans*?', at 10-11.

which tended against the adoption of a flexible approach to the doctrine of penalties based upon unconscionable dealings[188], and is opposed to the current approach as expounded by Allsop P in *Interstar* which favours a technical approach in order to promote commercial certainty.

In *State of Tasmania v Leighton Contractors*[189], (a decision which was later cited in *Yarra Capital* and also referred to by Dr Peden) the court indicated that the bargaining strength of the parties or whether one party was subject to unreasonable pressure in performance was considered a relevant consideration as to whether the stipulated sum was a penalty. However, the court in *State of Tasmania v Leighton*, did go on to indicate that there was uncertainty as to whether the term "unconscionable" affords a separate basis for consideration of a penalty (though noting that it was not necessary to decide in that case) and also referred to the High Court's then recent decision in *Ringrow* (where the High Court had also not decided the issue)[190].

The uncertainty regarding the role of unconscionability as recognised in *Yarra Capital*, has again been considered in *Talacko & Ors v Talacko*[191], where Kyrou J indicated (after referring to decisions of Mason and Wilson JJ in *AMEV-UDC* and of the Court of Appeal in *AMEV Finance v Artes Studios Thoroughbreds*) that there is uncertainty as to whether a sum may be a penalty on the independent ground that it imposes an unconscionable burden (citing *Yarra Capital*).

In an article written just before the Court of Appeal decided *Interstar*, Professor Baron, advocates the position that unconscionability is "a core concept in determining whether a liquidated damages clause is valid in Australia"[192] referring to many of the cases mentioned above. Professor Baron was of the view that unconscionability plays a role in determining whether the agreed sum is out of all proportion[193] and in

[188] Peden E., 'Penalty clauses and what would the High Court have made of *Interstar Wholesale Finance Pty Ltd v Integral Home Loans*?', at 11.
[189] *State of Tasmania v Leighton Contractors Pty Ltd* [2005] TASSC 133, at [23] and [31].
[190] *State of Tasmania v Leighton Contractors Pty Ltd*, at [23].
[191] *Talacko & Ors v Talacko* [2009] VSC 533, at [231]-[232].
[192] Baron P., 'Confused in words; Unconscionability and the doctrine of penalties', at 305.
[193] Baron P., 'Confused in words; Unconscionability and the doctrine of penalties', at 292, there relying upon statements made by Lord Dunedin in *Dunlop Pneumatic Tyre*, Mason and Wilson JJ in *AMEV-UDC*, at 194, and Deane J in *O'Dea*, at 400.

determining whether there was a degree of inequality of bargaining power between the parties akin to unconscionability in the *Amadio* sense[194]. Professor Baron was strongly of the view that unconscionability currently does and should continue to play a role in the application of the doctrine of penalties, though recognising that use of the concept of unconscionability should be well defined in its application to promote contractual certainty.

When regard is had to the operation of the doctrine as evidenced by the current state of authorities, particularly in light of *Interstar,* it becomes difficult to find practical support for the views as discussed above, that the current motivation is (as opposed to should be) to protect against unconscionability or inequality of bargaining power. As discussed, it is possible for agreements to contain clauses requiring payment or transfers to compel performance and providing they are made conditional upon the occurrence of specified events (as opposed to a breach or termination for breach), no matter the nature of the forfeiture involved or the intention to compel performance, the doctrine of penalties will not be applicable. This is so even where the specified event that gives rise to a forfeiture or payment is that one party forms the opinion that the other party has breached his or her obligations. That the doctrine of penalties is not available in such circumstances not only opens this area of law to criticism, on the basis that it is a triumph of form over substance (as parties are able to achieve the same practical effect of a penalty through the imposition of additional obligations to compel performance of the contract) but also makes it difficult to elucidate a particular concern to relieve against unconscionability occasioned through inequality in bargaining power.

Brereton J in his judgment, suggests that a requirement for the allegedly penal clause to operate upon a breach of contract represents "a triumph of form over substance", as it means that:

> the doctrine of penalties could always be evaded by the drafting of lists of events of default upon which termination was authorised and payment of a wholly

[194] Baron P., 'Confused in words; Unconscionability and the doctrine of penalties', at 297, there relying upon Mason and Wilson JJ in *AMEV-UDC, PC Developments* and Clarke JA in *AMEV v Artes Studios, Multiplex Constructions.*

> disproportionate sum was exigible, without including a contractual promise that those events would not occur[195].

The ability of draftsmen (or women) to take advantage of these rules of penalties, to ensure that their agreements do not fall within the scope of the doctrine (which has also been recognised by Mason and Wilson JJ in *AMEV-UDC*[196]) makes it even more difficult to justify the doctrine's purpose as being to provide relief to parties in positions of unequal bargaining power such that there is a degree of unconscionability. This is because the ability to draft out of the doctrine's application means that in practical reality parties with greater bargaining power will be able to ensure that the agreement is drafted so that the doctrine does not apply despite the same practical outcome being achieved in which case unconscionability will not be the touchstone of whether the clause is penal.

In answer to the criticism that the current formulation of the doctrine is a triumph of form over substance, is the assertion that if the form of the agreement is seen as the expression of freedom of contract, then any triumph of form should be understood as deference to the contractual freedom of the parties. Such a comment was made by Gummow J in the application for special leave to appeal to the High Court in the *Interstar* proceedings[197]. In the special leave application, it was suggested that despite the full flourishing of freedom of contract in the mercantile 19th century, the doctrine of penalties that existed before this, and which was concerned less with preservation of freedom of contract but with traditional equitable concerns of the unconscionability of the situation, went into no decline, survived, and still thrives. To this Gummow J responded "the question is how much does it thrive?"

So it seems that there remains some tension between what is perceived as the older equitable foundations of the doctrine of penalties, which are concerned with traditional concerns to relieve against unconscionability as against the more modern common law conception of the doctrine, which, whatever its foundation for intervention may be, has been circumscribed to give precedence to freedom of contract and ensuring certainty in commercial transactions. This tension is referred to

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[195] *Interstar*, NSWSC, at [73].
[196] *AMEV-UDC*, Wilson and Mason JJ, at 181.
[197] *Integral Home Loans Pty Limited & Anor v Interstar Wholesale Financial & Anor* [2009] HCATrans 87, 1 May 2009.

by P S Atiyah in *The Rise and Fall of Freedom of Contract*[198], where Atiyah observes that the "new attitude to the autonomy of private contracts was, inevitably difficult to reconcile with the old equitable doctrine about penalties and forfeitures" [199].

Bearing in mind that freedom of contract is the main circumscription of the modern conception of the doctrine, as expressed in the Court of Appeal decision in *Interstar*, and that after *Interstar*, it seems that the doctrine is not concerned with unconscionability, one may ask what then is the justification for intervention in freedom of contract in the first place?

If the doctrine is said to be concerned with clauses that operate *in terrorem* and to coerce compliance it would seem that the limitation of the doctrine to the consequences occasioned upon breach alone would defeat such purposes in any event. If additional obligations (or forfeitures or withholding of accrued entitlements) can be imposed upon the occurrence of specified events, such events being the formation of a reasonable opinion that breach has occurred, or that events have in fact occurred which may also constitute a breach, this seems very much to achieve the same collateral purpose of coercing contractual performance, yet the doctrine of penalties will not be engaged. So it would seem more accurate to say that the doctrine of penalties is only concerned with attempts to coerce compliance when such obligations are expressed as operating upon breach, or termination for breach (as opposed to operating on facts which amount to breach). Given such a narrow operation of the doctrine, whilst protecting contractual freedom and ensuring commercial certainty, it is difficult to justify the doctrine's interference with contractual freedom to begin with.

CONCLUSION

The repeated justification for the reluctance to extend the doctrine, despite the result that it is effectively possible to draft away the application of the doctrine, is the importance of ensuring freedom of contract[200]. Indeed the ability to draft out of the doctrine's application, is itself justified as deference to the form the agreement as the

[198] P S Atiyah in *The Rise and Fall of Freedom of Contract*, Clarendon Press, 2003.
[199] P S Atiyah in *The Rise and Fall of Freedom of Contract*, at 414.
[200] *AMEV-UDC*, at 194; 215; *Ringrow*, at 669*; Interstar*, NSWCA, at [111]*; Export Credits*, at 224.

form is the expression of such contractual freedom. It is the importance of protecting such freedom of contract and ensuring that there is a degree of certainty and predictability in relation to the application of the doctrine which explains the reluctance to intervene in circumstances where parties have agreed that in certain events a sum is payable. Indeed, despite an ability to conjure up examples of agreements to pay a sum of money in specified events which look very much like breach, there are many more conceivable examples of agreements to pay in specified events to which if the doctrine of penalties applied, would result in increased uncertainty and would impinge upon parties' freedom of contract.

Of the alternative formulations (and extensions of the doctrine) that have been suggested, one could view the formulation favoured by Deane J[201] and Brereton J[202] as attempting to protect freedom of contract through limiting the operation of the doctrine (once extended to apply to beyond the circumstances of breach) so that it would apply only where it is treated as lying within the area of obligation of a party. Another possible qualification is to limit the doctrine to circumstances arising upon specified events where it can be seen that as a matter of substance the clause operates *in terrorem* or to compel or coerce performance in unconscionable circumstances, which may include reference to the bargaining position of the parties[203]. Albeit these approaches seem to require more of a principled and qualitative approach rather than the mechanical or formulaic approach that seems to have been preferred in order to ensure doctrinal certainty (indeed Gummow J in the special leave application for the *Interstar* proceedings expressed similar reservations regarding the former[204]). Further, neither of these formulations would necessarily address all situations involving unconscionability associated with inequality in bargaining power, albeit they would go some way to so doing.

Leaving the doctrine in its current form or expression means that it is open to parties to seek to compel performance of a contract by including clauses that operate *in terrorem* (in that they coerce performance through imposition of collateral

[201] *AMEV-UDC*, at 199.
[202] *Interstar*, NSWSC, at [74].
[203] *State of Tasmania*; *Yarra Capital*; *AMEV-UDC*, Mason and Wilson JJ, at 194.
[204] *Integral Home Loans Pty Limited & Anor v Interstar Wholesale Financial & Anor* [2009] HCATrans 87.

obligations) provided that the allegedly penal clause is not expressed to operate upon breach or termination for breach. Performance of obligations can be coerced by including penal clauses operating upon the formation of an opinion that a breach has occurred or that certain events, which may make up a breach, have occurred and according to the position in *Interstar*, such clauses, despite the extravagance or unconscionability of the additional obligations imposed, will not be penal. This leads one to conclude that whatever should be the aim of the doctrine, in its current form, it will not address any oppression or unconscionability arising from inequality of bargaining power.

It would seem that the ultimate resolution of the issue of what is the main motivation or justification for the existence of the doctrine (and so the justification for its incursion into contractual freedom) which would then provide a sound basis upon which its applicability and operation could be developed and clarified (which could only be in support of commercial certainty) will have to be determined by the High Court. As Allsop P explained in *Interstar*:

> the relationship of penalties to relief against forfeiture and of the existence (or, perhaps, renewed recognition) of equity's role in the doctrine of penalties are matters for doctrinal consideration which will inevitably involve reconsideration of High Court authority, including *IAC (Leasing)* and *AMEV-UDC*. Therefore, it is a task for the High Court, not this Court, and not a judge at first instance[205].

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[205] *Interstar*, NSWCA, at [160].