

# The Doctrine of Penalties and the Test of Commercial Justification

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*The doctrine of penalties has long been a contentious area of the law. One reason for this is that court intervention to strike down an agreed sum is seen to be inconsistent with freedom of contract. The recent High Court case of Ringrow Pty Ltd v BP Australia sought to confine court intervention to situations where an agreed sum is 'out of all proportion' to the likely loss. In the United Kingdom, recent decisions have applied the 'commercial justification' test to determine the validity of an agreed sums clause. The purpose of this paper is to consider this new United Kingdom line of authority. Can the commercial justification test address some of the ongoing criticisms of the doctrine of penalties?*

The doctrine of penalties has pursued such a tortuous path in the course of its long development....<sup>1</sup>

**T**HE doctrine of penalties has long been considered problematic in the common law. In particular there has never been a 'bright line' between valid liquidated damages clauses and invalid penalties. Historically two lines of authority developed with rather different approaches to determining this issue: the so-called mechanical approach and the equitable approach. After the seminal decision of *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*<sup>2</sup> (hereafter *Dunlop*) a line of authority developed in the United Kingdom whereby courts would compare the agreed sum with the greatest sum likely to flow from the breach. If the former were to be greater than the latter, the sum would be likely to be characterised as a penalty. In Australia, this 'mechanical' approach was eschewed in favour of the so-called 'equitable' approach which focuses particularly upon whether the purported liquidated damages clause is 'unconscionable and extravagant'. If it is, the clause will be struck down.

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1. *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 186 (Mason & Wilson JJ).  
2. [1915] AC 79.

Recently, a new line of authority has developed in the United Kingdom. This holds that a difference, even a significant difference, between an agreed sum and the likely loss flowing from the breach will not necessarily invalidate an agreed sums clause. Rather, the court will uphold the clause if there is a commercial justification for the difference and the dominant purpose of the agreed sum is not to deter or punish the breach. This has been called the ‘commercial justification’ test. The purpose of this article is to consider this new line of authority. Will the commercial justification test address some of the criticisms of the doctrine of penalties?

The paper begins with a brief introduction to the doctrine of penalties. It then outlines the core principles of the doctrine before considering, in turn, the mechanical test, the equitable test and the commercial justification test. In the final section, it compares the commercial justification test with the current Australian approach. It also considers the decision in *Beil v Pacific View (Qld) Pty Ltd*,<sup>3</sup> the first case to consider both the commercial justification test and the Australian test post-*Ringrow Pty Ltd v BP Australia*<sup>4</sup> (hereafter *Ringrow*).

## THE DOCTRINE OF PENALTIES

Liquidated damages clauses are the means by which parties to a contract may predetermine the liability flowing from breach. That liability may be the payment of a sum of money<sup>5</sup> or the transfer of property.<sup>6</sup> In order to be valid, a liquidated damages clause must be a ‘genuine pre-estimate’ of the loss likely to be suffered by the breach. This calculation is taken at the time the contract is made.<sup>7</sup> The doctrine of penalties is the rule of public policy that allows the court to intervene to strike down a purported liquidated damages clause. It will do so in cases where it is satisfied that the agreed liability is not a genuine pre-estimate of loss but a penalty, that is, a means of deterring a party from, or punishing them for, breach. In such a case, the injured party, though denied the ability to enforce the impugned clause, will generally retain the right to claim common-law damages.<sup>8</sup>

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3. [2006] QSC 199.

4. (2006) 224 CLR 656.

5. See eg *Yarra Capital v Sklash* [2006] VSCA 109 (Unreported, Victorian Court of Appeal, Warren CJ, Chernov & Ashley JJA, 1 Dec 2005, 18 May 2006); *Beil v Pacific View*, above n 3.

6. See eg *Forestry Commission of NSW v Stefanetto* (1976) 133 CLR 507; *PC Developments Pty Ltd v Revell* (1991) 22 NSWLR 615; *Ringrow*, above n 4.

7. *Dunlop*, above n 1.

8. *Robophone Facilities Ltd v Blank* [1966] 3 All ER 128; *Challenge Finance Ltd v Forshaw* (No. 4) (1995) 217 ALR 264. The exception to this rule is where the parties are taken to have agreed expressly or by implication that liquidated damages are to be to the exclusion of any other remedy. Thus, in a standard form contract, for example, where the parties specify liquidated damages as ‘nil’ or leave the amount blank, the court may interpret this as agreement that no common law damages are payable: *Temloc Ltd v Errill Properties Ltd* (1987) 39 BLR 34.

The doctrine of penalties has been described as ‘a rule of the court’s own, produced and maintained for purposes of public policy’.<sup>9</sup> The historical origins of the doctrine lie in the penal bond<sup>10</sup> and a gradual extension of its principle to encompass any contract term that set a fixed sum of compensation for breach.<sup>11</sup> The rationale for non-enforcement of such obligations was that the promisor under a penal bond or similar contract had little option in the face of ‘overpowering economic need’ or the ‘illusion of hope’.<sup>12</sup>

The court’s intervention today is generally justified on two bases.<sup>13</sup> The first is that private punishment for breach is unacceptable. This is a reflection of the compensation principle in contract damages.<sup>14</sup> Courts do not award punitive damages for breach of contract.<sup>15</sup> Such damages should not, therefore, be made available to a party by agreement. The second justification is that pressure brought to bear upon a party to perform a contract is an unacceptable intrusion upon that individual’s freedom. This rationale reflects the importance of free and voluntary consent to contract terms, a principle taken up by other doctrines of contract law such as duress and unconscionability.<sup>16</sup>

Despite these justifications there is a wealth of literature on the doctrine of penalties, the majority of which is critical of the doctrine.<sup>17</sup> One commentator

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9. *Campbell Discount Co Ltd v Bridge* [1962] AC 600, 622 (Lord Radcliffe).

10. A penal bond was a sealed instrument ‘designed to secure performance by embodying a promise to pay a stipulated sum of money (usually twice the value of the contract itself) in case of breach, regardless of the actual damages caused by the breach’: AN Hatzis, ‘Having the Cake and Eating it Too: Efficient Penalty Clauses in Common and Civil Contract Law’ (2003) 22 Int’l Rev Law & Econ 381, 381. See further AWB Simpson, ‘The Penal Bond with Conditional Defeasance’ (1966) 82 LQR 392.

11. H Collins, *The Law of Contract* (2nd ed, London: Butterworths, 1993) 344; J Coopersmith, ‘Refocusing Liquidated Damages Law for Real Estate Contracts: Returning to the Historical Roots of the Penalty Doctrine’ (1990) 39 Emory LJ 267, 268.

12. Coopersmith, *ibid* 268.

13. Collins, *above* n 11, 344.

14. Contract damages are compensatory, that is, the party injured by a breach of contract is, so far as money can do it, to be placed in the same situation as if the contract had been performed. This is the rule in *Robinson v Harman* (1848) 154 ER 363, 365.

15. Punitive or exemplary damages are damages awarded in addition to compensatory damages in order to punish defendants for blameworthy conduct and deter them from engaging in such conduct in the future. Punitive damages for breach of contract are traditionally not available: see *Tak & Co Inc v AEL Corp Ltd* (1995) 5 NZBLC 103,887. For an examination of punitive damages as ‘private retribution’, see A Sebok, ‘Punitive Damages: From Myth to Theory’ (2007) 92 Iowa L Rev 957.

16. The notion of voluntary, informed consent to contract terms is a particularly important aspect of autonomy-based theories of contract. See eg C Fried, *Contract as Promise: A Theory of Contractual Obligation* (Cambridge: Harvard UP, 1981); RE Barnett, ‘A Consent Theory of Contract’ (1986) 86 Columbia L Rev 269; RA Epstein, ‘Unconscionability: A Critical Reappraisal’ (1975) 18 J Law & Econ 293.

17. See eg JW Carter & E Peden, ‘A Good Faith Perspective on Liquidated Damages’ (2007) 23 J Contract Law 157; T Thompson, ‘A Fresh Look at Liquidated Damages’ (2006) 22 Construction LJ 289; LA DiMatteo, ‘Penalties as Rational Response to Bargaining Irrationality’ (2006) Michigan State L Rev 883; LA DiMatteo, ‘A Theory of Efficient Penalty: Eliminating

has described this area of law as characterised by ‘a myriad of cases reaching contradictory conclusions and anomalous holdings’.<sup>18</sup> Criticism of the doctrine of penalties generally focuses upon three issues: the tension between the doctrine and freedom of contract; the economic inefficiency of the doctrine; and the lack of a clear delineation between a valid agreed sums clause and an invalid penalty.

### **The tension between the penalties doctrine and freedom of contract**

In their now classic paper on liquidated damages, Goetz and Scott argue that the penalty doctrine is ‘anomalous in terms of the theoretical underpinnings of modern contract law’.<sup>19</sup> Commentators such as Shiffrin find it difficult to understand why public policy should warrant court intervention in liquidated damages, but not in the area of, for instance, consideration. Shiffrin notes that it is difficult to defend the ban on penalties when consideration ‘may patently exceed the value of what is received in return’ and, indeed, ‘many punitive damage agreements can be recast as forms of consideration’.<sup>20</sup> This paradox has attracted considerable criticism from commentators. DiMatteo has described the doctrine of penalties as an ‘affront’ to freedom of contract<sup>21</sup> and masking ‘an unwarranted judicial intervention’.<sup>22</sup> This is because even clauses that are the product of express negotiation between parties of equal bargaining power will be struck down if they offend the doctrine.<sup>23</sup> Browder argues that the ‘collision’ between freedom of contract and the doctrine of penalties ‘has created a notoriously inconsistent area of law’.<sup>24</sup> Daniel and Marshall view the doctrine of penalties as paternalistic and thus at odds with freedom of contract. They claim the doctrine of penalties suffers ‘from hasty disregard of the parties’ intent by courts with altruistic notions of saving the parties from themselves’.<sup>25</sup> Some commentators acknowledge that, as a general rule, the courts have moved in favour of freedom of contract and away from a strict application of the doctrine of penalties<sup>26</sup> in recent years. Nevertheless, much dissatisfaction remains.

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the Law of Liquidated Damages’ (2001) 38 American Business LJ 633; R Hillman, ‘The Limits of Behavioural Decision Theory in Legal Analysis: The Case of Liquidated Damages’ (2000) 85 Cornell L Rev 717; E Lanyon, ‘Equity and the Doctrine of Penalties’ (1996) J Contract Law 234; R Goode, ‘Penalties in Finance Cases’ (1988) 104 LQR 25; K Clarkson, R Miller & T Murrs, ‘Liquidated Damages v Penalties: Sense or Nonsense’ (1978) Wisconsin L Rev 351; CJ Goetz & RE Scott, ‘Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach’ (1977) 77 Columbia L Rev 554.

18. Coopersmith, above n 11, 267.

19. Goetz & Scott, above n 17, 554, 555 n.12.

20. SV Shiffrin, ‘The Divergence of Contract and Promise’ (2007) 120 Harvard L Rev 708, 735.

21. DiMatteo, ‘A Theory of Efficient Penalty’, above n 17, 634.

22. Ibid 637.

23. DiMatteo, ‘Penalties as Rational Response to Bargaining Irrationality’, above n 17, 884–5.

24. D Browder, ‘Liquidated Damages in Montana’ (2006) 67 Montana L Rev 361, 363.

25. JL Daniel & KS Marshall, ‘Avoiding Economic Waste in Contract Damages: Myths, Misunderstandings and Malcontent’ (2007) 85 Nebraska L Rev 875, 911.

26. Browder, above n 24, 372.

## The economic inefficiency of the doctrine

A body of US literature, based in the law and economics tradition, is highly critical of the efficiency of the doctrine of penalties.<sup>27</sup> As a general rule, economic theory supports the enforcement of express agreements between rational contracting parties. The doctrine of penalties, then, has been described as ‘the inefficient pre-emption of private bargaining’.<sup>28</sup> Commentators in this tradition point to the benefits of liquidated damages clauses: there are savings in time and money if a contract is breached, as the injured party avoids the difficulties of proving his or her damages, needing to convince the court only of breach and causation.<sup>29</sup> Liquidated damages clauses also permit the injured party to claim compensation for damages that a court may have difficulty assessing accurately, such as the value of lost opportunities.<sup>30</sup> There are benefits, too, for the party in breach. As he or she knows the liability for breach at the outset, that party ‘can accurately calculate the costs and benefits of breaching the contract and allocate ...resources to more productive pursuits’.<sup>31</sup> Indeed, some US writers have argued that the doctrine of penalties should be abandoned altogether. As the rule against penalties is often justified on the basis of the compensation principle in contract damages, this argument has been<sup>32</sup> linked to calls for punitive damages in law.<sup>33</sup> Klass, for example, writing with specific reference to the problem of obstructive breach, argues that a ‘punitive damages clause’ is the ‘only generally effective remedy’.<sup>34</sup>

## The lack of clear delineation between an agreed sum and a penalty

The failure of courts to delineate clearly the line between a valid agreed sums clause and an invalid penalty has also attracted criticism. Courts in Australia and the United Kingdom have almost unanimously accepted the test promulgated by

27. For an overview of the economics approach to the doctrine of penalties, see Hatzis, above n 10, 389–401.

28. DiMatteo, ‘A Theory of Efficient Penalty’, above n 17, 635. There is something of a dichotomy, however, in the law and economics literature, as proponents of the ‘efficient breach argument’ hold that penalties should not be enforced as the punitive nature of a penalty may deter a party from an otherwise efficient breach. Recently, a body of literature has emerged in the US which applies Behavioural Decision Theory (BDT) to assess the appropriateness of the penalties doctrine and to challenge some of the assumptions of law and economics. See eg Hillman, above n 17; PB Marrow, ‘The Unconscionability of a Liquidated Damages Clause: A Practical Application of Behavioural Decision Theory’ (2001) 22 Pace L Rev 27; DiMatteo, ‘Penalties as Rational Response to Bargaining Irrationality’, above n 17.

29. Browder, above n 24, 367.

30. Ibid.

31. Ibid.

32. Ibid 396.

33. It should be acknowledged, however, that it is argued by some scholars that punitive damages could deter some efficient breaches ‘or would increase transaction costs in such a way that a contract law with punitive damages and more permissive specific performance rules would be less economically efficient in the specified sense than one without them’: Shiffrin, above n 20, 731.

34. G Klass, ‘Contracting for Cooperation in Recovery’ 117 Yale LJ 2, 32.

Lord Dunedin in *Dunlop*.<sup>35</sup> That test focuses upon the distinction between a valid liquidated damages sum, which is compensatory in nature; and a penalty, which is a sum intended to coerce performance or punish the breach. There is, however, much variation in the application of that test. To some extent, inconsistency is a result of the fact that each case must turn on its own facts, so precedent is of relatively limited value.<sup>36</sup> Nevertheless, Collins observes that the line between a valid liquidated damages clause and a penalty is never clear.<sup>37</sup> Goode observes that ‘judges remain sharply divided as to the fundamental objective of the rule [against penalties] and the circumstances in which it may be invoked’.<sup>38</sup> Carter and Peden observe that questions of the how the distinction between liquidated damages and penalties is drawn and the way in which the law gives effect to that distinction are ‘complex questions’.<sup>39</sup> Nor is there greater satisfaction with US jurisprudence in this area. Rather less charitably than Carter and Peden, DiMatteo describes the jurisprudence of the penalties doctrine as ‘chaotic’, the cases reflecting ‘a number of prejudices including a judicial propensity not to enforce such clauses and the use of semantics within contracts to avoid the need to apply the cumbersome requirements for liquidated damages’.<sup>40</sup> As the distinction between a valid clause and an invalid penalty is the aspect of the doctrine that is most central to this discussion, I turn now to consider the core principles for determining whether a liquidated damages clause is valid.

## THE CORE PRINCIPLES AND THEIR APPLICATION

The classic statement of the principles for determining whether a clause is valid or is to be struck down as a penalty were provided by Lord Dunedin in *Dunlop*, and consolidated the principles from previous cases.<sup>41</sup> This statement is as follows:

1. Though the parties to a contract who use the words ‘penalty’ or ‘liquidated damages’ may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages. This doctrine may be said to be found passim in nearly every case.
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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35. Above n 2.

36. *Bridge Wholesale Acceptance Corporation (Aus) Ltd v Rega Pty Ltd* (1992) Aus Contract Rep 90-019 [14] (Giles J), noting that it was not possible simply to apply the decision in *Citicorp Australasia Ltd v Hendry* (1985) 4 NSWLR 1, despite the similarities in the respective contractual provisions in the two cases.

37. Collins, above n 11, 346; see also L Miller, ‘Penalty Clauses in England and France: A Comparative Study’ (2004) 53 Int’l & Comparative LQ 79, 82.

38. Goode, above n 17, 25.

39. Carter & Peden, above n 17, 158.

40. DiMatteo, ‘A Theory of Efficient Penalty’, above n 17, 657.

41. *Dunlop*, above n 2, 86.

3. The question whether a sum stipulated is 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....
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:
  - (a) It will be held to be 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 ...
  - (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 ...
  - (c) There is a presumption (but no more) that it is 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'.<sup>42</sup>

These guidelines have been widely accepted by courts in Australia and the United Kingdom. Despite this apparent consensus, the interpretation and application of Lord Dunedin's guidelines have varied significantly between and within these jurisdictions. The primary source of contention relates to Principle 4(a) and, in particular, the interpretation of the words 'extravagant and unconscionable'. Two distinct lines of authority emerged over time for determining whether or not an agreed sum was a penalty. The first has been described as a mechanical approach based in the application of doctrine and principle. The second has been described as an equitable approach based in notions of conscience.<sup>43</sup> The United Kingdom tended, after *Dunlop*, towards a more mechanical approach, while Australia adopted the equitable approach. Another way of expressing this difference is that, while courts in the United Kingdom tended to emphasise the word 'extravagant' in Lord Dunedin's principle 4(a), Australian courts tended to focus upon the word 'unconscionable'.

## The mechanical approach

Under the mechanical approach, it is sufficient for the court to be satisfied that the agreed sum exceeds the likely loss flowing from breach in order to strike down the clause as a penalty. The definition of a penalty given by Diplock LJ in *Philip Bernstein (Successors) Ltd v Lidiate Textiles Ltd*<sup>44</sup> reflects this view:

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42. Ibid 86–7.

43. Acknowledgment of these two lines of authority can be found both in the judgment of Mason & Wilson JJ in *AMEV-UDC* above n 1, 190. Meagher JA in *PC Developments v Revell*, above n 6, 650 explicitly identifies them as the mechanical and equitable approaches.

44. (1962) CA Transcript 238.

In the ordinary way a penalty is a sum which, by the terms of a contract, a promisor agrees to pay to the promisee in the event of non-performance by the promisor of one or more of the obligations *and which is excess of the damage caused by non-performance*.<sup>45</sup>

The source of this approach is generally acknowledged to be the decision in *Cooden Engineering Co Ltd v Stanford*<sup>46</sup> (hereafter *Cooden*). In that case, the agreed sum was found to be a penalty because, although it was not the case that the amount exceeded the greatest loss that could possibly follow on from the breach, it would 'exceed it in all except the exceptional case'.<sup>47</sup> A similar approach can be seen in *Jobson v Johnson*,<sup>48</sup> where Nicholls LJ was of the view that a penalty clause remains in the contract in question and can be sued upon, but it will not be enforced by the court beyond the sum which represents actual loss.<sup>49</sup> It has been explicitly acknowledged in some cases, such as *Robophone Facilities Ltd v Blank*,<sup>50</sup> that a difference in amount between the agreed sum and the likely loss only gives rise to an inference that the sum is a penalty and is thus capable of being rebutted.<sup>51</sup> Nevertheless, there has been no real consideration of equitable notions of conscience in the assessment by UK courts.

In Australia, Samuels J in *Malouf (WT) Pty Ltd v Brinds Ltd*<sup>52</sup> accepted the validity of the mechanical approach:

[T]he words 'extravagant and unconscionable' in Lord Dunedin's test appear as elements in the formulation of one test designed to establish that a stipulated sum is a penalty. But it does not follow that that conclusion cannot be drawn unless the elements of extravagance and unconscionability are shown. It may be established otherwise, without recourse to those characteristics, that the sum is not a genuine pre-estimate, as I think it has in the present case. And the comparison is to be made now between the sum stipulated and the maximum benefit which might be derived if all contingencies were resolved in the promisee's favour, but between that sum and a genuine pre-estimate of damage.<sup>53</sup>

However, this approach was not to find favour in subsequent Australian decisions.<sup>54</sup>

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45. Quoted by Chadwick LJ in *Euro London Appointments Ltd v Claessens International Ltd* [2006] EWCA Civ 385, 439 (emphasis added).

46. [1953] 1 QB 86.

47. Ibid 98 (Somervell LJ).

48. [1989] 1 WLR 1026.

49. Ibid.

50. [1966] 3 All ER 128.

51. Ibid, 143.

52. (1981) 52 FLR 442.

53. Ibid 462.

54. This is not to say that the mechanical approach does not re-emerge in Australia from time to time. See eg *Challenge Finance Ltd v Forshaw (No 4)*, above n 8, 267, where Young J noted that although the magistrate in this case had stated the test correctly, 'he in fact applied the discarded mechanical test as to whether the liquidated sum exceeded the damages that could be obtained for breach of contract'.

## The equitable approach

The Australian line of authority derives primarily from the joint judgment of Mason and Wilson JJ in *AMEV-UDC Finance Ltd v Austin*.<sup>55</sup> Their Honours undertook a careful historical analysis of the doctrine of penalties and concluded that the court had long maintained a supervisory jurisdiction to relieve against provisions ‘which are so unconscionable or oppressive that the nature is penal, rather than compensatory’.<sup>56</sup> Identifying the mechanical approach which derived from *Cooden*, their Honours noted that this approach ‘eroded’ the principles derived from *Clydebank Engineering and Shipbuilding Company Ltd v Done Jose Ramos Yzquierdo Y Castanada*<sup>57</sup> and *Dunlop* in the interests of greater certainty.<sup>58</sup> Mason and Wilson JJ called for a return to the principles of these latter cases. Their Honours considered that the test of whether or not an agreed sums clause is a penalty is one of degree and depends on a number of circumstances: the degree of disproportion between the sum and the greatest loss that the innocent party could suffer from the breach;<sup>59</sup> the nature of the relationship between the parties and the unconscionability in the plaintiff seeking to enforce the provision.<sup>60</sup>

Subsequent Australian decisions followed this equitable approach.<sup>61</sup> However, the emphasis upon unconscionability was to generate some ambiguity. Unconscionability, although a key concept in Australian contract jurisprudence, has been the source of some contention and uncertainty.<sup>62</sup> In its specific reference to the doctrine of penalties, unconscionability has variously been applied to the amount of the agreed sum (and thus, effectively, the substantive fairness of the transaction);<sup>63</sup> to the relationship of the parties and, in particular, any equality of bargaining power between them at the time of contracting;<sup>64</sup> and/or to an unfair

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55. Above n 1.

56. Ibid 193.

57. [1905] AC 6.

58. Above n 1, 190.

59. In the US in *Moser v Gosnell* 334 SC 425, 513 SE 2d 123 (Ct App, 1999) the Court struck down an agreed sum, saying that the test is whether the stipulated sum is so large that it is plainly disproportionate to any probable damage resulting from the breach of contract. In this case, the agreed sum was \$585,000 while the evidence showed that the actual damages amounted only to a few thousand dollars.

60. *AMEV-UDC v Austin*, above n 2, 192–3.

61. Australian cases have almost unanimously accepted and applied the decision of Mason & Wilson JJ in *AMEV-UDC*, above n 2. The two most recent cases of significance, *Ringrow* above n 4; and *State of Tasmania v Leighton Contractors Pty Ltd* (2005) 15 Tas R 243 have continued this trend.

62. The uncertainties of the term were acknowledged by the High Court in its discussion of statutory unconscionability in *ACCC v Berbatis Holdings* (2003) 197 ALR 153.

63. See eg *Ringrow* above n 4; *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd* (1989) 15 NSWLR 564.

64. See eg *AMEV v Artes Studios Thoroughbreds*, ibid; *PC Developments v Revell*, above n 6. This approach has not been without criticism. See *Esanda Finance Corp v Plessnig* (1989) 166 CLR 131, 141 where Wilson & Toohey JJ were critical of the Full Court’s decision for placing too much emphasis on the superior bargaining position of Esanda.

compulsion of performance;<sup>65</sup> or to some combination of all these matters.<sup>66</sup>

Arguably, what was intended by Mason and Wilson JJ was just such a wide-ranging consideration of all these factors in determining unconscionability. Indeed, in the recent case of *State of Tasmania v Leighton Contractors Pty Ltd*,<sup>67</sup> this was the approach taken by the court. Their Honours considered that Lord Dunedin's test from *Dunlop* of whether a sum was extravagant and unconscionable encapsulated a number of principles, including a comparison between the agreed sum and the greatest loss likely to flow from the breach; comparison between the sum provided and the nature of the breach; equivalence of bargaining power at the time of the agreement or whether one party was subject to unreasonable pressure in performance; the potential outcomes to which the clause was directed; and the means, if any, used in the compilation of the sum provided for. At the same time, their Honours acknowledged that the court should not too readily strike down an agreed sums clause, as to do so would undermine freedom of contract. In this case, the liquidated sum had not been arbitrarily chosen even if there were some errors in the calculation of likely loss; and it was relevant that there was no imbalance of power at the time the contract was made.

Their Honours claimed to be applying Lord Dunedin's principles, particularly Principle 4(a). However, the relationship between the parties does not figure explicitly in Lord Dunedin's guidelines, nor implicitly in Principle 4(a), where unconscionability refers only to the difference in amount between the agreed sum and likely loss flowing from the breach. Some return to the idea that the term 'unconscionable' should be read more narrowly to refer primarily to the amount of the agreed sums clause *vis a vis* the likely loss flowing from the breach was evident in the High Court's decision in *Ringrow*.<sup>68</sup> In this case, the Court, Gleeson CJ, Gummow, Kirby, Hayne, Callinan and Heydon JJ, decided that a contractual clause allowing for the re-acquisition of a service station following breach and without any payment for goodwill did not constitute a penalty. Although the Court was of the view that the application of the principles relating to penalties was slightly different where the issue was 'money's worth' rather than money and, in this case, there might be a 'suspicion' that BP was getting on the retransfer something worth more than the money paid for it (because of the exclusion of good will), this was not sufficient to strike down the clause. The Court observed that:

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65. See eg *Integral Home Loans Pty Ltd v Interstar Wholesale Finance Pty Ltd* [2007] NSWSC 406 (Unreported, Brereton J, 22–23 Feb, 27 Apr 2007) [10]; *Bartercard Ltd v Myallhurst Pty Ltd* [2000] QCA 445 (Unreported, Davies & Thomas JJA, Ambrose J, 27 Oct 2000) [26]; *Yuwana Nominees Pty Ltd v Jason Ong* [2008] NSWSC 56.

66. See eg *Multiplex Constructions Pty Limited v Abgarus Pty Limited* (1992) 33 NSWLR 504, 509–10 (Cole J).

67. (2005) 15 Tas R 243.

68. Above n 4.

[A] mere difference is not enough, let alone a suspicion of a difference. The comparison calls for something 'extravagant and unconscionable' ... it calls for a 'degree of disproportion' sufficient to point to oppressiveness.<sup>69</sup>

In this case, however, the evidence did not establish the existence of valuable goodwill, so Ringrow could not establish that the amount was extravagant and unconscionable. This case appears to move the Australian courts rather closer to an emphasis upon the term 'extravagant' in Principle 4(a) of Lord Dunedin's formulation, although the Court is obviously not adopting the 'mechanical' approach of the United Kingdom.

## THE COMMERCIAL JUSTIFICATION TEST

A recent line of authority in the United Kingdom has started to move the courts away from the mechanical approach. These decisions adopt the so-called 'commercial justification' test. Under this approach, a liquidated damages clause will not be invalidated as a penalty, despite the difference in amount between the agreed sum and likely loss, provided the court is satisfied of two matters. Firstly, the court must be convinced there is a commercial justification for the difference; and, secondly, it must be persuaded that the clause does not have the dominant purpose of punishing or deterring the breach.

As noted above, the United Kingdom courts did not focus upon conscience in their deliberations of whether a liquidated damages clause was valid. In 1993, however, the Australian line of authority was cited with approval in *Philips Hong Kong v AG of Hong Kong*<sup>70</sup> (hereafter *Philips*). Lord Woolf, delivering the judgment of the Court, noted the decision of Mason and Wilson JJ in *AMEV-UDC* with approval. He went on to observe that except in cases where one party is able to dominate the other in choice of the contract terms, merely identifying situations where the agreed sum might be greater than actual loss will be insufficient to strike down a clause. Even in situations where such dominance existed, the clause would be upheld so long as it was not extravagant having regard to the range of potential losses that could be suffered.

This case was the first indication of a change in the approach to penalties that was to result in the commercial justification test. The test emerged three years after *Philips* in *Lordsvale Finance plc v Bank of Zambia*<sup>71</sup> (hereafter *Lordsvale*). In that case, the Bank of Zambia entered two agreements with two syndicates of banks to borrow US\$100 million and \$130 million respectively. The agreements provided that in the event of default, the Bank of Zambia was to pay a percentage for the cost of obtaining dollar deposits to fund the bank's participation. In addition, it

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69. *Ringrow*, above n 4, 666.

70. (1993) 61 BLR 49.

71. [1996] QB 752.

was to pay an additional (but unexplained) one per cent. The central issue was whether this one per cent was a penalty.<sup>72</sup>

His Honour accepted the formulation of Lord Dunedin in *Dunlop*, particularly the principle that an agreed sum will be invalid where its dominant purpose is to deter breach. Applying this principle to the facts, Colman J was clear that if the interest rate were to be increased retrospectively on default, it would have ‘all the indicia of a penalty’. However, there was no reason why a prospective increase should be invalid ‘if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach’.<sup>73</sup> In his judgment, Colman J cited, inter alia, the Australian case of *David Securities Pty Ltd v Commonwealth Bank of Australia*,<sup>74</sup> which made a similar distinction between a retrospective and a prospective rate increase.<sup>75</sup> In a case such as this, the additional amount was directly proportional to the period of time during which the default in payment continued, but also:

[T]he borrower in default is not the same credit risk as the prospective borrower with whom the loan agreement was first negotiated. Merely for the pre-existing rate of interest to continue to accrue on the outstanding amount of the debt would not reflect the fact that the borrower no longer has a clean record. Given that money is more expensive for a less good credit risk than for a good credit risk, there would in principle seem to be no reason to deduce that a small rateable increase in interest charged prospectively upon default would have the dominant purpose of deterring default. That is not because there is in any real sense a genuine pre-estimate of loss, but because there is a good commercial reason for deducing that deterrence of breach is not the dominant contractual purpose of the term.<sup>76</sup>

The commercial justification test outlined by Colman J was not taken up again until 2003, in the decision *Cine Bes Filmcilik v Yapimcilik v United International Pictures*<sup>77</sup> (hereafter *Cine*). In that case, Mance LJ considered the authorities on the doctrine of penalties, including *Dunlop* and *Lordsvale*. He noted with approval Colman J’s observation that the traditional dichotomy between a genuine pre-estimate of damages and a penalty does not necessarily cover all the possibilities. Mance LJ described this observation as ‘helpful’, as there are clauses which may operate on breach which fall into neither category but which may be commercially perfectly justifiable.<sup>78</sup>

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72. Ibid 761. Colman J noted that the issue was significant for UK banking law, because a default interest rate uplift was a widely used device, particularly in syndicated loans.

73. Ibid 763.

74. (1990) 93 ALR 271.

75. Although His Honour noted that the court cited a ‘long line of authority’ to this effect, Colman disagreed, arguing that there had been only around three cases since 1725 that made this distinction.

76. *Lordsvale*, above n 71, 763.

77. [2003] EWCA Civ 1669.

78. Ibid [14].

The commercial justification test was accepted and elaborated upon by Arden LJ in *Murray v Leisureplay plc*.<sup>79</sup> In her judgment, Arden LJ referred, inter alia, to *Dunlop*, *Cine* and *Philips* with approval, using the judgment of Mance LJ in the *Cine* case as her ‘starting point’.<sup>80</sup>

What, to my judgment, is striking about the statement of the law in the *Cine* case and its application is the way in which the court sought objectively to rationalise its conclusions as to whether the provisions of the agreement constituted a penalty. The court’s reasoning turns on a comparison between the overall amount payable under the agreement in the event of a breach with the overall amount that would have been payable if a claim for damages for breach of contract had been brought at common law. The court proceeded on the basis that, if such a comparison discloses a discrepancy, which can be shown not to be a genuine pre-estimate of damage *or to be unjustified*, the agreement provides for a penalty.<sup>81</sup>

From her analysis of the authorities, Arden LJ proposed the following ‘step by step guide’ to the determination of whether an agreed sum is a penalty:

- (i) To what breaches of contract does the contractual damages provision apply?
- (ii) What amount is payable on breach under that clause in the parties’ agreement?
- (iii) What amount would be payable if a claim for damages for breach of contract was brought under common law?
- (iv) What were the parties’ reasons for agreeing to the relevant clause?
- (v) Has the party who seeks to establish that the clause is a penalty shown that the amount payable under the clause was imposed *in terrorem*, or that it does not constitute a genuine pre-estimate of loss for the purposes of the *Dunlop* case, and, if he has shown the latter, is there some other reason which justifies the discrepancy between (i) and (ii) above?

Her Honour noted there was no authority on situations where there is no evidence at trial as to why the parties agreed on a particular clause; or where there is such evidence but the parties were mistaken as to the amount payable in common law damages should breach occur. In the first circumstance, Arden LJ was of the view that the court could draw inferences of fact as to the reasons and the genuineness of those reasons; in the second circumstance, the test is objective: ‘[a] pre-estimate is genuine if it is not unreasonable in all the circumstances’.<sup>82</sup>

Clarke LJ described the *Lordsvale* and *Cine* decisions as the ‘modern approach’ to Lord Dunedin’s test in *Dunlop*. His Honour cited Colman J with approval. He had a particular view on Colman J’s observation that one could deduce whether the contractual function is deterrent by comparing the amount that would be

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79. [2005] EWCA Civ 963.

80. Ibid [39].

81. Ibid [44] (emphasis added).

82. Ibid [55].

payable on breach with the loss that might be sustained if the breach occurred. Clarke LJ argued Colman J was not saying that such a discrepancy will lead to the conclusion that the clause is a penalty. Rather, this was no more than a guide to the determination of whether the clause was a penalty. His Honour also referred to *Philips* in support of this proposition.<sup>83</sup> Clarke LJ further expressed the view that an agreed sum will only be a penalty if it is extravagant or unconscionable.

Buxton LJ also accepted the commercial justification test<sup>84</sup> and agreed with the finding of Arden LJ that the clause in this case was not penal. His Honour disagreed with Arden LJ's step by step approach, however, claiming it 'introduced a rigid and inflexible element into what should be a broad and general question'.<sup>85</sup> Notably, the approach advocated by Arden LJ has not been adopted by subsequent cases.

This line of authority is still in the process of development, the commercial justification test finding acceptance in only a few further decisions. In *Euro London Appointments Ltd v Claessens International Ltd*,<sup>86</sup> the liquidated damages clause in question was not found to be a penalty as it was a condition precedent to exercising a right to a refund, not a measure of damages for breach. Nevertheless, Chadwick LJ, in delivering the Court's judgment, considered both the dominant purpose of the clause and the commercial justification for the amount, should it be the case that the clause was a penalty. The commercial justification test was also applied, this time to strike down a clause as a penalty, in *CMC Group plc v Zhang*.<sup>87</sup> The test was also accepted in *M & J Polymers Ltd v Imerys Minerals*.<sup>88</sup> In this case, Burton J considered whether a 'take or pay' clause<sup>89</sup> could be a penalty. His Honour decided that the clause in question was not a penalty. Acknowledging the commercial justification test, he found that on the facts of the case before him:

[T]he take or pay clause was *commercially justifiable*, did not amount to *oppression*, was negotiated and freely entered into between *parties of comparable bargaining power*, and did not have the *predominant purpose of deterring a breach of contract* nor amount to a provision '*in terrorem*'.<sup>90</sup>

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83. Ibid [106].

84. Ibid [116].

85. Ibid [114].

86. [2006] EWCA Civ 385.

87. [2006] EWCA Civ 408.

88. [2008] EWHC 344.

89. A clause that obliges the purchaser to pay for a minimum quantity of a contracted product each year, whether or not the purchaser takes delivery of the product: *Alliance Petroleum Australia Pty Ltd; Re Application for a Review of a Determination of the Australian Competition and Consumer Commission* [1996] BC9705137 (Unreported, Federal Court, Lockhart J, Brunt J & Aldrich, Dr 17–21, 24–27 Mar, 2–4, 7–8, 14–15 Apr 1997, 14 Oct 1997).

90. *Polymers v Imerys Minerals*, above n 88, [46] (emphasis added).

## UNCONSCIONABILITY OR COMMERCIAL JUSTIFICATION?

There are some commonalities between the Australian equitable approach and the UK test of commercial justification in determining the validity of a liquidated damages clause. Both accept, as had previous cases, Lord Dunedin's principles from *Dunlop* as a correct statement of the law. Both lines of authority implicitly accept that a simple mechanical approach of comparing the agreed sum and likely loss is unsatisfactory. Both lines of authority place considerable importance upon freedom of contract: the commercial justification test and *Ringrow*'s 'significant disproportion' test are designed to limit the circumstances in which courts should intervene to strike down agreed damages clauses as penalties.<sup>91</sup> Both lines of authority also reflect continuing evolution in the doctrine of penalties. Notably none of the recent decisions in either jurisdiction offer any suggestion (in contrast with the views expressed particularly in US literature) that the doctrine of penalties should be abolished, either in favour of an unfettered right to agree on liquidated damages; or a right limited by the application of the general doctrines of duress or unconscionability.

Despite these commonalities, the tests remain rather different in their underpinnings. Australia remains wedded to the equitable approach despite the fact that *Ringrow* would appear to move us closer to an emphasis on 'extravagance'. The United Kingdom remains more focused upon a common law doctrinal approach, still relying in the first instance upon the difference between the agreed sum and the likely loss but acknowledging that that difference may be justified on a commercial basis. In practice, however, the outcomes from these different analyses may be very similar.

The only case to date to consider both lines of authority has been *Beil v Pacific View (Qld) Pty Ltd*.<sup>92</sup> This case concerned an agreement to increase the interest rate on a loan to 25 per cent per annum should default in repayment occur. In finding the increased rate to be a penalty, Chesterman J referred inter alia to the decision of Colman J in *Lordsvale*, and in particular, Colman J's analysis of *David Securities v Commonwealth Bank of Australia*.<sup>93</sup> He also noted the acceptance of Colman J's judgment in *Cine Bes* and *Murray v Leisureplay*. Applying Coleman J's analysis, Chesterman J considered that sum in issue in *Beil* was deterrent rather than compensatory, particularly in light of the fact that no greater losses were suffered by the plaintiff upon default.

His Honour then went on to consider *Ringrow*. He noted the acceptance by the Court of Lord Dunedin's principles and its decision that a penalty will only be

91. For a recent acceptance of the importance of freedom of contract in relation to the court's intervention, see *Harrison Ford Pty Ltd v Ford Motor Co of Australia* [2008] VSC 235 (Unreported, Supreme Court of Victoria, Hapsberger J, 27–28 Feb, 2 Jul 2008).

92. Above n 3.

93. (1992) 175 CLR 353.

found where the amount is ‘extravagant and unconscionable’ and ‘out of all proportion’ to the loss likely to be suffered. However, Chesterman J pointed out that *Ringrow* did not involve a money payment, but an obligatory transfer of property in the event of breach. His Honour noted that the High Court had said in such a case a different approach was required to so-called ‘typical penalty cases’. The facts before him being such a ‘typical penalty case’, Chesterman J considered that he should accept the authority of *David Securities* and Colman J in *Lordsvale*. Nevertheless, His Honour also found the increase in interest rate to be unconscionable and extravagant within the meaning of *Ringrow*. Whether superior courts accept the distinction between a sum of money and some other liability arising on breach remains to be seen.

## CONCLUSION

Does the commercial justification test address some of the ongoing criticisms of the doctrine of penalties? Firstly, of course, the doctrine does not address the theoretical and economic arguments that challenge *any* intervention of the courts in this area of contract. There is no suggestion in the commercial justification cases of abandoning the doctrine of penalties. Nor are there calls for legislative change. The commercial justification test does seek to limit court intervention in the interests of freedom of contract. As was noted earlier, this trend towards upholding the principles of freedom of contract has been a feature of recent cases in this area in all common law jurisdictions, including Australia.<sup>94</sup>

The commercial justification test seems unlikely to create greater certainty in the determination of whether or not an agreed sums clause is valid. As was noted earlier, Mason and Wilson JJ pointed out in *AMEV-UDC* that the mechanical approach tended to erode the principles of *Dunlop* in the name of certainty. The commercial justification approach gives rather more scope for argument. It is not difficult to imagine that courts will be faced with disputes as to what constitutes a ‘commercial justification’ for the difference between the agreed sum and likely loss; and whether or not the ‘dominant purpose’ of the clause was to deter or punish breach.

It seems unlikely that there would be any great difficulty for a party to argue for commercial justification. There are generally valid reasons for a difference between the agreed sum and the likely damages, particularly the nature of the risk involved.<sup>95</sup> As has been observed, a primary purpose of agreed damages clauses is

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94. As has been pointed out, the need for court intervention is also seen to be lessened by the advent of modern consumer laws that are designed to protect less sophisticated contracting parties: J Twyford, ‘Liquidated Damages: A Comparative Study of the Law in England, Australia, New Zealand and Singapore’ (2007) 133 J Professional Issues in Eng Educ & Practice 210.

95. Good examples are provided by *Yarra Capital v Sklash* [2006] VSCA 109 (Unreported, Victorian Court of Appeal, Warren CJ, Chernov & Ashley JJA, 1 Dec 2005, 18 May 2006); *PC Developments v Revell*, above n 6.

to control risk: they are a type of insurance, the parties ‘willing to agree to a set price today in order to avoid potentially greater loss tomorrow’.<sup>96</sup>

Rather more ambiguity, it is submitted, will surround the issue of whether or not the dominant purpose of the clause is to deter or punish breach. Again, the reformulation of Lord Dunedin’s principle which we find in the commercial justification cases is a move in favour of freedom of contract so that, even if a purpose is to deter or punish breach, that will be insufficient to strike down the clause provided this is not *the dominant* purpose. The question then arises: when would a court be likely to find that the dominant purpose of a clause was to compel performance or punish breach? One answer to this may be to focus once again on the difference between the agreed sum and the likely loss, so that where the agreed sum is ‘out of all proportion’ to the likely loss – the *Ringrow* test – its dominant purpose would be to deter or punish breach. Alternatively, the court may focus on the nature of the relationship between the parties in order to determine whether that relationship was oppressive and the dealing was unfair. In this context, however, one must note the comment of Arden LJ in *Murray v Leisureplay* that ‘oppression on a party to make a contract is [not] of itself a criterion in determining whether a contractual sum is a penalty’.<sup>97</sup>

Either way, the problems of uncertainty in determining the lines between a valid liquidated damages clause and an invalid penalty appear unlikely to be resolved by the commercial justification test. The difficulty is that the courts still seem unsure of the basis on which they can and should legitimately interfere with freedom of contract. On this point it is worth considering the points made by Coopersmith. He argues that, historically, the doctrine of penalties looked to unfairness, rather than reasonableness; and that unfairness was considered in relation to the contract process, rather than outcome. This being so, the central issue for the court’s consideration is whether the parties agreed willingly to the agreed sum. On this basis, the unreasonableness of the agreed sum, vis a vis the likely loss, even if extreme, is only relevant as an indication that oppression or unfairness may have taken place in the contractual process –

if we assume that informed people simply do not agree to something that is unreasonable, a conclusion that the amount was unreasonable at contract formation is equivalent to a belief that unconscionability, fraud, duress or some other unfair practice was at work’.<sup>98</sup>

On this analysis, the doctrine operates in the same way as other contract doctrines, such as unconscionability, which justify court intervention where agreement to the contractual terms is the result of oppressive or unfair conduct in the contract process. The doctrine would thus be consistent with, rather than antithetical to, freedom of contract. Whether the commercial justification test will evolve in this way remains to be seen.

96. Coopersmith, above n 11, 284.

97. *Murray v Leisureplay*, above n 79, [49].

98. Coopersmith, above n 11, 289–90.